

# BVI economic substance legislation

Last reviewed: December 2019

## Introduction

The Economic Substance (Companies and Limited Partnerships) Act, 2018 (the **Act**) came into force on 1 January 2019 and imposes economic substance requirements on companies and limited partnerships in the British Virgin Islands (**BVI**). The Act was brought into force to address the concerns of the EU Code of Conduct Group (Business Taxation) regarding the existence of a favourable tax regime facilitating offshore structures generating profits without real economic activity. The Act also reflects the BVI's commitment as a member of the OECD's Inclusive Framework on Base Erosion and Profit Shifting (**BEPS**) and, in particular, BEPS Action 5<sup>1</sup>.

The Rules on Economic Substance in the Virgin Islands (the **Rules**) issued by the BVI International Tax Authority (**ITA**) came into force on 31 October 2019, providing useful guidance as to how the economic substance regime will operate in practice. Further, the Beneficial Ownership Secure Search System (Time Limit for Filing Prescribed Information) Regulations, 2019 (the **Regulations**) were issued this month and came into force retrospectively on 1 October 2019. These Regulations set the time limit for filing the prescribed information on economic substance to be the period of six months following the end of the financial period in question.

## In-scope legal entities

The new economic substance regime applies to the following 'legal entities':

- BVI business companies and foreign companies registered in the BVI ; and
- BVI limited partnerships and foreign limited partnerships registered in the BVI.

The definition of 'legal entity' does not include:

- 'non-resident' companies and 'non-resident' limited partnerships, being those entities which are resident for tax purposes in a jurisdiction outside the BVI which is not on the EU's 'blacklist' of non-cooperative jurisdictions for tax purposes<sup>2</sup>; or
- limited partnerships in relation to which the general partner(s) have elected that the limited partnership shall not have legal personality in accordance with the provisions of the Limited Partnership Act, 2017.

<sup>1</sup> The Inclusive Framework on BEPS decided to resume the application of BEPS Action 5 to no or only nominal tax jurisdictions in October 2018. BEPS Action 5 focuses on the requirement for substantial activities in preferential regimes, including intellectual property regimes, which attract geographically mobile business income.

<sup>2</sup> Annex I to the [EU list of non-cooperative jurisdictions for tax purposes](#)

## Relevant activities

A legal entity will fall within the scope of the economic substance regime if it carries on a 'relevant activity'. The term **relevant activity** captures regulated activities such as banking business, fund management business and insurance business, together with distribution and service centre business, finance and leasing business, headquarters business, holding business, intellectual property (IP) business and shipping business. The Act provides further detail as to the meaning of each relevant activity.

## Economic substance test

Under the Act, a legal entity which carries on a relevant activity during any financial period must comply with the economic substance requirements in respect of that activity. If a legal entity carries on more than one relevant activity, it must comply with the economic substance requirements in respect of each activity.

A legal entity complies with the economic substance test if:

1. the relevant activity is directed and managed in the BVI, (the **directed and managed test**);
2. having regard to the nature and scale of the relevant activity:
  - (a) there are an adequate number of suitably qualified employees physically present in the BVI;
  - (b) adequate expenditure is incurred in the BVI;
  - (c) there are appropriate physical offices or premises; and
  - (d) where the relevant activity is IP business and requires the use of specific equipment, that equipment is located in the BVI,(together the **adequacy test**); and
3. the legal entity conducts core income-generating activity (**CIGA**) in the BVI, (the **CIGA test**).

## Directed and managed test

The Rules provide that for a relevant activity to be 'directed and managed' in the BVI, there must be an adequate number of board meetings held in the BVI, having regard to the nature of the relevant activity and its importance in the overall business of the legal entity. Board meetings held in the BVI must have a quorum of directors physically present in the BVI. Board minutes recording decisions regarding the relevant activity should be maintained and kept in the BVI.

## Adequacy test

The Rules do not contain definitions of the terms 'adequate', 'suitable' or 'appropriate' and provide that they must be given their ordinary English meaning. The ITA acknowledge that the employees, expenditure and premises which are adequate or appropriate for one business may not suffice for another and the application of the adequacy test will vary dependent on the facts.

The Rules provide guidance on how to determine the number of employees engaged in a relevant activity and how to account for considerations, such as part-time employees, employees employed for part of the financial period in question and where only part of the employee's role is spent on the relevant activity. It is not necessary that the individual be an employee of the legal entity carrying on the relevant activity. However, they must be managed as if they were an employee of the legal entity.

A BVI-based employee will be treated as physically present in the BVI throughout the period of his employment, including where part of their duties are performed outside the BVI. However, occasional work in the BVI by an employee based overseas cannot be counted.

"Expenditure" means expenditure incurred in the operation of the relevant activity only. The Rules provide that the amount of expenditure incurred and the number of employees (and their qualifications) employed globally in a relevant activity, will be key in determining whether there is adequate expenditure and employment in the BVI. It would not be sufficient to show that the majority of the employees employed in connection with the relevant activity are based in the BVI, if the only employees with the technical qualifications actually to manage the relevant activity are based overseas.

