CAREY OLSEN

Guernsey proposes new substance requirements for 'relevant activities' from 2019

Service area / Trusts and Private Wealth

Location / Guernsey

Date / October 2018

2019 Budget Proposal

Guernsey's 2019 Budget is due to be debated by the States of Deliberation (Guernsey's parliament) at its meeting on **6 November 2018**. Section 5 of the 2019 Budget sets out proposed changes to be introduced under domestic legislation in order to meet commitments given to the European Union ("**EU**") in relation to the introduction of economic substance requirements for companies that are regarded as tax resident in Guernsey. These changes are to be introduced through a combination of amendments to existing legislation by a new ordinance, a new regulation and guidance, all due to be published and brought into effect from **1 January 2019**.

This briefing note provides a summary of the key changes being proposed in the Budget to introduce substance requirements in Guernsey and the context in which these proposals have arisen.

Background to proposed substance requirements

On **1 December 1997**, the Council of the European Union adopted a resolution on a code of conduct for business taxation with the objective of curbing harmful tax competition. In **1998**, the Code of Conduct Group on Business Taxation (the "**Code Group**") was set up to assess tax measures and regimes that may fall within the code of conduct.

In **November 2017** the EU wrote to the States of Guernsey, amongst other offshore jurisdictions with low or zero rates of corporation tax, stating that Guernsey, along with other third countries to the EU, had been assessed by the Code Group against new criteria as part of its programme of screening for:

- tax transparency;
- fair taxation; and
- compliance with anti–Base Erosion and Profit Shifting ("**BEPS**") measures.

No concerns were raised about Guernsey's standards of tax transparency and anti-BEPs compliance. Guernsey was also assessed as compliant with the general principles of fair taxation and was deemed non-harmful in **2012** when it was assessed against the Code Group's criteria at that stage.

The Code Group said that the purpose of the more recent screening programme was to ensure that "jurisdictions should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic substance". This represents a new criterion, which the Code Group refers to as the '2.2' requirements. In the context of this screening process the Code Group concluded that Guernsey did not have a "legal substance requirement for entities doing business in or through the jurisdiction".

The Code Group were concerned that this perceived lack of legal substance requirement "increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence". On the basis of this assessment, the EU proposed including Guernsey, amongst other similarly identified offshore jurisdictions, on a new list of non-cooperating jurisdictions unless Guernsey agreed to introduce changes aimed at evidencing real economic activity and substance for relevant businesses in Guernsey within the required time frame. The Code Group set out the specific measures and conceptual definitions that they are expecting jurisdictions to adopt to meet the '2.2' requirements in a paper published on **22 June 2018** (the "**Scoping Paper**"). The Scoping Paper was endorsed by the EU's Economic and Financial Affairs Council ("**ECOFIN**") and forms the basis against which the new substance requirements will be assessed.

Guernsey's commitment

In response, on **17 November 2017** Guernsey made a commitment to address the Code Group's concerns by the end of December 2018 in order to avoid being placed on the EU's blacklist of non-compliant jurisdictions. Guernsey is therefore currently (as at **11 October 2018**) on a so-called "**grey list**" of 12 other jurisdictions[1], which have similarly been targeted by the Code Group and have made their own commitments to address issues identified by the Code Group during their screening process.

New law making powers to be introduced into the taw law

The Budget explains that the Income Tax (Guernsey) Law, 1975 (the "**Tax Law**") is to be amended to enable the Policy & Resources Committee (the "**P&R Committee**") to make regulations requiring companies carrying on or undertaking relevant and other specified activities to have a substantive presence in Guernsey by meeting 'substance requirements'. The power will give the P&R Committee authority to introduce regulations that:

- identify activities that will be subject to substance requirements;
- set out the detailed substance requirements applicable to those activities;
- introduce sanctions and enforcement measures;
- enable the obtaining and exchange of information in relation to substance; and
- provide for the supervision, monitoring and verification of compliance.

These changes will apply to companies that are regarded as tax resident in Guernsey and engage in key activities identified by the EU in its Scoping Paper.

They will have to demonstrate as part of their annual tax return that they satisfy the required substance requirements for the relevant period. This will apply for accounting periods commencing after **31 December 2018**.

