

Economic substance requirements for Guernsey companies

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Introduction

The States of Guernsey has approved the Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance, 2018 (the **Amendment Ordinance**), effective 1 December 2018.

The Amendment Ordinance amends the Income Tax (Guernsey) Law, 1975 (the **Income Tax Law**) and gives the States of Guernsey's Policy and Resources Committee the ability to make regulations which require companies which are tax resident, and which carry on relevant activities or other specified business, in Guernsey to demonstrate that they each have a substantive presence in Guernsey.

The purpose of the Amendment Ordinance is to address the concerns of the EU Code of Conduct Group for Business Taxation that certain Guernsey tax resident companies may be used to artificially attract profits that are not commensurate with economic activities and substantial economic presence in Guernsey. Similar changes in Jersey and the Isle of Man are being made to their local laws to address the EU's concerns in those jurisdictions.

Draft regulations, namely the Income Tax (Substance Requirements) (Implementation) Regulations, 2018 (the **Substance Regulations**), have been published ahead of the Amendment Ordinance in order to provide as much information as possible before 2019, as the Regulations are expected to come into force on 1 January 2019. The Substance Regulations are a new measure to ensure that real economic activity is being carried on in Guernsey in respect of the profits and income of the companies in question.

The Substance Regulations impose economic substance requirements on companies that are tax resident in Guernsey and which carry on a relevant activity or a specified business in respect of accounting periods beginning after 31 December 2018 (and every following accounting period). Essentially, such companies will have to demonstrate that they have substance in Guernsey by being directed and managed in Guernsey, having adequate people, premises and expenditure in Guernsey and conducting core income generating activities (**CIGA**) in Guernsey. Note that a separate substance test applies to Guernsey tax resident holding companies - see paragraph 8 below.

The key aspects of the proposed economic substance requirements (the **Key Aspects**) have also been issued by Guernsey, Jersey and the Isle of Man, jointly, together with a useful flowchart, both of which are available on the States of Guernsey's website [here](#). The Key Aspects are intended to be read in conjunction with the proposed local legislation and are to be supplemented by comprehensive guidance notes which will clarify how the substance test can be met.

The questions below should be considered to determine whether the substance test applies to a company and whether that test will be met. We will publish a further guide once the guidance notes have been issued by the Director of the Revenue Service (the **Director**) with the requisite clarification.

1 Is the company tax resident in Guernsey?

A company is tax resident in Guernsey if (i) it is controlled in Guernsey or (ii) it is incorporated in Guernsey and has not been granted tax exempt status (a **resident company**).

The Director considers 'control' for these purposes as meaning control by a natural person(s) who may (or may not) be connected with each other and who, on their own or jointly, control the company.

'Control' is defined in the Income Tax Law as the power of a person to secure, by means of the holding of shares, the possession of voting power or being a loan creditor, that the affairs of the company are conducted in accordance with the wishes of that person(s). For example, an overseas subsidiary of a Guernsey company, which is controlled by non-resident individuals, would not be treated as tax resident in Guernsey. In contrast, an overseas company controlled by Guernsey resident individuals is tax resident in Guernsey.

That being said, the definition of 'resident' in the Income Tax Law has more recently been amended by the States of Guernsey so that, with effect from 1 January 2019, a Guernsey company which would otherwise be tax resident in Guernsey (on the basis of (i) or (ii) above), will **not** be treated as tax resident in Guernsey in a year of charge if it satisfies the following conditions:

- (a) the company is, under the domestic law of another territory (**Territory A**), tax resident in Territory A;
- (b) its business is centrally managed and controlled in Territory A;

- (c) either:
 - (i) the company is tax resident in Territory A under the domestic law of Territory A by virtue of a double tax agreement or an international tax measure made between Territory A and Guernsey; or
 - (ii) the highest rate of tax on a company in Territory A is at least 10 per cent; **and**
- (d) the company's tax resident status in Territory A is not motivated by the avoidance, reduction or deferral of the liability of any person to tax under the Income Tax Law.

