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UPDATE

Consultation on future Channel Island Fund Management Substance: the Codification of a Sustainable Model

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On 6 August 2018, the governments of Guernsey and Jersey, moving in lock-step with their Isle of Man counterparts, have issued substantially identical high level Consultation documents which signal the substance requirements corporate fund managers tax resident in the Channel Islands (**CIs**) will be required to meet from 1 January 2019. The proposals, now subject to local industry consultation until 31 August 2018, have been designed to reassure the EU's Code of Conduct Group on Business Taxation (the **Code Group**) that the activities of CI tax resident corporate fund managers (and CI companies undertaking certain other "relevant activities") which are subject to a zero rate of corporate income tax, are carried on with an appropriate level of local substance. (The other "relevant activities", which are not the subject of this briefing, are: banking, insurance, financing and leasing, headquarters activities, shipping and holding company activities.)

Background

In addition to supporting international standards on tax transparency and good governance, the Channel Islands have pursued a long-standing "good neighbour" policy towards the European Union, voluntarily committing to the Code Group and having had their corporate tax regimes assessed as compliant by historic Code Group review processes. Throughout 2017, the Code Group conducted an intensive screening process where the tax structures of over 90 jurisdictions, including the Crown Dependencies and Overseas Territories, were subject to detailed analysis. In December 2017, EU Finance Ministers (**ECOFIN**) decided to include a number of jurisdictions on an EU list of non-cooperative tax jurisdictions. ECOFIN Ministers identified both Guernsey and Jersey as cooperative tax jurisdictions, so they were not placed on that list.

As part of ongoing dialogue with the EU over its listing process, the government of each Channel Island made a number of commitments to address concerns raised by the Code Group in relation to a need for businesses in the Islands to demonstrate economic substance in the relevant Island. The proposals in the Consultation papers issued on 6 August 2018 constitute the proposed legislative response of the governments of the Channel Islands to address these concerns.

Evolution, not revolution

Those familiar with the customary operation of Channel Islands fund management companies will know that they have long been required to adduce relatively high levels of local substance and governance through the operation of their board of directors, often in conjunction with staff and registered office support from licensed expert local service providers, such as fund administrators. These historic arrangements have, in part, been enshrined in local regulation, with the Guernsey and Jersey Financial Services Commissions generally requiring the appointment of experienced local directors on the boards of regulated CI fund managers and the appointment of a licenced local service provider to administer a CI fund. In recent years, increasing numbers of fund managers have bolstered that core CI substance offering by employing their own CI employees and occupying their own premises.

It is likely therefore that, in most cases, these Consultation proposals will simply be regarded as a codification into CI income tax law of substance arrangements already largely adhered to by the local fund management industry, although care will be needed to ensure:- the core management activities flagged in

the Consultation (see below) are carried out by the CI manager, with strategic decisions made by a board quorum physically present in the Island; adequate levels of expenditure are deployed in the direct retention (or indirect retention, through outsourcing to local service providers) of local employees and premises which are proportionate to levels of activity in the Island; and each CI manager properly completes the proposed new corporate income tax returns for, and beyond, the 2019 year of assessment.

The detail of the proposed new CI fund management substance requirements are as follows:

1 Core fund management activities:

CI-resident fund management companies will be required to demonstrate the existence of the following "core income generating activities" in the relevant Island (either by the company itself or a mandated third party): *taking decisions on the holding and selling of investments, calculating risks and reserves, taking decisions on currency, interest fluctuations and/or hedging positions, preparing relevant regulatory and/or other reports for government authorities and investors*. These, of course, are core fund management activities which have long been the preserve of CI fund managers, but care may need to be taken in future to ensure that they are undertaken by the CI manager, with input from a local administrator where necessary, rather than by non-resident investment managers or advisors.

2 Core governance requirements:

CI-resident fund management companies will be required to demonstrate that the company is directed and managed in the relevant Island as follows:

- there must be meetings of the board of directors in the Island at adequate frequencies given the level of decision making required;
- during these meetings, there must be a quorum of the board of directors physically present in the Island;
- strategic decisions of the company must be set at meetings of the board of directors and the minutes must reflect those decisions;
- all company records and minutes must be kept in the Island; and
- the board of directors, as a whole, must have the necessary knowledge and expertise to discharge their duties as a board.

Again, the above requirements are likely reflect the pre-existing operational arrangements for the vast majority of CI fund management boards, but additional care may need to be taken in future (i) in relation to fund managers running rapid-trading strategies; (ii) in ensuring that key strategic board decisions are always properly minuted; and (iii) in ensuring that the board members, collectively, do have appropriate asset management knowledge and expertise to run their fund's strategy and adhere to applicable governance requirements. With a deep existing pool of individuals resident in the CIs with directorship experience across the alternative asset management classes, whether non-executive or provided by expert fund administrators, this requirement creates a relative opportunity, rather than a challenge, for CI fund managers.