## CIGA test

CIGA will be carried on in the BVI if it is carried on by employees working in the BVI, or outsourced to a person whose employees work in the BVI. The Act lists certain core activities that are considered to be CIGA for the purposes of each relevant activity (and which are detailed in the Schedule to this Guide). The list is not exhaustive and what constitutes CIGA will be determined on the facts in each case.

In addition, as the risk of artificial profit shifting is considered to be greater, the Act contains a rebuttable presumption that a high risk IP legal entity<sup>3</sup> does not conduct CIGA.

## Outsourcing

The Act recognises that legal entities may use service providers located in the BVI to carry out activities on their behalf. The activities of the service provider may be taken into account when considering whether the legal entity meets the economic substance requirements, provided that (amongst other things) the legal entity is able to monitor and control the activity being carried out by the service provider or other entity.

The Rules provide that where a legal entity outsources part of its relevant activity, and that work meets the requirements for outsourcing:

- the expenditure on the outsourcing will be taken into account when assessing the adequacy of the legal entity's expenditure in the BVI.;
- the extent of the work done under the outsourcing arrangement will be taken into account when assessing the adequacy of the number of the entity's employees, and the suitability of their qualifications.

Consequently, the Rules acknowledge that the more work is outsourced for genuine purposes, the fewer the number of employees which need to be employed "in house" in order to have an adequate number of employees.

## Pure equity holding entities

Pure equity holding entities<sup>4</sup> are subject to a reduced economic substance test under the Act. As such, a pure equity holding entity, which carries on no relevant activity other than holding equity participations and earning dividends and capital gains, will have adequate substance if it:

- complies with its statutory obligations under the BVI Business Companies Act, 2004 or the Limited Partnership Act, 2017 (as applicable); and
- had adequate employees and premises for holding and/or managing equitable interests or shares.

Where the legal entity actively manages its equity participations, it should therefore have adequate and suitably qualified employees, and appropriate premises, in the BVI to carry out this function. However, if the legal entity only holds equity participations, the Rules acknowledge that the relevant activity is therefore entirely passive in nature and the requirements for adequate and suitably qualified employees and for appropriate premises will be applied accordingly.

There are no restrictions on the extent to which a pure equity holding entity may outsource its activity in the BVI and the extent of any outsourcing will be taken into account in assessing the adequacy of the employees in the BVI.

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<sup>3</sup> A **high risk IP legal entity** is a legal entity which carries on an IP business and which acquired the IP asset (i) from an affiliate or (ii) in consideration for funding research and development by another person situated in a country or territory other than the BVI; and licenses the IP asset to one or more affiliates or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by foreign affiliates.

<sup>4</sup> A **pure equity holding entity** is a legal entity that only holds equity participations in other entities and only earns dividends and capital gains.

## Timing

The economic substance requirements apply to legal entities formed or incorporated on or after 1 January 2019. Legal entities existing prior to 1 January 2019 were required to comply with the economic substance requirements by 30 June 2019. As detailed above, the Regulations have now prescribed the time limit for filing the required economic substance information as six months from the end of the financial period in question.

## Reporting obligation

The Beneficial Ownership Secure Search System Act, 2017 (the **BOSS Act**) has been amended by the Act in order to facilitate the monitoring and enforcement of the economic substance requirements. The ITA, will assess whether a legal entity has complied with the economic substance requirements based upon information required to be filed by each legal entity with its registered agent (each, an **RA**). That information will be uploaded by the RAs to databases created in accordance with, and searchable upon request from, certain authorities under, the BOSS Act<sup>5</sup>.

## Information to be filed

The information which will need to be filed by a legal entity with its RA in relation to economic substance includes the following:

- whether it carries on a relevant activity and, if so, details of the relevant activities which it carries on;
- where an entity claims to be out of scope of the economic substance regime by virtue of being a non-resident company/limited partnership, confirmation of the jurisdiction in which that entity is tax resident, together with supporting evidence;
- with respect to each relevant activity carried on by a legal entity which is not a non-resident company/limited partnership;
  - the total turnover generated by the relevant activity;
  - the total amount of expenditure incurred on the relevant activity worldwide and the amount of that expenditure which is incurred within the BVI;
  - the total number of employees engaged in the relevant activity worldwide and the total number of those employees engaged in the BVI;
  - the address of any premises within the BVI used in connection with that relevant activity;
  - the nature of any equipment located in the BVI which is used in connection with the relevant activity;
  - the name of the persons responsible for the direction and management of the relevant activity, together with their relationship to the entity and confirmation of whether those persons are resident in the BVI; and
  - where CIGA are carried out on a legal entity's behalf by another entity, the name of the entity which carries out those activities, together with details of the resources deployed by that entity in carrying out the outsourced activities.

