

Impact Of Pandemic On Fund Manager Substance Arrangements

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Whilst the coronavirus (COVID-19) pandemic has affected everyone, the consequences of non-compliance with Jersey's economic substance rules for in-scope entities such as fund managers can be severe.

The impact of the pandemic sparked concern for in-scope companies regarding their ability to meet the economic substance requirements under the Taxation (Companies - Economic Substance) (Jersey) Law 2019 ('Substance Law'), due to the extensive travel disruption into and out of Jersey, requirements for social distancing and mandatory self-isolation upon entry into the Island which remains ongoing.

Ordinarily, the executive directors sitting on the board of a Jersey tax-resident fund manager who are not Jersey-resident would fly into the Island, typically on a quarterly basis, to physically attend board meetings and to have face to face discussions with the Jersey-resident directors, so that the non-executive directors could be fully appraised and then undertake their functions of scrutiny and oversight.

We must remember that this time last year, virtual and video conferencing was not prolific.

The practical guidance from Jersey's Comptroller of Taxes in March of 2020 stating that where a company had to alter its operating practices to compensate for the coronavirus outbreak, the Comptroller would not determine that such company had failed the economic substance test under Article 6 of the Substance Law, was very welcome indeed. This concession, however, only applied to adjustments to normal operating practices required to minimise the impact of the outbreak.

Incidentally, the Comptroller also reassured non-Jersey companies that are deemed tax resident in Jersey as a result of being 'managed and controlled' in the Island that their corporate tax residency would not be disturbed by temporary adjustments to their operations. This is useful to foreign fund managers who utilise Jersey as a centre of excellence for administration and for its large pool of experienced NEDs.

As the consequences of the coronavirus pandemic are continuing to affect the Island, the Comptroller has recently issued further guidance by way of clarification of the above concession. The Comptroller has stipulated that its concession only applies to the 'directed and managed' limb of the economic substance test, and it is still expected that companies should be able to satisfy the other substance requirements, such as demonstrating an adequate number of employees physically present in Jersey and expenditure and physical assets in the Island (Article 5(2)(b) of the Substance Law).

Additionally, companies seeking to rely on the concession are urged to keep sufficient records evidencing the adjustments that have been made as a result of the pandemic and specifying the reasons for these changes. These records will have to be made available to officers of Revenue Jersey in the event that the authority investigates whether the concession was correctly applied. The fact that a company has relied on the concession must be disclosed in the company's 2020 tax return.

This concession is, of course, temporary and will cease to be available as soon as circumstances in Jersey permit.

Under the Substance Law, the Comptroller is charged with determining whether companies have met the economic substance test during any financial period. It is worth reminding readers that the Substance Law has real teeth and provides progressively serious penalties for non-compliance including financial penalties, strike-off from the register of Jersey companies and reporting to relevant tax or regulatory authorities. The Comptroller will be keen to ensure that it is seen to be using the enforcement powers available to it under the Substance Law to identify and penalise those companies that have failed to comply with the substance test, notwithstanding the pandemic.

This means that during the pandemic, not only have fund managers had to deal with valuation fluctuations, shoring up investments, suspending dealings, defaulting investors, undertaking due diligence virtually, coordinating completions electronically, and not being able to meet with investors face to face, they have also had to adjust their business practices as working from home has become the norm and to consider how they will continue to meet the 'directed and managed' element of the substance test.

In April 2020, the Jersey Financial Services Commission issued an industry update to regulated entities relating to board resilience and span of control. This recognised that members of senior management might temporarily be unable to undertake their duties, thereby compromising the ability of regulated entities to comply with the minimum requirements for senior individuals involved in the governance and management of regulated entities, as set out in the Codes of Practice for such entities.

The expectation of the regulator in such circumstances is for businesses to identify individuals who

can temporarily fulfil the relevant roles; ensure that responsibilities are appropriately shared and critical functions separated; ensure that the governance arrangements continue to allow ongoing monitoring and control of the business (including the compliance function); document any changes to policies and procedures; update business continuity plans; and actively engage with the regulator should regulatory approval be required as a consequence of any of the changes implemented. Deadlines for the submission of compliance and other returns to the regulator were also extended.

Fund managers have had to make a number of adjustments to ordinary business practices in line with this guidance, and there has been a huge amount of reliance on the Jersey fund administrators and local directors to ensure continued compliance with regulatory obligations.

For example, we have witnessed the appointment of additional Jersey-resident alternate directors to fund manager boards in case a director becomes incapacitated or unable to travel, and powers of attorney being granted so that additional directors can be appointed if necessary. Furthermore, non-Jersey resident directors have been cautious when joining board meetings from abroad and sometimes prefer to attend as an observer or be briefed after a board meeting. Overall, fund managers and boards have swiftly adapted to the new way of operating, using available technology and video conferencing for board meetings and other communications.

Another adjustment we have seen in terms of transaction management during the pandemic has been a complete reinvention of the completion process given signatory inability to easily travel, print, sign and post wet-ink documents. Electronic signatures have replaced the wet-ink signatures previously required on most transactional documents and, as a result, transactions have generally been more easily and efficiently managed by the administrator and counsel.

Our sense is that the requirements of the economic substance test have played to Jersey's strengths in that Jersey has always been a jurisdiction which has required substance on the ground for businesses operating in the regulated space. As a result, fund managers located in Jersey have largely been able to operate on a 'business as usual' basis and, in this regard, have weathered the pandemic well.

The administrators we work with with have confirmed that the strong relationships they have with the fund managers they look after, as well as the robust composition of boards with Jersey-resident directors, has meant that in most instances, entities were able to meet the "directed and managed" test throughout 2020.

This is good news indeed because, as noted above, for those fund managers who have relied on the Comptroller's concession, they are required to notify the Comptroller of the fact in the company's 2020 tax return and they will be under greater scrutiny to demonstrate they are operating within its limitations.

In conclusion, the strength of the governance framework in Jersey has meant minimal impact to

the ability of fund managers to manage the funds themselves which, in turn, will be a relief to investors.

We should add a note that self-managed funds will be brought within scope of Substance Law, in terms of their fund management activities, for accounting periods commencing on or after 1 January 2021. This was a largely anticipated development to the Substance Law and Revenue Jersey is, in tandem, reviewing the application of the directed and managed test to self-managed funds with a view to issuing further guidance in due course.

Economic substance is still therefore very much on the agenda for 2021.

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