

Guernsey's Substance Requirements - Application to IP Companies and the August Amendments

Service area / [Taxation and Economic Substance](#)

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As with other offshore jurisdictions, Guernsey has implemented legislative economic substance requirements, which came into force on 1 January 2019. This followed on from Guernsey's commitment to address concerns raised by the EU Code of Conduct Group on Business Taxation that Guernsey's corporate tax system could facilitate offshore structures aimed at attracting profits which do not reflect real economic substance.

Following a review of Guernsey's new regime on 12 March 2019 the EU Council confirmed that Guernsey had met its commitment to introduce economic substance requirements. As a consequence, Guernsey is regarded as a cooperative jurisdiction and is not listed on the 'blacklist' of non-cooperative jurisdictions.

Our previous briefings on substance requirements included a detailed background on the new rules and can be found [here](#). The core of Guernsey's substance requirements is contained in The Income Tax (Substance Requirements) (Implementation) Regulations, 2018, as amended (the **Regulations**). The Regulations were most recently amended with effect from 1 August 2019 (the **August Amendments**). The August Amendments included changes to the definitions of intellectual property (IP) assets and what is meant by a high risk IP company. There is also clarification of what counts as core income generating activity (CIGA) for an IP company and of the type of information required to rebut the presumption that applies where a high risk IP company fails to demonstrate applicable substance requirements. This briefing addresses the changes made by the August Amendments.

The States of Guernsey Revenue Service (the **Revenue Service**) has been working with the tax authorities of Jersey and the Isle of Man to produce comprehensive guidance notes that provide more detail than the high-level 'key aspects' document published jointly by the Crown Dependencies at the end of 2018. The first iteration of the guidance notes was issued on 26 April 2019. This guidance continues to be developed and the next update is expected any time soon, which should add further guidance in relation to companies deriving income from IP.

What is in scope?

A Guernsey tax resident company (**Resident Company**) is subject to substance requirements where and to the extent that it is within any one of the following categories:

- it carries on one or more of the following relevant activities: banking, insurance, fund management, financing and leasing, headquartering, shipping and distribution and service centre (**Relevant Activity Company**);
- it is a holding company and has as its primary function the acquisition and holding of shares or equitable interests in other companies and it carries on no commercial activity (**Pure Equity Holding Company**); or
- it derives income from IP (**IP Company**).

This briefing note focuses on the application of the substance requirements to IP Companies and does not cover the substance requirements that are applicable to Relevant Activity Companies or Pure Equity Holding Companies (and which were covered in our earlier briefing notes).

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IP

The August Amendments replace the definition of IP assets with the following text: *'intellectual property assets' means any intellectual property right including copyright, design right, trademark, patent, brand or similar asset.* The new definition replaces the previous, non-exclusive list of eight types of assets regarded as IP assets but as these would still fall within the definition of IP under the replacement text this change is not seen as substantive.

Importantly, an IP Company will not be subject to substance requirements for a particular accounting period where in that period it derives no income from IP.

IP Companies

An IP Company must comply with the following:

- it is directed and managed in Guernsey;
- it carries on applicable CIGA in Guernsey;
- it has an adequate level of appropriately qualified employees in Guernsey (whether or not employed by the IP Company or another entity and whether on temporary or long-term contracts) proportionate to the level of activity carried on in Guernsey;
- it has an adequate level of expenditure in Guernsey that is proportionate to the level of that activity carried on in Guernsey; and
- it has an adequate physical presence (including offices and/or premises) in Guernsey proportionate to the level of that activity carried on in Guernsey.

Directed and managed in Guernsey

To meet this requirement, board meetings of the IP Company must be held in Guernsey with adequate frequency (having regard to the level of decision-making required of the board) during which there must be a quorum of directors physically present in Guernsey. For these purposes, the periodic decisions of non-Guernsey resident members of the board are not taken into account and so the quorum requirements for meetings must be met with Guernsey-resident directors.