3 Adequacy of local employees and premises (whether retained directly or outsourced) and expenditure

CI-resident fund management companies will be required to demonstrate that there are:

- an adequate level of (qualified) employees in the relevant Island, or adequate level of expenditure on outsourcing to service companies (eg fund administrators) in the Island proportionate to the activities of the company;
- an adequate level of annual expenditure incurred in the Island, or adequate level of expenditure on outsourcing to service companies (eg fund administrators) in the Island, proportionate to the activities of the company; and
- adequate physical offices and/or premises in the Island, or adequate levels of expenditure on outsourcing to service companies (eg fund administrators) in the Island, for the activities of the company.

For the increasing number of CI fund management companies that have already directly engaged employees and occupy their own, dedicated premises in the Islands, these requirements are unlikely to

prove problematic in practice. For those smaller local managers whose board members rely more heavily on the administrative and registered office support of a licensed local fund administrator, the proposals effectively confirm the acceptability of those outsourcing arrangements, so long as an adequate and proportionate level of local expenditure is reflected in the service provider's fees – query whether some administration agreements entered into by those smaller managers may require amendment to ensure that the requisite support is provided.

4 Enhanced corporate income tax return process for (and beyond) the 2019 year of assessment:

The Consultations indicate that the minimum information CI corporate fund managers will be required to submit to their local tax authority through their corporate income tax return for the 2019 year of assessment onwards will include:

- their business activity;
- the amount and type of their gross income;
- the amount and type of their expenses and assets;
- their premises; and
- their number of employees, specifying the number of full time (equivalent) employees.

Some clarification is likely to be needed through the consultation process on the exact meaning of the above terms and how those managers outsourcing some of their staffing and registered office requirements will report on the final two elements.

Impact on CI Fund Companies

In the context of Channel Island funds that are established as companies, the Consultation documents recognise that reduced substance requirements should apply to them as they differ from other companies with geographically mobile income. Fund vehicles are, after all (un-controversially), designed to be tax transparent wherever they may be formed globally. It is proposed that the reduced substance requirements for CI fund companies will therefore be aligned with the applicable regulatory framework in Guernsey or Jersey, as applicable. In any event, many CI funds are, of course, established as limited partnerships or unit trusts, rather than companies.

Implementation and Penalties for Non-compliance

It is proposed that the substance requirements above would be imposed through amendments to the income tax laws of the Islands, implemented for the 2019 year of assessment, to include all CI companies carrying on a "relevant activity" with accounting periods beginning on or after 1 January 2019. It is envisaged that the local tax authorities in the Islands will enforce compliance with the new requirements via a formal hierarchy of sanctions for non-compliant companies, with increasing severity for persistent non-compliance. Sanctions may commence with requests for additional information, the rejection of incomplete returns and formal detailed audits, followed by financial penalties and potentially being struck-off the local register of companies, where there is persistent non-compliance.

New Beneficial Ownership Information and Mandatory Disclosure Rules by 31 December 2019

In line with the expectations of the Code Group's own 8 June 2018 scoping document, the Consultations also signal an intention to progress two additional transparency measure requirements sought by the EU relating to beneficial ownership information and mandatory disclosure rules. The governments of the Channel Islands plan to introduce legislation for mandatory disclosure of legal and beneficial ownership information in relation to bodies corporate, aligned to the EU's Mutual Assistance Directive, by 31 December 2019 (the timescale that countries within the EU are also working towards). Subject to ensuring appropriate data safeguarding measures are in place, this would enable such information to be appropriately shared in a real-time or close to real time manner with EU tax and law enforcement authorities on a reciprocal basis (akin to arrangements already in place with the UK).

Conclusions: Another Welcome Opportunity to Demonstrate how the CIs Embrace Global Standards

For decades the Channel Islands have been amongst the most stable and successful international finance centres in the world. They have demonstrated a clear commitment to the highest standards of tax

transparency and financial regulatory compliance, thereby gaining a well-deserved reputation as trusted and sustainable finance centres.

Successive international assessments by the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes and by MONEYVAL have confirmed the leading position of the Channel Islands. The Islands also have a well-established record as early adopters of international standards, including the OECD's Common Reporting Standard (CRS) and through their early commitment to participating in the OECD's Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Designed to reflect the OECD's Forum on Harmful Tax Practices (FHTP) work on preferential regimes, in accordance with the Code Group's 8 June 2018 scoping document (helpfully reflecting a global, rather than EU-only, standard), these Consultation proposals provide the Channel Islands with another opportunity to demonstrate, in accordance with a new codification assessed by the Code Group, that the substance norms of their fund management industry are accepted and sustainable in the eyes of the international community.

It is also very welcome to see the governments of the Crown Dependencies move forward together in lock-step, with the Isle of Man, on this important international initiative.

Local CI businesses seeking to respond to the Consultations have until 31 August 2018 to do so, via the following links:

Guernsey:

https://www.gov.gg/article/166654/Consultation-on-the-introduction-of-substance-requirements-for-companies-tax-resident-in-Guernsey

Jersey:

https://www.gov.je/Government/Consultations/Documents/Consultation%20on%20the%20introduction%20of%20substance%20requirements%20for%20companies%20tax%20resident%20in%20Jersey.pdf

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