2 Does the resident company have any income?

If a resident company does not have any income from the relevant activity or other specified business in a particular accounting period, then it will not need to comply with the substance requirements in that accounting period.

3 Is the resident company carrying on any relevant activity?

A resident company with income arising from a relevant activity or a specified business is subject to the substance test.

The relevant activities ((a) to (g) inclusive, together a **relevant activity**) and other specified business ((h) and (i)) are:

- (a) **banking**: deposit-taking business within the meaning of the Banking Supervision (Bailiwick of Guernsey) Law, 1994 carried on by a licensed institution within the meaning of that Law;
- (b) **insurance**: insurance business within the meaning of the Insurance Business (Bailiwick of Guernsey) Law, 2002 carried on by a licensee within the meaning of that Law;
- (c) **fund management**: 'management' within the meaning of paragraph 5 of Schedule 2 to the Protection of Investors (Bailiwick of Guernsey) Law, 1987 (the **POI Law**), that is to say exercising any managerial function in relation to an investment or in relation to the assets underlying an investment, when carried on in connection with a collective investment scheme within the meaning of the POI Law under the authority of a licence issued under that Law;
- (d) **financing and leasing**: the provision of credit facilities of any kind for consideration (including interest) to any person ('customer'). The provision of credit may be by way of instalments for which a separate charge is made and disclosed to the customer in connection with:
 - (i) the supply of goods by hire purchase;
 - (ii) financial leasing (excluding land and interests in land); or
 - (iii) conditional sale or credit sale.

For example, a resident company making an interest-bearing intra-group loan will be conducting finance and leasing business. However any activity falling within the definition of banking, insurance or fund management does not constitute financing and leasing for the purposes of the Substance Regulations;

- (e) **headquartering**: the provision of any of the following services to non-resident intra-group persons of the resident company:
 - (i) the provision of senior management;
 - (ii) the assumption or control of material risk for activities carried out by, or assets owned by, any of those intra-group persons; and
 - (iii) the provision of substantive advice in relation to the assumption or control of risk for such activities or assets,

but does not include any business or activity falling within the definition of banking, insurance, fund management, financing and leasing, shipping or a distribution and service centre, or the business of holding intellectual property assets;

- (f) **shipping**: the operation of ships in international traffic for income from the transport of passengers or cargo, and includes any of the following activities where directly connected with, or ancillary to, such operation:
 - (i) the rental on a charter basis of ships;

- (ii) the sale of tickets or similar documents and the provision of services connected with the sale of tickets or similar documents, either for the enterprise itself or any other enterprise;
 - (iii) the use, maintenance or rental of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise; or
 - (iv) the management of the crew of ships;
- (g) **distribution and service centre**: a business the sole or main activity of which is:
- (i) to purchase raw materials and finished products from other members of the same group which are non-resident and to re-sell them for a small percentage of profits; or
 - (ii) the provision of services to other members of the same group which are non-resident,
- but does not include any business or activity falling within the definition of banking, insurance, fund management, financing and leasing, shipping or headquartering;
- (h) **intellectual property assets**: include copyright, database rights, design rights (registered and unregistered), image rights, patents and biotechnological inventions, performers' rights, plant breeders' rights and trade marks, and the rights and interests in those assets; and
- (i) **pure equity holding**: a company which has as its primary function the acquisition and holding of shares or equitable interests in other companies which does not carry on any commercial activity and which is a holding company within the meaning of the Companies (Guernsey) Law, 2008 (the **Companies Law**).

4 Is the resident company, which is carrying on a relevant activity, directed and managed in Guernsey?

This first limb of the substance test is satisfied if:

- (a) the resident company's board of directors meets in Guernsey with adequate frequency having regard to the level of decision-making required of the board (and it is expected that the majority of board meetings will be held in Guernsey and that even companies with a minimal level of activity will hold at least one board meeting each year);
- (b) during each meeting of the board of directors in Guernsey, a quorum of the directors is physically present in Guernsey;
- (c) strategic decisions of the resident company are made at meetings of the board of directors and the minutes of the meetings record those decisions;
- (d) the board of directors, as a whole, has the necessary knowledge and expertise to discharge the duties of the board; and
- (e) all minutes of board meetings and all other company records required by the Companies Law (or, as the case may be, the Companies (Alderney) Law, 1994) to be kept by the company are kept in Guernsey.