Strategic decisions of the IP Company must be set at these board meetings and the minutes must record those decisions. The board, as a whole, must have the necessary knowledge and expertise to discharge their duties as a board and all minutes and company records must be kept in Guernsey.

This does not mean that every board meeting must occur in Guernsey, but that an adequate number of meetings will need to occur in Guernsey. What is 'adequate' will depend on the relevant facts and circumstances.

CIGAs

The possible CIGAs for IP Companies are aligned to international standards identified by the OECD's Forum on Harmful Tax Practices, although the list in the Regulations is not exhaustive. Back office functions, such as IT support, do not comprise CIGAs.

For IP Companies, the CIGAs were revised by the August Amendments and are now set out in the Regulations as follows:

- in respect of a business exploiting IP assets which are patents and assets that share the same feature of a patent, research and development;
- in respect of a business exploiting IP assets which are marketing intangibles such as trademarks, any marketing, branding and distribution; and
- in exceptional cases, and other than in the case of a high risk IP company (see below) other CIGAs relevant to the business and the IP assets, which may include:
 - taking the strategic decisions and managing (as well as bearing) the principal risks relating to the development and subsequent exploitation of the IP asset;
 - taking the strategic decisions and managing (as well as bearing) the principal risks relating to third party acquisition and subsequent exploitation of the IP asset; and
 - carrying on the underlying trading activities through which the IP asset is exploited and which lead to the generation of revenue from third parties.

Where CIGAs are conducted at a board meeting or by a committee of the board, a majority of the persons involved in making the decision must be physically present in Guernsey when making decisions. This may be more than the quorum. Again, the periodic decisions of non-Guernsey resident persons in relation to CIGAs will also be disregarded.

Physical presence

An IP company must demonstrate it has, in each case, an adequate level of appropriately qualified employees, proportionate expenditure and physical presence in Guernsey.

Whether these aspects of the Company's operations will be regarded as adequate for the purposes of meeting applicable substance requirements will be a question of fact and degree, taking into account the activities of the IP Company and not just its CIGAs. As with other Relevant Activity Companies, employee qualifications for the purpose of meeting of applicable substance requirements for an IP Company can include academic qualifications, vocational qualifications, relevant industry qualifications and, crucially, qualifications by relevant experience. Where an IP Company relies on a Guernsey-based administrator or corporate services provider to meet these requirements the resources of that administrator or services provider will be taken into account but there can be no double counting of personnel.

High Risk IP Companies

Certain IP Companies that are considered 'high risk' are subject to further substance requirements. The definition of a high risk IP Company was revised by the August Amendments.

Under the new definition, an IP Company is a **High Risk IP Company** where it:

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- holds IP that it did not create;
- acquired the IP either intra-group or in consideration of funding research and development by another person situated in a territory outside Guernsey; and
- licenses the IP to one or more non-Guernsey resident intra-group persons or otherwise generates income from the IP in consequence of activities (such as facilitating sale agreements) performed by non-Guernsey resident intra-group persons.

The further substance requirements applicable to a High Risk IP Company concern:

- spontaneous exchange of information – broadly, the Revenue Service will spontaneously exchange information regarding the High Risk IP Company with the tax authorities of the jurisdiction(s) where the immediate parent entity, ultimate parent entity or the ultimate beneficial owners of the High Risk IP Company are tax resident and, where applicable, the jurisdiction in which the High Risk IP Company is incorporated (in either case where and to the extent that, and in accordance with, an exchange of information agreement or other applicable international tax measure is in place with that jurisdiction); and
- a rebuttable presumption that it has not complied with the substance requirements. This presumption can be rebutted with the provision of evidence. The August Amendments now include details regarding the evidence that will be considered. It includes evidence that there is, and historically was, a high degree of control over the development, exploitation, maintenance, enhancement and protection of the IP assets, exercised by an adequate number of full-time employees with the necessary qualifications, who permanently reside and perform their activities in Guernsey. Where satisfactory evidence of these matters can be provided, therefore, the presumption that a High Risk IP Company does not meet substance requirements is rebutted.