Whilst the current focus is on amending the Tax Law by a new ordinance to enable the introduction of substance requirements by regulation, it is anticipated that Guernsey will be required to consider the introduction of further tax measures to satisfy future tax initiatives and standards in order to demonstrate Guernsey's ongoing commitment to meeting international standards of tax transparency and information exchange. So that Guernsey is able to respond to future demands in a timely and efficient manner the new ordinance will also amend the Tax Law to include regulation-making powers to enable further domestic legislation to be introduced where necessary, whilst preserving the ability of the States of Deliberation to maintain oversight of the regulation making process. This will be done in a manner that mirrors the existing legislative procedures for the implementation of double tax agreements, which are introduced into Guernsey's domestic law by resolution of the States of Deliberation under section 172 of the Tax Law.

Which businesses are affected

The behaviour which the Code Group has identified as being harmful refers to measures that enable a taxpayer to benefit from a low or no tax rate simply by moving to a jurisdiction in which the taxpayer does not have to demonstrate real economic activity and presence and yet can still benefit from the preferential tax regime in a question.

The Code Group has identified the types of business sectors which are both geographically mobile (and therefore can move their operations between different jurisdictions) and have traditionally been the focus of preferential tax regimes (i.e. businesses whose profits are subject to low or no tax). It is for these businesses that the Code Group is keen to have substance requirements in place. The Budget refers to such businesses as carrying on '**relevant activities**'.

Businesses conducting relevant activities are:

- banking
- insurance
- fund management
- finance and leasing
- leasing headquarters
- shipping
- intellectual property
- holding companies that generate income from any of the above activities
- holding companies that hold shares in other companies

1 Anguilla, Bahamas, Bahrain, Bermuda, BVI, Cayman Islands, Isle of Man, Jersey, Marshall Islands, Turks and Caicos Islands, UAE and Vanuatu: see https://www.consilium.europa.eu/media/36705/st_6236_2018_rev_4_en.pdf

Continued

The draft legislation enables the list of relevant activities to be updated by secondary legislation if required in the future. It is noted that the Budget does not include companies that operate as collective investment vehicles ("**CIVs**") within the list of businesses carrying on relevant activities.

CIVs are subject to supervision by the Guernsey Financial Services Commission (the "**GFSC**") and in any event, if they have been granted exempt body status under existing legislation, such CIVs would not be regarded as tax resident in Guernsey and would therefore be outside of the scope of the new substance requirements.

Substance requirements

The Budget says the substance requirements will vary for each relevant activity to reflect the different needs of the companies and their respective risk exposure (of artificial profit shifting). The requirements will be aligned to international standards identified by the OECD's Forum on Harmful Tax Practices (the "**Forum**") as part of their work on BEPs. Whilst the Budget does not set out in detail the substance requirements for each type of relevant activity it is anticipated that the new legislation will reflect the requirements set out in the Code Group's Scoping Paper which refers to the work of the Forum in this sphere. The Budget confirms that guidance to be published by Guernsey's tax authority, the newly rebranded Revenue Service, on the substance requirements will, where appropriate, build on existing regulatory requirements relating to local substance. The Budget states that companies carrying on relevant activities will be required to:

- demonstrate that they are directed and managed in Guernsey by meeting the statutory requirements to be set out in legislation;
- carry on Core Income Generating Activities in Guernsey;
- have adequate and appropriately skilled employees in Guernsey;
- have an adequate level of annual expenditure incurred in Guernsey; and
- have an adequate physical presence in Guernsey to reflect the amount of profits accounted for in Guernsey.

Directed and managed in Guernsey

Based on the Code Group's Scoping Paper, it is anticipated that a Guernsey resident company that is carrying on relevant activities will be required to demonstrate the following to meet the statutory requirement that it is directed and managed in Guernsey:

- its board of directors meet in Guernsey with adequate frequency given the level of decisions required for that business;
- during board meetings in Guernsey there must be a quorum of directors physically present in Guernsey;
- strategic decisions must be made at board meetings and the minutes of those meetings must record those decisions;
- the board of directors as a whole must have the necessary knowledge and expertise to discharge their duties; and
- all minutes and company records must be kept in Guernsey.

Core income generating activities

The Core Income Generating Activities ("**CIGA**") for each relevant activity will be defined in the legislation. All companies carrying on relevant activities will be required to report the CIGA activities that take place in Guernsey. The Budget says legislation will provide that these CIGA activities can be outsourced to another entity within Guernsey, provided the outsourcing is adequately supervised by the company and is not used to circumvent the substance requirements. The new legislation will include an anti-avoidance provision to ensure that outsourcing is not used to undermine the principles and purposes of the substance requirement regime.

