

Economic substance requirements for Guernsey companies

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Introduction

Guernsey has brought into force the Income Tax (Substance Requirements) (Implementation) Regulations, 2018, as amended (the **Substance Regulations**) in order to address concerns of the EU Code of Conduct Group that certain Guernsey tax resident companies could be used to artificially attract profits that are not commensurate with economic activities and substantial economic presence in Guernsey. EU Finance Ministers signalled their approval of the Substance Regulations by whitelisting Guernsey on 12 March 2019.

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 (as defined below) in respect of accounting periods commencing on or after 1 January 2019 (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 9 below.

The questions below should be considered to determine whether the substance test applies to a company and whether that test will be met. Guidance notes were issued on 26 April 2019 (the **Guidance Notes**) by the Director of Revenue Service (the **Director**) (jointly with the tax authorities in Jersey and the Isle of Man) to clarify how the substance test can be met.

1 Is the company tax resident in Guernsey?

A company will be treated as tax resident in Guernsey in a year of charge if:

- (a) it is controlled, or is centrally managed and controlled, in Guernsey in that year of charge; or
- (b) it is incorporated in Guernsey and has not been granted an exemption from tax for that year of charge, (in each case, a **resident company**).

A company will not however be treated as resident in Guernsey in a year of charge, even if it is incorporated or controlled in Guernsey, if it is proved to the satisfaction of the Director that:

- (a) the company is, under the domestic law of another territory (**Territory A**), tax resident in Territory A; and
- (b) the company's business is centrally managed and controlled in Territory A; and
- (c) either:
 - (i) the company is tax resident in Territory A in accordance with a double taxation arrangement in which a tie-breaker clause applies; 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.

2 Does the resident company have any gross income?

If a resident company does not have any gross income from a relevant activity or specified business in a particular accounting period, then it will not need to comply with the substance requirements in that accounting period. The Guidance Notes contain an anti-avoidance rule for instances where companies seek to manipulate or suppress income to avoid being subject to the substance requirements. A company in liquidation that has gross income from a relevant activity or specified business is subject to the substance requirements albeit that it will be the liquidators of the company that are required to demonstrate that the substance requirements are met.

3 Is the resident company undertaking any relevant activity or specified business?

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

The relevant activities ((a) to (g) inclusive) and specified business ((h) and (i)) (collectively referred to as a **relevant activity**) 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 (and, in this regard, a

company that does not take deposits but is part of a banking group will not be undertaking banking business although it may be undertaking another relevant activity);

- (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. Funds themselves are not caught and neither are other types of services which funds require such as administration, advisory services or custodian services;
- (d) **financing and leasing:** the provision of credit facilities of any kind (including intra-group loans) for consideration (such as interest or a lending fee, but not the grant of security). Companies which purchase debt securities as an investment are not caught. A provider of credit includes a company that becomes the transferee of a loan. 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.

Where credit is offered without expectation of consideration when the credit is provided, it is not caught (such as where an interest free credit period is given on a sale of goods but late payment interest is charged thereafter). Banking, insurance and fund management are excluded from being within the scope of financing and leasing;

- (e) **headquartering:** the provision of any of the following services to non-resident intra-group persons (as defined below) 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 such business undertaken as part of banking, insurance, fund management, financing and leasing, shipping or a distribution and service centre to prevent duplicate reporting. It also excludes 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 non-resident members of the same group and to re-sell them for a profit; or
 - (ii) the provision of services (such as administrative, advisory, consulting or employee services) to other non-resident members of the same group,

but does not include purchasing from, or providing services to, third parties or any such activity undertaken as part of any other relevant activity (banking, insurance, fund management, financing and leasing, shipping or headquartering) to prevent duplicate reporting. Services provided under sub-paragraph 3(g)(ii) need have nothing to do with distribution undertaken in sub-paragraph 3(g)(i) so companies that provide any services to non-resident members of the same group will be subject to the Substance Regulations.

The Substance Regulations use the term 'group' which is a collection of enterprises related through ownership or control such that it is either required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange;

- (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 trademarks, and the rights and interests in those assets (see paragraph 7 below); 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**) (see paragraph 9 below).

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 given the level of decision-making required at that level (and, for these purposes, it is not necessary that all board meetings are held in Guernsey provided that a majority are and even companies with a minimal level of activity should hold at least one board meeting each year);
- (b) during each board meeting, a quorum of directors is physically present in Guernsey (quorum being determined in accordance with the Companies Law and a company's articles of incorporation) and where a company has a sole director, written resolutions are signed while the director is physically present in Guernsey;
- (c) strategic decisions of the resident company are set at board meetings and the minutes reflect those decisions (and such minutes should refer to all relevant decisions taken, even where a course of action has been considered and rejected);
- (d) the board of directors, as a whole, have the necessary knowledge, expertise and experience to discharge their duties as a board (and they are not giving effect to decisions taken outside of Guernsey whether by the directors or others); 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 (eg constitutional documents, financial statements, operating licences, copies or originals of major funding documentation and mortgages and other documents required by a board of directors to make decisions; and in the case of a non-Guernsey company that is Guernsey tax resident, additional requirements apply).