In the case of corporate directors, the requirements will apply to the individual officers of the corporate director who actually perform the duties.

5 Does the resident company, which is carrying on a relevant activity, conduct Guernsey core income generating activities?

The second limb of the substance test is a requirement that the resident company carries on CIGA in relation to the relevant activity in Guernsey.

The CIGA for:

- (a) **banking** includes raising funds, managing risk, taking hedging positions, providing loans, credit or other financial services to customers, managing regulatory capital and preparing regulatory reports and returns;
- (b) **insurance** includes predicting and calculating risk, insuring or re-insuring against risk and providing client services;
- (c) **fund management** includes taking decisions on the holding and selling of investments, calculating risks and reserves, taking decisions on currency or interest fluctuations and hedging positions and preparing relevant regulatory or other reports for governmental or regulatory authorities and investors;

- (d) **finance and leasing** includes agreeing funding terms, identifying and acquiring assets to be leased (in the case of leasing), setting the terms and duration of any financing or leasing, monitoring and revising any agreements and managing any risks;
- (e) **headquartering** includes taking relevant management decisions, incurring expenditures on behalf of group entities and co-ordinating group activities;
- (f) **shipping** includes managing crew (including hiring, paying and overseeing crew members), hauling and maintaining ships, overseeing and tracking deliveries, determining what goods to order and when to deliver them and organising and overseeing voyages; and
- (g) **distribution and service centre** includes transporting and storing goods, components and materials, managing stocks, taking orders and providing consulting or other administrative services.

The following should also be noted:

- (a) it is not necessary for a resident company to perform all of the CIGA listed for a relevant activity in order to demonstrate substance;
- (b) a resident company may undertake or outsource all or part of an activity outside of Guernsey and if that activity is not part of the CIGA (eg back office functions) it will not affect the company's ability to meet the substance test;
- (c) where Guernsey CIGA is undertaken for the resident company by another entity (eg by an administrator or another group company), the company must be able to demonstrate that it has adequate supervision of the outsourced activity and that the outsourcing is performed in Guernsey;
- (d) where a CIGA is outsourced, the resources of the service provider in Guernsey will be taken into consideration when determining whether the people and premises test is met (but there must be no double counting if the services are provided to more than one company);
- (e) the substance requirement does not preclude resident companies seeking expert professional advice or engaging the services of specialists in other jurisdictions; and
- (f) the income subject to tax in Guernsey must be commensurate to the CIGA undertaken in Guernsey.

6 Does the resident company, which is carrying on a relevant activity, meet the adequacy test?

This third limb of the substance test is satisfied if the resident company is able to demonstrate that:

- (a) there is an adequate level of appropriately qualified employees in Guernsey proportionate to the level of that relevant activity carried on in Guernsey, whether or not employed by it or another entity and whether on temporary or long-term contracts;
- (b) there is an adequate level of expenditure in Guernsey proportionate to the level of that relevant activity carried on in Guernsey; and
- (c) there is an adequate physical presence in Guernsey (including, without limitation, offices and/or premises) proportionate to the level of that relevant activity carried on in Guernsey.

A resident company will be responsible for ensuring accurate information is reported on its tax return including precise details of the resources employed by its service providers (eg based on the use of timesheets or another allocation methodology). A resident company will therefore have to ensure it maintains and retains appropriate records to demonstrate the adequacy of the resources utilised and expenditure incurred.

7 Is the resident company an IP company?

A resident company with income from intellectual property assets (an **IP company**) is subject to the substance test.

For the purpose of the Substance Regulations, income from intellectual property assets includes income or profits derived from, or from the holding, development or exploitation of, intellectual property assets (including, without limitation, royalties, income from franchise agreements and income from licensing such assets).

