

Guernsey's New Substance Requirements - Application to the Funds Industry

Service area / [Investment Funds](#)

Location / [Guernsey](#)

Date / [November 2018](#)

Background

Like other offshore jurisdictions, Guernsey will be implementing legislative economic substance requirements by the end of 2018 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.

Our previous briefing on the substance requirements as set out in Guernsey's 2019 Budget includes a detailed background on the rules and can be found [here](#).

A draft of the detailed legislation for Guernsey's substance requirements, The Income Tax (Substance Requirements) (Implementation) Regulations, 2018 (the **Regulations**), was released on 8 November 2018 and guidance on the key aspects of the economic substance requirements was released on 5 November 2018. The States of Guernsey Revenue Service (the **Revenue Service**) is working with the tax authorities of Jersey and the Isle of Man to produce comprehensive guidance notes.

This briefing note focuses on the application of the substance requirements to the funds industry.

What is in scope?

A Guernsey tax resident company (**Resident Company**) will be 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 activities: banking, insurance, fund management, financing and leasing, headquartering, shipping and distribution and service centres (**In-Scope 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 intellectual property (**IP Company**).

For the funds industry, we expect that the most relevant of the above activities for In-Scope Companies will be:

- fund management, which is "management" within the meaning of the Protection of Investors (Bailiwick of Guernsey) Law, 1987 (the **POI Law**) when carried on by a licensee under that law in connection with a collective investment scheme within the meaning of that law;
- financing, which is drafted widely and captures all lending for interest or other consideration, whether by an originator or an assignee;
- headquartering, which relates to the provision of certain intra-group services to a non-resident group member, being the provision of senior management, the assumption or control of material risk for activities carried out by, or assets owned by, any of those intra group persons, and the provision of substantive advice in relation to the assumption or control of risk for such activities or assets; and
- distribution and services centres, which whilst focussed on goods does also capture a Resident Company whose sole or main purpose is to provide services to non-Resident Companies in the same group.

Given the broad definitions used in the Regulations, we expect that a number of Resident Companies that are used in acquisition and holding structures will be carrying out activities within the above. Pure Equity Holding Companies will also be relevant in the context of private equity fund structures.

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The substance requirements will depend on which of the above categories apply to the Resident Company. Given that the POI Law and the associated rules and guidance issued by the Guernsey Financial Services Commission already require a high level of governance and substance from a regulatory perspective, it is expected that In-Scope Companies which conduct fund management will be able to readily comply with the new substance rules in relation to fund management.

Pure Equity Holding Companies will be subject to reduced substance requirements and IP Companies will be subject to enhanced substance requirements. IP Companies are not covered in this briefing.

What is not in scope?

The following entities are not expected to be in scope of the substance requirements:

- collective investment schemes; and
- non-company entities such as limited partnerships, limited liability partnerships and trusts, although a corporate general partner or corporate trustee may be an In-Scope Company.

Further, a company that is not resident for tax purposes in Guernsey is not subject to substance requirements, even if it is incorporated in Guernsey. Under current law, where a Guernsey company is tax resident in another jurisdiction with which Guernsey has a double tax agreement (DTA), such as the UK, then depending on the facts that company may not be a Resident Company under the terms of the applicable DTA. Guernsey has announced amendments to its corporate tax residence rules that are to take effect from 1 January 2019 and which will need to be taken into account. Further amendments are expected during the course of 2019.

A Resident Company will not be subject to substance requirements for a particular accounting period where in that period it derives no income from the activities that would otherwise cause it to be subject to the substance requirements.

In-Scope Companies

An In-Scope Company must comply with the following in relation to the activities that trigger substance requirements:

- it is directed and managed in Guernsey;
- it carries on applicable core income generating activity (CIGA) in Guernsey;
- it has an adequate level of appropriately qualified employees in Guernsey (whether or not employed by the In-Scope 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 In-Scope 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. Strategic decisions of the In-Scope 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. If an In-Scope Company does have a board meeting outside of Guernsey it will need to take care that, under the legislation of the jurisdiction in which the meeting occurs, it does not become subject to tax or breach regulatory or corporate law requirements.

CIGAs

The possible CIGAs for In-Scope Companies are aligned to international standards identified by the OECD’s Forum on Harmful Tax Practices. CIGAs vary depending on the activity carried out by the In-Scope Company and the list in the Regulations is not exhaustive. Back office functions, such as IT support, do not comprise CIGAs. An In-Scope Company does not need to be carrying out all CIGAs that are listed in the Regulations but must comply with substance requirements in relation to the CIGAs that it undertakes.