Adequate

What is regarded as 'adequate' will depend upon the facts and circumstances of each business, including the nature of the business activity and its risk exposure. The Budget says that the requirements are designed to be fair and proportionate. It is anticipated that guidance to be published by the Revenue Service on how the term 'adequate' will be interpreted in practice for different businesses will reflect this approach.

Special rules for IP companies and pure equity holding companies

The Code Group's Scoping Paper indicates that companies that derive their income from intellectual property ("**IP**") and companies that hold shares in other companies ("**pure equity holding companies**") should be subject to different levels of substance requirements from those that apply to companies conducting other types of relevant activities.

IP Companies

The Budget confirms that IP companies are to be divided into 'high risk' IP companies and non-high risk IP companies. For high risk IP companies, there will be rebuttable presumption that the CIGA test is not satisfied. The onus will be on the high risk IP company to demonstrate that it has sufficient substance in Guernsey. Even if the company is able to rebut the presumption that it does not meet the substance test, the new regulations will provide power for the Director of Revenue Service spontaneously to exchange information about the company with the competent authority of the EU Member State where either the immediate or ultimate parent company of the Guernsey-based IP company is tax resident. This will be in accordance with approved international agreements or international tax measures relating to the spontaneous exchange of information.

Continued

The Budget sets out the characteristics of high risk IP companies as follows:

- the company holds intellectual property assets but did not create the intellectual property in the intellectual property assets which it holds;
- the company acquired the intellectual property assets either from an intra-group person, or through funding research and development by another person situated in a territory other than Guernsey;
- the company licences the intellectual property asset to one or more non-resident intra-group persons or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by non-resident intra-group persons; or
- the company holds intellectual property assets but does not carry on either of the CIGA of research and development or marketing, branding and distribution.

The Budget also states that the periodic decisions of non-resident board members meeting in Guernsey would not be sufficient to demonstrate that a company with income from IP (whether high risk or not) is directed and managed in Guernsey.

Pure equity holding companies

The Code Group's Scoping Paper acknowledges that the tax exemptions/tax benefits available to pure equity holding companies are "based on policy considerations other than notions of value creation". In other words the Code Group is of the view that there may be no correlation between income-generating activities and the preferential tax treatment received. It is therefore anticipated that pure equity holding companies that are tax resident in Guernsey will need to respect all applicable corporate law filing requirements and should have adequate people and premises for holding and managing equity participations in order to meet the requirements set out in the Scoping Paper. This would meet the Code Group's longstanding aversion to 'letter box' and 'brass plate companies'. These are structures and practices that do not feature as part of Guernsey's well-regulated financial services industry. The Budget itself does not set out in detail how pure equity holding companies are to meet the new substance requirements but it is hoped that they will not be subject to higher levels of substance requirements than the Code Group's expectations as expressed in its Scoping Paper.

Sanctions and penalties

The Budget indicates that the new regime will be accompanied by an escalating level of penalties and sanctions for failure to comply with substance requirements. Since the additional reporting under the new regime will be incorporated into the annual corporate tax return, the starting point for ensuring compliance will be existing sanctions for failure to file accurate and complete returns within the given timeframe.

Thereafter the Budget indicates that the following sanctions could be applied progressively:

- financial penalties for substance failure;
- spontaneous exchange of information concerning the company with any EU Member States where the immediate and ultimate parent entities are tax resident; and
- the striking off of a company incorporated in Guernsey from the Guernsey Register for failure to comply.

The new sanctions and penalties supporting enforcement of the new regime will be supplemented by powers granted to the Revenue Service to obtain further information, including from the GFSC, in order to verify compliance and support exchange of information. The increased lines of communication between the tax and regulatory authorities in Guernsey will also support further transparency measures to which the EU has asked Guernsey to provide further commitment.

Further transparency measures

The Budget explains that two specific commitments have been requested in the context of further transparency measures. One is in respect of the provision of beneficial ownership information and the other relates to mandatory disclosure rules.

Beneficial Ownership Information

It is proposed that a commitment at political level is given to introducing legislation for the purpose of enabling real-time or close to real-time access to beneficial ownership information by EU tax and law enforcement authorities, on a reciprocal basis, subject to ensuring appropriate data and safeguarding measures are in place. The Budget explains that this would not be a public register. It is understood that EU Member States are currently working towards the establishment of central registries that would be interconnected by 2021. The Budget explains that the political commitment to implement legislation to support the exchange of beneficial ownership information would be in line with previous commitments given in 2016 to help shape an international standard in automatic exchange of beneficial ownership information.