Tax returns

The corporate income tax return will be amended to include greater detail for accounting periods beginning on or after 1 January 2019. IP Companies will need to include in their corporate income tax returns details of their business activities, amount and type of gross income, expenses and assets, premises and number of employees (specifying the number of full time equivalent employees), details of the CIGAs conducted including any outsourced CIGAs and financial statements. High Risk IP Companies will need to provide further confirmations. This will allow the Revenue Service to monitor compliance with the regime. The information provided in the return is expected to be monitored annually on the basis of the level of risk presented (of profit shifting), with additional monitoring by random selection for audit in line with the existing practice for the monitoring of domestic tax compliance.

Information powers

The Regulations give the Director of the Revenue Service various powers to enable further enquiries into an IP Company, including a right of entry onto business premises and to inspect documents (these rights being subject to certain provisos such as occupier consent, a minimum period of notice and the need for Court approval for the exercise of powers of entry and inspection).

The Director of the Revenue Service cannot exercise these powers to inspect documents that are subject to legal professional privilege. IP Companies should bear this in mind when seeking assistance from non-legal professionals in relation to substance, as any advice obtained other than from a lawyer is vulnerable to be disclosable to the Revenue Service if the Revenue Service seeks to exercise its powers to obtain information.

Sanctions

Various sanctions apply for non-compliance with substance requirements including:

- financial penalties that increase depending on the number of consecutive accounting periods over which the IP Company is in default. The fines range from a maximum of £10,000 for the first accounting period of default, to a maximum of £100,000 for the fourth consecutive accounting period of default (the level of fines payable per accounting periods are different for High Risk IP Companies);
- audit for continued non-compliance;
- spontaneous exchange of information relating to the IP Company by the Revenue Service with any jurisdiction where the immediate parent entity, ultimate parent entity or the ultimate beneficial owners are tax resident, provided that Guernsey and that jurisdiction have information exchange arrangements in place; and
- (where applicable) strike off from the Guernsey Registry, which can occur from the first accounting period of default if the Director of the Revenue Service decides that there is no realistic possibility of the IP Company complying with the substance regime.

Penalties for failure to supply information or for providing false information can also apply and there are criminal penalties for providing false statements or false documents. Companies may appeal penalties levied by the Director of the Revenue Service in certain circumstances.

Anti-avoidance

The Regulations contain a broad anti-avoidance rule which can disregard any transaction, or series of transactions entered into with a main purpose of avoiding any obligation or liability under the substance rules. 'Transaction' is broadly defined and captures any arrangement, omission and decision, whether or not legally enforceable.

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Practical steps

Guernsey companies and their administrators and corporate service providers should consider taking the following steps to ascertain whether they or their clients are compliant with the substance rules:

- check the tax residence status of the company – whilst a company incorporated in Guernsey is in principle a Resident Company, depending on the facts it may qualify for treatment as a non-Guernsey resident. Equally, a non-Guernsey incorporated company may be a Resident Company if it is centrally managed and controlled in Guernsey;
- ensure that the board of the IP Company comprises a sufficient level of appropriately qualified Guernsey resident directors;
- consider whether the IP Company is a High Risk IP Company and, if so, ensure that appropriate measures are in place to comply with the enhanced substance requirements;
- maintain records of the applicable CIGAs and the income and profits allocated to those CIGAs;
- ensure that sufficient board meetings are held in Guernsey and that detailed minutes of all board meetings are maintained;
- consider maintaining a substance register which summarises key facts about each board meeting, including who attended, when they were physically present, details of CIGAs conducted, etc.;
- analyse the terms of all their outsourcing arrangements to ensure that the parameters of the outsourced activity are appropriately drafted, the activity is properly overseen from Guernsey and sufficient CIGA is carried on in Guernsey; and
- administrators and corporate service providers should review their staff structure, internal systems, records, staff time sheets and outsourced activities to ensure that they have the on-island resources and systems to allow their clients to comply and demonstrate compliance with substance requirements and prepare for tax return disclosures.



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