In general, the substance requirements have been designed to respect the outsourcing model (“outsourcing” for these purposes includes delegation), although where an In-Scope Company outsources a CIGA it must adequately supervise the outsourced activity.

The principal aim of the substance requirements is to ensure that the level of profits that are attributed to the In-Scope Company in relation to its CIGAs are commensurate with its economic activity and economic presence. Accordingly, an In-Scope Company that outsources CIGAs or other activities should ensure that the related fees are appropriately priced such that the resulting net profit attributable to Guernsey is commensurate to the CIGAs undertaken in Guernsey.

Adequate physical presence, level of appropriately qualified employees and proportionate expenditure in Guernsey

An In-Scope Company should be able to meet the requirements relating to adequate physical presence and employees where a Guernsey-based administrator or corporate services provider provides the appropriate premises and personnel.

Whether these adequacy requirements are met will be a question of fact and degree, taking into account the activities of the In-Scope Company. Where an In-Scope Company relies on a Guernsey-based administrator or corporate services

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provider to meet these requirements the resources of that administrator or services provider will be taken into account and there can be no double-country of personnel.

Pure Equity Holding Companies

Pure Equity Holding Companies are seen as 'low risk' and therefore are subject to reduced substance requirements. These requirements are that it:

- complies with all of its obligations under applicable corporate law in Guernsey; and
- has an adequate level of persons in Guernsey and an adequate physical presence in Guernsey, in each case proportionate to the level of activity carried on in Guernsey, for holding or managing the shares or equitable interests that it holds.

A Pure Equity Holding Company should be able to meet the latter requirement where a Guernsey-based administrator or corporate service provider provides the appropriate personnel and premises. However, if a Resident Company also conducts other activities, for example it has made a loan to a subsidiary, it will not be a Pure Equity Holding Company and may instead be an In-Scope Company.

Compliance and monitoring

Tax returns

The corporate income tax return for Resident Companies will be enhanced for accounting periods beginning on or after 1 January 2019. Resident Companies subject to substance requirements will need to include in their corporate income tax returns details of the Resident Company's business activity, amount and type of gross income, expenses and assets, premises and number of employees (specifying the number of full time (equivalent) employees). This will allow the Revenue Service to monitor compliance with the regime. The information provided in the return will be monitored on a risk (of profit shifting) basis as well as by random selection of Resident Companies for audit each year 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 a Resident Company, including a right of entry onto business premises and a right to inspect documents (these are subject to certain provisos such as occupier consent, at least one week's notice and the approval of the Bailiff to the entry and inspection). The Director of the Revenue Service cannot exercise these powers to inspect documents that are subject to legal professional privilege.

Sanctions

Various sanctions apply for non-compliance with substance requirements, and these include:

- financial penalties which increase depending on the number of consecutive accounting periods the Resident Company is in default. These range from up to £10,000 for the first accounting period of default to up to £100,000 for the fourth consecutive accounting period of default;
- audit for continued non-compliance;
- spontaneous exchange of information by the Revenue Service regarding the Resident Company with any EU Member States where the immediate parent entity, ultimate parent entity or the ultimate beneficial owners are tax resident; and
- (where applicable) strike off from the Guernsey corporate register.

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. Resident Companies may appeal penalties levied by the Director of the Revenue Service provided certain grounds are met.

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.

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 exempt status or qualify for treatment as a non-Guernsey resident under an applicable DTA;
- carry out a detailed review of the company's activities to ascertain whether it is an In-Scope Company, a Pure Equity Holding Company or an IP Company;
- maintain records of the applicable CIGAs and the income and profits allocated to those CIGAs;
- where the company is an In-Scope Company, ensure that sufficient board meetings are held in Guernsey and that detailed minutes of all board meetings are maintained;
- In-Scope Companies should analyse the terms of all their outsourcing arrangements to ensure that the parameters of the outsourced activity are appropriately drafted and the activity is properly overseen from Guernsey and that sufficient CIGA is carried on in Guernsey; and

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- 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.

We expect that the ultimate application of the substance requirements in Guernsey will be the same as in Jersey and the Isle of Man, and all three islands are collaborating on the comprehensive guidance. More details will emerge once this guidance has been issued.



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