



## Bermuda lodges legislation to introduce substance requirements and to improve investment funds regulatory regime

Service area / [Investment Funds, Regulatory](#)

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The government of Bermuda has published the Economic Substance Act 2018 (the “**ESA**”). The ESA, once adopted, is intended to meet the commitment made by Bermuda to address certain concerns raised by the European Union’s Code of Conduct Group (Business Taxation) (the “**Code Group**”) in relation to the need for relevant businesses to demonstrate economic substance in Bermuda. In addition, the ESA makes a number of amendments to the Investment Funds Act 2006 (the “**IFA**”) in order to bring Bermuda’s investment fund regulatory regime further into line with international standards, create consistency with other regulatory regimes in Bermuda and ensure that Bermuda’s regulatory framework remains both capable of meeting the demands of Bermuda’s investment funds industry and competitive with equivalent regimes in other jurisdictions. This briefing note summarises the key provisions of the ESA and the rationale for the ESA’s introduction.

### Overview

- The ESA was prepared by the Bermuda Government in consultation with industry and following dialogue with the Code Group, the EU Commission and the Organisation for Economic Co-operation and Development. Similar concerns on substance were raised by the Code Group in relation to certain other British Overseas Territories and Crown Dependencies, most of which are also in the process of enacting similar legislation.

- The ESA has been passed by the Bermuda Parliament and, subject to receiving Royal Assent, is expected to take effect for financial periods starting on or after 1 January 2019. The ESA, once adopted, will require affected companies to file annual economic substance returns (“**Returns**”) with the Bermuda Registrar of Companies (the “**Registrar**”).
- The amendments to the IFA will enhance the regulatory regime in Bermuda applicable to certain funds which were previously exempted or excluded from its scope. These funds will now be brought within the IFA’s purview and made subject to the supervision of the Bermuda Monetary Authority (the “**BMA**”).

### Scope of ESA

The ESA provides that “every entity [that is engaged in a relevant activity] shall maintain a substantial economic presence in Bermuda, and in that regard shall comply with the economic substance requirements set forth in [the ESA].”

An “entity” for this purpose is either a company to which the Companies Act 1981 (the “**Companies Act**”) applies, which would include an overseas company with a permit to engage in business in Bermuda, a limited liability company formed under the Limited Liability Company Act 2016 (the “**LLC Act**”), or an exempted partnership, an exempted limited partnership or an overseas partnership that has elected, or elects, to have separate legal personality under the Partnership Act 1902 (the “**Partnership Act**”).

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In order to determine whether an entity is compliant with the new legislation the following questions must be considered:

#### Is the entity engaged in any “relevant activity”?

A “relevant activity” for the purposes of the ESA is banking business, insurance business, fund management business, financing business, leasing business, headquarters business, shipping business, distribution and service centre business, intellectual property holding business and conducting business as a holding entity. It is expected that regulations to be published under the ESA will contain more detailed definitions of each of these activities.

#### If the entity is engaged in any “relevant activity”, does it meet the “economic substance requirements”?

The draft ESA provides that an entity will meet the “economic substance requirements” if:

- the entity is managed and directed in Bermuda;
- core income generating activities (as may be prescribed in regulations) are undertaken in Bermuda with respect to the relevant activity;
- the entity maintains adequate physical presence in Bermuda;
- there are adequate full time employees in Bermuda with suitable qualifications; and
- there is adequate operating expenditure incurred in Bermuda in relation to the relevant activity.

These requirements will of course vary between industries and the circumstances under which a given entity carries on relevant activity. It is anticipated that regulations to be promulgated under the ESA will provide a list of factors (including the nature and extent of the relevant activity carried on by the entity, the nature and extent of the entity’s presence in Bermuda, whether the entity is managed and directed in or from Bermuda, and the nature and extent of any outsourcing arrangements to affiliates or service providers in Bermuda) to

which the Minister must have regard in assessing whether a company complies with the economic substance requirements in any given financial period. During its consultation with industry groups, the Bermuda government acknowledged that the requirements will necessarily vary with the core income generating activity of the subject entity. It is anticipated, therefore, that further, more detailed regulations and guidance will be issued that include industry-specific provisions and which provide illustrative examples.