The three limbs of the substance test listed in paragraphs 4 to 6 above apply equally to an IP company, except that:

- (a) in relation to the directed and managed limb of the substance test, an IP company is directed and managed in Guernsey if its board of directors meets in Guernsey with adequate frequency given the

level of decision-making required of the board and for these purposes periodic decisions of non-resident board members of an IP company are **not** taken into account (cross-refer with paragraph 4(a) above); and

- (b) the CIGA in relation to intellectual property assets (the second limb of the substance test) include:
 - (i) research and development (rather than acquiring or outsourcing);
 - (ii) marketing, branding and distribution;
 - (iii) taking strategic decisions and managing (as well as bearing) the principal risks relating to the development and subsequent exploitation of the intellectual property asset;
 - (iv) taking the strategic decisions and managing (as well as bearing) the principal risks relating to the third party acquisition and subsequent exploitation and protection of the intellectual property asset; and
 - (v) carrying on the underlying trading activities through which the intellectual property asset is exploited and which lead to the generation of revenue from third parties.

8 What are the substance requirements for a pure equity holding company?

A resident company which is a pure equity holding company with income from that activity is also subject to the substance test.

A 'pure equity holding company' is a company which:

- (a) has as its primary function the acquisition and holding of shares or equitable interests in other companies;
- (b) carries on no commercial activity; and
- (c) is a holding company within the meaning of section 531 of the Companies Law (disregarding subsections 531(6) and (7)).

To satisfy the substance test, a resident company which is a pure equity holding company must ensure that:

- (a) it complies with all obligations applicable to it under the Companies Law (or, as the case may be, the Companies (Alderney) Law, 1994);
- (b) there is:
 - (i) an adequate level of persons in Guernsey proportionate to the level of activity carried on in Guernsey; and
 - (ii) there is an adequate physical presence in Guernsey (including, without limitation, offices and/or premises) proportionate to the level of that activity carried on in Guernsey,for holding and managing the shares or equitable interests.

9 Is the company a high risk IP company?

A high risk IP company is either:

- (a) a company which:
 - (i) holds intellectual property assets;
 - (ii) did not create the intellectual property in the intellectual property assets which it holds;
 - (iii) acquired the intellectual property assets from an intra-group person or in consideration of funding research and development by another person situated in a territory other than Guernsey; and
 - (iv) 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
- (b) a company which holds intellectual property assets but does not conduct, in Guernsey, research and development (rather than acquiring or outsourcing) or marketing, branding and distribution as part of its Guernsey CIGA.

As the risks of artificial profit shifting are considered to be greater, there is a rebuttable presumption that a high risk IP company will fail the substance test during an accounting period unless the company provides sufficient evidence to rebut the presumption and satisfy the Director that the substance test is met.

To rebut the presumption, a high risk IP company will have to produce materials which will explain how the development, enhancement, maintenance, protection and exploitation functions have been under its control, and that this has involved people who are highly skilled and perform their core activities in Guernsey.

This high evidential threshold requires:

- (a) detailed business plans which clearly lay out the commercial rationale for holding the intellectual property assets in Guernsey;
- (b) concrete evidence that the decision making is taking place in Guernsey; and
- (c) information on employees in Guernsey, their experience, their contractual terms, qualifications and length of service.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets, will not rebut the presumption.

Self-assessment

A resident company will be required to provide any information reasonably required by the Director to assist the Director in determining whether the substance test has been met. It is anticipated that certain information will be required to be provided by a resident company in its tax return each year for these purposes. It is anticipated that the information required will, as a minimum, include business activities, the amount and type of income, amount and type of expenses and assets, premises and number of full time equivalent employees and their qualifications.

Exchange of information

If the Director is of the opinion that a resident company has not met the substance test for an accounting period, the Director will, in accordance with any approved international agreement or international tax measure relating to the spontaneous exchange of information, disclose to a competent authority any information which relates to the company.

In the case of a high risk IP company, whether or not it meets the substance test for any accounting period, the Director must disclose to a competent authority any information which relates to a high risk IP company for that period.