If the legal entity files a return that it does not carry on a relevant activity, no further information relating to economic substance is required. Similarly, if the legal entity carries on a relevant activity but claims to be a non-resident company or a non-resident limited partnership, it will only be required to confirm this with evidence of tax residency overseas.

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<sup>5</sup> For more information, see our [Guide](#) on BVI Beneficial Ownership Legislation

## Reduced reporting requirements for holding business

In addition to the reduced economic substance test for legal entities conducting the relevant activity of holding business<sup>6</sup>, reduced reporting also applies requiring only:

- the total number of employees engaged in the relevant activity worldwide and the number of those employees engaged in the BVI; and
- the address of any premises in the BVI which is used in connection with the relevant activity.

## Reporting requirements where the relevant activity is outsourced

Where any aspect of relevant activity is outsourced, the legal entity must:

- identify the name of the third party which carries out the income-generating activity on its behalf;
- identify what activities, and what proportion of the entity's total income-generating activity, is carried out by the third party;
- identify the geographical location of the activities carried out by the third party
- state how the legal entity monitors and controls the activity carried out on its behalf by the third party; and
- state the resources employed by the third party in performing the outsourced activity.

## Penalties

Failure to meet the economic substance test may lead to an initial fine of up to \$20,000 (or up to \$50,000 for high risk IP legal entities). Continued failure to meet the test in the following year could lead to an additional penalty of up to \$200,000 (or up to \$400,000 for high risk IP legal entities), and possibly being struck from the Register. The minimum initial fine is US\$5,000 and minimum fine on second determination of non-compliance is \$10,000.

In determining the amount of the penalty, the ITA will take into account the following factors:

- nature and seriousness of the non-compliance;
- reason for the breach;
- whether this is the first financial period in which the entity has failed to comply with the economic substance requirements, or whether it has previously been deemed non-compliant;
- total turnover of the entity;
- the entity's conduct during the assessment process and (where relevant) following the first determination of non-compliance, and in particular whether it has been cooperative with the ITA; and
- what steps (if any) the entity has taken to prevent a recurrence of the breach.

It is also an offence to fail to provide information requested by the ITA, or to intentionally provide false information, punishable by a fine of up to \$75,000 and/or up to five years' imprisonment.

A legal entity who has been served with a notice of non-compliance by the ITA may appeal against both the determination of non-compliance and the amount of any penalty imposed within 30 days.

## Information sharing

The BOSS Act has also been amended to require the ITA to disclose economic substance information to relevant overseas competent authorities in certain circumstances, including where a legal entity:

- is in breach of the economic substance requirements under the Act; and
- claims to be tax resident in a jurisdiction outside the BVI.

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<sup>6</sup> Holding business is defined in the Substance Act as the "business of being a pure equity holding entity" (ie a legal entity that only holds equity participations in other entities and only earns dividends and capital gains).

In the latter case where an entity is carrying on relevant activities and claims to be tax resident outside the BVI, a notification of this claim will be sent to the jurisdiction in which the entity claims to be tax resident. Furthermore, if a beneficial owner or legal owner of the entity is resident in an EU member state, the competent authority of that member state will also be notified that the legal entity is claiming tax residence outside the BVI and be provided with the name of the jurisdiction in which tax residence is claimed.

## Contacts

A full list of contacts specialising in economic substance legislation can be found [here](#).

## Schedule

### Core income generating activities

Section 7 of the Act defines CIGA as including the following:

- *in respect of banking business*
  - raising funds, managing risk including credit, currency and interest risk;
  - taking hedging positions;
  - providing loans, credit or other financial services to customers;
  - managing regulatory capital;
  - preparing regulatory reports and returns;
- *in respect of distribution and service centre business*
  - transporting and storing goods;
  - managing stocks;
  - taking orders;
  - providing consulting or other administrative services;
- *in respect of insurance business*
  - predicting and calculating risk;
  - insuring or re-insuring against risk;
  - providing insurance business services to clients;
- *in respect of fund management business*
  - taking decisions on the holding and selling of investments;
  - calculating risks and reserves;
  - taking decisions on currency or interest fluctuations and hedging positions;
  - preparing relevant regulatory or other reports for government authorities and investors;
- *in respect of finance or leasing business*
  - 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;
  - managing any risks;
- *in respect of headquarters business*
  - taking relevant management decisions;
  - incurring expenditures on behalf of affiliates;
  - co-ordinating group activities;
- *in respect of shipping business*
  - managing the crew (including hiring, paying and overseeing crewmembers);
  - hauling and maintaining ships;
  - overseeing and tracking deliveries;
  - determining what goods to order and when to deliver them;
  - organising and overseeing voyages;
- *in respect of intellectual property business*
  - where the business concerns intellectual property assets such as patents, research and development;
  - where the business concerns non-trade intangible assets such as brand, trademark and customer data, marketing, branding and distribution.