Mandatory disclosure rules

The second political commitment to be proposed in the Budget relates to compliance with the OECD's Common Reporting Standard ("**CRS**") which was introduced in Guernsey with effect from 2016. The commitment to be given is in respect of the introduction of legislation for the mandatory disclosure of CRS avoidance arrangements and opaque offshore structures. These rules would require promoters of avoidance arrangements and service providers to disclose information on the arrangement or structure to the Revenue Service. Such information would include the identity of any user or beneficial owner and would then be exchanged with the tax authorities of the jurisdiction in which the user and/or beneficial owner is resident, provided there is a relevant information exchange agreement in place between Guernsey and that jurisdiction.

Continued

The rules would reflect the 'best practice' standards for countering CRS avoidance. In this respect, the Budget explains that the introduction of mandatory disclosure rules is an inevitable part of the compliance strategy of the Revenue Service.

Collaboration and consultation

The Code Group also assessed Jersey and the Isle of Man as lacking substance requirements and required similar commitments from them. Accordingly, the Crown Dependencies have been working together with the aim of meeting their respective commitments to the EU through the introduction of substance requirements under their respective domestic legislation. The British Overseas Territories are in a similar positon but, given the different approach to taxation in those territories, the Crown Dependencies have not engaged with them to the same extent.

Representatives of the Crown Dependencies have had meetings and discussions with the European Commission (Taxation and Customs Union - TAX UD) and the Code Group. They have been assisted in this work by the Channel Islands Brussels Office.

The States of Guernsey has also engaged with representatives of the finance industry and conducted a public consultation in August 2018 in which reference to the Scoping Paper was made, to which over 200 responses were received. The feedback from that consultation has informed the drafting of the proposed legislation and will assist with the smooth implementation of the changes in due course.

Significance of changes

Whilst no concerns were raised by the Code Group regarding Guernsey's standards of tax transparency, and anti-BEPS compliance, the perceived need for substance requirements falls within the Code Group's new criteria under the principles of 'fair taxation'. Prior to this new criterion being introduced, Guernsey was assessed as non-harmful by the Code Group in 2012 and as recently as July 2018 the OECD assessed Guernsey as achieving the highest rating of 'Compliant' based on Guernsey's legislative and administrative regime for tax transparency and exchange of information with partner jurisdictions.

Nevertheless, the States of Guernsey and the majority of respondents to the public consultation on the proposed changes, acknowledge the necessity of complying with the new criterion. The motivation behind adopting the new substance requirement regime is the concern that being included on an EU blacklist could result in sanctions being imposed by EU Member States, which could be damaging for Guernsey's reputation and economy and undermine its status as a well-regulated, transparent and co-operative jurisdiction. This is so especially as the EU Member States have, in parallel to the Scoping Paper, considered a number of defensive measures in both non-tax and tax areas that can be applied to black-listed jurisdictions in a co-ordinated manner.

Thus, although the intention is to introduce new substance requirements to be complied with on an annual basis for certain businesses in Guernsey, the methodology underpinning compliance builds on existing obligations so as to keep the burden of compliance manageable within existing corporate and regulatory rules and practices relating to local substance. By introducing the new requirements and providing the political commitments requested by the EU, it is hoped that Guernsey will continue to maintain its premier position as a well-regulated, tax transparent international financial centre that is committed to the principles of fair taxation.

Next steps

Assuming the Budget proposals have been approved on **6 November 2018**, Guernsey is likely to publish the new ordinance to amend the Tax Law followed by the new regulations and guidance setting out the new substance requirement regime in detail and how it is to be applied. The proposed changes are likely to impact at some level all businesses that file tax returns in Guernsey. As further information becomes available the degree to which individual businesses will be impacted will become clearer.

There is a short timeframe within which government is able to draw up the necessary legislation and guidance in order to implement the required changes by **1 January 2019** so as to meet the commitment given to the EU last year. In the meantime companies may like to consider:

- whether their businesses are likely to be regarded as carrying on relevant activities as listed in the Budget;
- reviewing their corporate governance procedures and record keeping protocols in the event they are required to demonstrate that the company is directed and managed in Guernsey;
- assessing levels of staff, expenditure, office accommodation and facilities in terms of adequacy;
- reviewing outsourcing arrangements;
- documenting criteria which may be relevant to the demonstration of CIGA and other substance requirements; and
- reviewing budgets for internal compliance procedures leading to annual tax return submissions going forward.

Continued

FIND US

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 trusts and private wealth 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 2018