Deciphering Economic Substance Requirements

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The finance industry is a big fan of buzzwords. These pop up and form the basis of conversation, head scratching and change before fading once again as people move on to the next big thing or become familiar with the new obligations they have taken on. The issue of "economic substance" first began generating interest across the Crown Dependencies in 2016 encouraging unprecedented cross-jurisdictional co-operation between the three islands when the European Council first turned its attention to the topic culminating in parallel legislation being approved at the end of 2018.

What is economic substance?

Economic substance is a doctrine which originated in the United States whereby transactions must have a substantive purpose other than reducing tax and an economic effect other than such tax effect.

In its introduction into Guernsey law via the Income Tax (Substance Requirements) Regulations 2018, as amended (the Regulations), Guernsey sought to address concerns raised by the EU Code of Conduct Group on Business Taxation (the Code of Conduct Group) that some companies which were tax resident in Guernsey (amongst other jurisdictions) did not have economic activity and presence in Guernsey commensurate with the potential tax saving gained by its registration in Guernsey. In layman's terms, it was feared that people were using offshore entities to benefit from all of the savings associated with low-tax jurisdictions whilst using the jurisdiction as a mere letterbox.

Who has to demonstrate substance?

Substance requirements apply to (i) companies carrying out certain relevant activities, (ii) certain companies owning intellectual property and (iii) certain holding companies. Affected companies will generally be incorporated in Guernsey, however, companies registered elsewhere but directed and managed in Guernsey may also be captured. Relevant activities include banking, insurance, shipping and fund management.

As intended, the scope of the Regulations are broad and capture a wide range of companies. Licensees will have carried out an extensive audit to ensure that they capture all client companies that fall within the remit of the Regulations and ensure that internal processes and procedures include the necessary filings.

How is substance demonstrated?

In order to demonstrate economic substance in the jurisdiction, companies which are captured by the Regulations need to show that they are directed and managed in Guernsey. This test is separate to the traditional “management and control” test used to determine tax residency.

In addition, each company caught within the scope of the Regulations must show it has an adequate number of qualified employees in Guernsey proportionate to its activities, adequate expenditure locally and conducts core income-generating activity here.

Each company carrying on relevant activities will be required to provide extensive information about its activities in its income tax filing in order to satisfy the authorities that such company has sufficient substance.

If there is concern that the company has not met substance requirements, the Guernsey authorities are entitled to disclose information relating to the company to any competent authority.

The penalties for non-compliance are stringent; both civil and criminal penalties can be applied, substantial fines can be imposed and strike off sought.

The Guernsey reaction

Rather than treating economic substance as a spectre to be feared, governments, regulatory bodies, advisers and industry have embraced the enhanced reporting requirements and enhanced reputational benefits this further step into the international fold has generated. The Guernsey substance regime has been reviewed by the Code of Conduct Group, resulting in the Economic and Financial Affairs Council of the European Union (ECOFIN) reaffirming that Guernsey is a cooperative jurisdiction with respect to good tax governance. Furthermore, the Organisation for Economic Co-operation and Development (OECD) has declared the Guernsey legal framework on substance is in line with the relevant standard following reviewed by their Forum on Harmful Tax Practices.

Joint guidance has been issued by the Crown Dependencies setting out detailed notes on the minutiae of the Regulations and what is expected of companies in terms of reporting and scope. The States Revenue Service have also consulted locally and are working with local industry bodies such as the Guernsey Investment and Funds Association (GIFA) to provide more detailed guidance on the practicalities of the Regulations. More guidance is expected in the short term as it develops.

Whilst buzzwords are all well and good, the real impact of economic substance has been to impose a greater regulatory and reporting burden upon licensed businesses in the Bailiwick, incurring additional costs to comply with statutory obligations. This additional reporting burden will enhance the outward reputation of Guernsey as a jurisdiction but it is uncertain if this cost is one which business can easily pass on in their fees.

The importance of this legislation should not be underestimated by the finance industry and the majority of businesses should be well on the way to appropriately documenting compliance. The GTA University Centre has instigated introductory training sessions with respected industry figure Christopher Jehan, managing director of Midshore Consulting and Chair of GIFA, to allow delegates to gain a broad understanding of the impact of the substance requirements for their business, help to classify and calculate which of their entities might fall within scope, and practical help in ensuring that substance requirements are met.

Christopher commented on the importance of understanding and correctly implementing the economic substance obligations now in force in Guernsey:

“The introduction of the Regulations, brings another round of impactful legislation to financial services licensees in the Bailiwick. The Regulations show how much significance is being placed on maintaining the international standing of Guernsey and again demonstrating compliance with the most rigorous of international standards. Given the complexity of the legislation and the obligations imposed upon those in the financial services industry it is important that those at a senior level within businesses ensure that their processes and reporting meet the required standard.”

Conclusion

Whilst companies which are subject to substance requirements should be well on the way to reporting for their 2019 financial year end, financial services businesses must ensure that they are documenting compliance with the Regulations, that their records will cover the reporting requirements and that staff understand their responsibilities and the implications of failure to comply. The introduction of substance requirements across the Crown Dependencies shows commitment by the respective governments to further international transparency and accountability and continues a trend seen in recent years.

An Introduction to Economic Substance Requirements with Christopher Jehan is scheduled at the GTA University Centre for 22 November 2019 at a cost of £99 per delegate.