#### Guidance

The ESA makes provision for the Minister to issue guidance on the application of the economic substance test. It is anticipated that such guidance will address the meaning of “adequate” as used in that test, having regard to the type of relevant activity being undertaken and the particular circumstances of the entity. For example, it is understood that pure equity holding companies, which only hold equity participations and earn only dividends and capital gains (and which the Code Group’s scoping paper recognises represent less of a risk for BEPS) may not require much in the way of substance in order to exercise their main activity of holding and managing equity participations. It is anticipated that such entities will be able to meet the economic substance requirements through demonstrating compliance with applicable corporate governance requirements set forth in the Companies Act, the LLC Act, the Partnership Act or the Exempted Partnership Act 1992 such as keeping records of account, financial statements and submission of the Return.

#### Penalties and exchange of information

If an entity fails to file a Return, the Registrar may impose fines and progressive penalties using powers granted to it under the Registrar of Companies (Compliance Measures) Act 2017. Failure to meet the economic substance test will also result in exchange of information with relevant EU competent authorities.

#### Rationale for the ESA

In December 2017, Bermuda's commitment to cooperation in international tax transparency and compliance with BEPS (Base Erosion Profit Shifting) requirements saw the Code Group confirm Bermuda as a cooperative tax jurisdiction after a year-long screening process involving over 90 jurisdictions.

While Bermuda was determined to be a cooperative tax jurisdiction, the Code Group expressed concern that the absence of a general statutory substance requirement in Bermuda increased the risk of profits being registered in Bermuda which do not reflect real economic activity in the jurisdiction.

Bermuda, therefore, made a written commitment to address the Code Group's concerns by the end of 2018 in order to ensure it maintains its position as a cooperative tax jurisdiction. The adoption of the ESA is intended to meet that commitment and is reflective of Bermuda's deserved reputation as a well-regulated and transparent jurisdiction.

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## Amendments to IFA

In its scoping paper, the Code Group recognised that investment funds are different in nature to other entities since a fund is a vehicle for pooling monies from investors, frequently on a global basis, and is typically managed by an external investment manager or adviser, and so any economic substance requirements should not automatically apply to funds. However, during recent consultation between the Bermuda government and the Code Group, the Code Group expressed a desire for Bermuda to enhance the regulatory regime applicable to “exempted” and “excluded” funds under the IFA before the end of 2018.

The extremely short timeframe for compliance demanded by the Code Group meant that these amendments were included in the ESA at a late stage, leaving government in the unprecedented situation of having to pass legislation without being able to consult with industry on the proposed amendments beforehand. Nevertheless, the ESA contains a number of amendments to the IFA:

- “Exempted funds” (i.e. funds intended only for qualified participants) will be known as “professional funds” and “excluded funds” (i.e. funds for fewer than 20 investors) will be known as “private funds”. Professional funds and private funds will collectively be known as “registered funds”.
- Registered funds will need to apply to the BMA for registration and approval before commencing trading. The current self-certification process (for exempted funds) or notification process (for excluded funds) will no longer be available. Funds which are currently excluded or exempted will have a transition period of six months to comply with the new registration and approval requirement.
- Private funds will need to appoint a Bermuda-based service provider in order to demonstrate economic substance in Bermuda. The current definition of “service provider” in the IFA will be expanded to include corporate services providers, it being anticipated that most funds will meet this requirement through the engagement of a Bermuda corporate services provider.
- Registered funds will need to meet the requirement currently applicable to authorised funds to engage a custodian unless able to demonstrate appropriate alternative arrangements to the BMA.
- The BMA will have both greater powers of supervision and enforcement over registered funds and the power to make rules for registered funds concerning investor disclosures and related matters in the same way as it has for authorised funds under the Fund Prospectus Rules 2007.

## Conclusion

Entities which may fall within the scope of the ESA should consider its impact and its potential application to their particular business and circumstances, although we expect that existing good practice in Bermuda will mean that many entities will find they readily satisfy the requirements.

The changes introduced to the IFA, meanwhile, represent another opportunity for Bermuda to demonstrate to the investment funds industry it remains committed to credible and prudent regulation in accordance with the highest international standards.

If you have any queries in relation to the potential impact of the changes introduced by the ESA, please contact any of the authors or your usual [Carey Olsen Bermuda contact](#).



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