For the purposes of the Substance Regulations, a 'competent authority' means a person, body or authority designated as a competent authority by the Director in respect of:

- (a) the United Kingdom or any Member State of the European Union in which country the immediate or ultimate parent company, or the beneficial owner, of the relevant company is resident; or
- (b) where the relevant company is not a registered Guernsey or Alderney company, the territory in which the company is registered or otherwise incorporated,

for the purposes of an approved international agreement or international tax measure or the Substance Regulations and includes competent authority within the meaning of the Income Tax Law.

Penalties

If the Director determines that a resident company has failed to meet the substance test in respect of its first accounting period of default, the Director will issue a notice to the company imposing a penalty not exceeding £10,000.

The notice must state the grounds of the Director's decision, set out particulars of the substance requirements which (in the opinion of the Director) are applicable in that accounting period and which the resident company has not complied with; explain the sanctions (civil or criminal) that may arise or be imposed in respect of non-compliance; and set out the particulars of any right of appeal that may be applicable. The notice may also require the provision of such documents or information as the Director may require for the purpose of their functions under the Substance Regulations.

The same applies in relation to a resident company's failure to meet the substance test in respect of its third and fourth accounting period of default, the penalty for such being up to £50,000 and £100,000 respectively.

If the Director determines that a resident company has failed the substance test in respect of its fourth accounting period of default, ie its fourth consecutive accounting period beginning after 31 December 2018, the Director may, in addition to the imposition of a penalty of up to £100,000, take measures which may ultimately lead to the company being struck off.

Conclusion

Companies which are subject to the substance test should start making preparations now or early in their next accounting period commencing on or after 1 January 2019 to ensure that the test can be met during that and subsequent accounting periods.

Things to think about

It is recommended that, pending issue of the guidance notes, consideration is given to the following matters if the substance test applies to a company:

- (a) assessing where board meetings are held and whether quorum requirements in articles of incorporation or other corporate documentation (eg shareholders' agreements) might prevent meetings being held in Guernsey;
- (b) assessing whether directors of the company have the necessary qualifications and expertise to discharge the duties of the board (the rubber stamping of decisions taken elsewhere is unlikely to pass the substance test);
- (c) improving the way board meetings are minuted so that the detail of a board's deliberations are captured and that decisions not to take action are minuted as well as decisions to take action;
- (d) assessing what CIGA is undertaken in Guernsey and what is undertaken outside Guernsey;
- (e) evidencing in board minutes where CIGA are discharged, or otherwise documenting at board level where decisions in relation to CIGA are to be made;
- (f) assessing where the company's statutory and non-statutory records are located to ensure that they are located in Guernsey or accessible from Guernsey;
- (g) assessing the company's staff, premises and expenditure in Guernsey and outside Guernsey and assessing whether this is proportionate and adequate;
- (h) reviewing outsourcing arrangements to see whether relevant CIGA is or can be undertaken in Guernsey;
- (i) considering how to complete the company's Guernsey tax return for the year before these changes come into effect (because the return for that year is due to become more complex as a precursor to the substance changes);
- (j) ensuring that administration agreements are amended to:
 - (i) require the administrator to ensure adequate service provision by employees of the administrator both in terms of time and qualifications/experience;
 - (ii) require the administrator to make adequate premises available when needed;
 - (iii) require the administrator to report to the company the necessary information as regards time allocation, qualifications and experience of staff, premises and expenditure;
 - (iv) require the administrator to maintain procedures that enable levels of input to be measured/ascertained including, for example, the use of timesheets; and
 - (v) agree the fees for assessing whether a company is in or out of scope and, if it is in scope, the fees for any additional service required to meet the tests;
- (k) assessing the adequacy of the supervision and monitoring by the company of any outsourced CIGA;
- (l) assessing the way the company makes decisions, how decisions are implemented and how execution of decisions and outsourcing is monitored as well as making an assessment of the adequacy of the same; and
- (m) documenting policies and procedures to improve decision making, implementation and oversight.

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