

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

Service area / [Investment Funds](#)

Location / [Guernsey](#)

Date / [December 2019](#)

Background

Like other offshore jurisdictions, Guernsey has implemented legislative economic substance requirements, which came into force on 1 January 2019, to meet a 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.

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](#).

The detailed legislation for Guernsey's substance requirements is contained in The Income Tax (Substance Requirements) (Implementation) Regulations, 2018, as amended (the **Regulations**), and guidance on the key aspects of the economic substance requirements was updated on 21 December 2018.

On 12 March 2019, the EU Council confirmed that Guernsey had met its commitment to introduce economic substance requirements and therefore removed Guernsey from the list of jurisdictions that had committed to make certain changes, and did not place Guernsey on the "blacklist" of non-cooperative jurisdictions.

The States of Guernsey Revenue Service (the **Revenue Service**) has worked with the tax authorities of Jersey and the Isle of Man to produce comprehensive guidance notes, which were first issued on 26 April 2019 and updated on 22 November 2019. This guidance continues to be developed and will be updated in due course. Further amendments to the Regulations were made with effect from 1 August 2019 and further details of these amendments can be found [here](#).

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**) 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 (**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**).

Certain exempt companies (**Exempt Companies**) are subject to substance requirements if they are an In-Scope Company, a Pure Equity Holding Company or an IP Company. Regulated funds continue to be out of scope of substance requirements, although certain 'self-managed' funds are expected to come in scope with effect from 1 January 2020. Subsidiaries of regulated funds are subject to the requirements even if they have exempt status. References to Exempt Companies below are to those that can be subject to the requirements.

Although limited partnerships and LLPs are out of scope of substance requirements, where a Resident Company or an Exempt Company is a partner of a limited partnership or a member of an LLP that carries on a relevant activity or derives income from intellectual property, then the Resident Company

OFFSHORE LAW SPECIALISTS

or Exempt Company is treated as carrying out the relevant activity or deriving the income from intellectual property.

For the funds industry the most relevant of the above activities for In-Scope Companies are:

- 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 and leasing, 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 service centre, which whilst focussed on goods does also capture a Resident Company or Exempt Company whose sole or main purpose is to provide services to non-resident group members.

Given the broad definitions used in the Regulations, a number of Resident Companies or Exempt 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.

Substance requirements depend on which of the above categories apply to the Resident Company or Exempt 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 generally expected that In-Scope Companies which conduct fund management are able to readily comply with the new substance rules in relation to fund management.

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

What is not in scope?

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

- collective investment schemes (although certain ‘self-managed’ collective investment schemes are expected to come in scope with effect from 1 January 2020); and
- non-company entities such as limited partnerships, limited liability partnerships and trusts, although as noted above partners in partnerships can be subject to substance requirements.

Further, a company that is not resident for tax purposes in Guernsey (other than an Exempt Company) is not subject to

substance requirements, even if it is incorporated in Guernsey. New corporate tax residence rules took effect in Guernsey from 1 January 2019 need to be taken into account. Further details regarding these new residence rules can be found [here](#). If a Guernsey company is tax resident in another jurisdiction it should consider whether it can become non-Guernsey resident under these new rules.

A Resident Company or Exempt 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

Continued

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.

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 the decision. This may be more than the quorum.

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 activities, including CIGAs, 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 provider to meet these requirements the resources of that administrator or services provider will be taken into account and there can be no double counting 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 its applicable corporate law; 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 it conducts its holding activities at board meetings in Guernsey (although there is no statutory

requirement for a Pure Equity Holding Company to hold board meetings in Guernsey). The resources of the company's Guernsey-based administrator or corporate services provider may also be relevant. However, if a Resident Company or Exempt 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 will be enhanced for accounting periods beginning on or after 1 January 2019. Resident Companies or Exempt Companies subject to substance requirements 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), CIGAs conducted and any outsourced CIGAs. They will also need to file their financial statements. This will allow the Revenue Service to monitor compliance with the regime. The information provided in the return is expected to be monitored on a risk (of profit shifting) basis as well as by random selection of Resident Companies or Exempt 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 or Exempt 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 or Exempt 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 or Exempt Company 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 corporate

Continued

register, 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 Resident Company or Exempt Company complying with substance.

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 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 be an Exempt Company or 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;
- 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;
- 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.;
- In-Scope Companies should analyse the terms of all their outsourcing arrangements to ensure that the parameters of the outsourced activity are appropriated drafted and the activity is properly overseen from Guernsey and that 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.



FIND US

Carey Olsen (Guernsey) LLP
PO Box 98
Carey House
Les Banques
St Peter Port
Guernsey GY1 4BZ
Channel Islands

T +44 (0)1481 727272

E guernsey@careyolsen.com



FOLLOW US

Visit our investment funds team at careyolsen.com

Please note that this briefing is only intended to provide a very general overview of the matters to which it relates. It is not intended as legal advice and should not be relied on as such. © Carey Olsen (Guernsey) LLP 2019