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 all of a resident company's CIGA are performed in Guernsey. It is not necessary for a resident company to perform all of the CIGA listed in the Substance Regulations for the particular relevant activity, but it should perform the CIGA that generates the income that it has.

The CIGA for:

- (a) **banking** includes 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 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 (and the majority of those making the decision should be physically present in Guernsey), calculating risk across a fund and the reserves required on a strategic basis, taking decisions on currency or interest

- fluctuations and hedging positions in relation to a fund's position as a whole and ensuring that systems and processes are in place to ensure timely and accurate preparation of regulatory reports and returns;
- (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 (and the majority of those making the decisions should be physically present in Guernsey), incurring expenditures on behalf of group entities and co-ordinating group activities to produce the best outcome for the group;
 - (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 particular relevant activity in order to demonstrate substance but the appropriate CIGA should be undertaken in Guernsey;
- (b) a resident company may undertake or outsource all or part of an activity outside of Guernsey only if that activity is not part of the CIGA (eg back office functions);
- (c) the CIGA requirements do not preclude resident companies seeking expert professional advice or engaging the services of specialists in other jurisdictions;
- (d) a fund manager can appoint one or more brokers outside Guernsey to buy and sell investments and may even give those brokers some discretion to execute trades without breaching the requirement for CIGA to be conducted in Guernsey provided that the brokers act within investment parameters set by the fund manager which are carefully monitored and controlled by the fund manager;
- (e) a company undertaking financing and leasing business will need to evidence decision making by its board in relation to decisions to lend, setting the terms of loans and monitoring and managing the risk of loans;
- (f) whether a company will be undertaking headquartering will depend on the extent to which management and responsibility for subsidiaries by the company is in fact taking place;
- (g) where CIGA is undertaken for the resident company by another entity in Guernsey (eg by an administrator or another group company), the company must be able to demonstrate that it supervises the carrying on of that activity by the other entity and, to meet the substance test, that it undertakes such supervision in Guernsey;
- (h) 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);
- (i) the income subject to tax in Guernsey must be commensurate to the CIGA undertaken in Guernsey; and
- (j) the Guidance Notes contain no guidance in relation to insurance, shipping and intellectual property assets which will be included in a later edition.

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.

For the purposes of assessing adequacy:

- (a) what is adequate will be assessed by reference to its ordinary dictionary meaning being 'enough or satisfactory for a particular purpose' which will be dependent on the particular facts of the company and its business activity;
- (b) owner-managers and directors will be treated as employees;
- (c) employees must collectively demonstrate appropriate qualifications, experience, competency and a broad, complementary skill set relevant to the relevant activities undertaken;
- (d) when considering what an adequate number of qualified employees is, this must relate to the employees needed to conduct the relevant activity as a whole and not just the CIGA (and employing qualified staff, and adopting digitisation and automation of processes, may mean that fewer staff are needed);
- (e) the employee count is based on the number of full time equivalents (**FTE**) working a 35 hour week (so, if two people worked part time for 17.5 hours a week for or on behalf of a company during an accounting period, this would equal one FTE and, for these purposes, directors should be counted as a fraction of a FTE reflecting the time committed to the role);
- (f) where a company outsources its CIGA to a service provider in Guernsey (and provided that the company adequately supervises the outsourced activities):
 - (i) the time spent by the staff of that service provider providing services to the company will count towards assessing whether the company has an adequate number of employees;
 - (ii) where the service provider makes available meeting rooms for board meetings to be held in Guernsey, that this will count towards assessing whether the company has adequate premises; and
 - (iii) the cost of outsourcing to a service provider in Guernsey will count towards assessing whether the company has an adequate level of expenditure.

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.

It should be noted that for IP assets such as patents, it is expected that the CIGA will include research and development. For non-trade intangible assets such as brand, trademark and customer data, it is expected that the CIGA will include marketing, branding and distributions activities. However, the CIGA associated with an intangible will depend on the nature of the asset and how it is used to generate income. Periodic decisions by non-resident directors or local staff holding intangible assets will not be capable of demonstrating CIGA for intellectual property.

As noted above, the Guidance Notes contain no guidance in relation to intellectual property assets which will be included in a later edition.

8 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.

The Guidance Notes contain no guidance in relation to high risk IP companies which will be included in a later edition.

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

A resident company which is a pure equity holding company with gross 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, which are controlling stakes, in other companies. It will be subject to the substance requirements if it receives income as a beneficial owner (and not, for example, as trustee or general partner) from those holdings;

- (b) does not carry on any commercial activity (and, for these purposes, placing dividend monies on deposit or using them to acquire and passively hold other securities will not constitute a commercial activity); and
- (c) is a holding company within the meaning of section 531 of the Companies Law (disregarding subsections 531(6) and (7)).

If a holding company is also conducting another relevant activity, then the higher substance requirements of the other relevant activity will apply.

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.

Self-assessment and reporting

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. The Guernsey corporate income tax return (and any related guidance) has not yet been issued however 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 (Guernsey) Law, 1975.

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 the Director's 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.

The Director may, in addition to the imposition of a financial penalty, 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. Mourant can assist Guernsey companies carrying on a relevant activity which needs advice on complying with the Substance Regulations.

Things to think about

It is recommended that 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) 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;
- (j) assessing the adequacy of the supervision and monitoring by the company of any outsourced CIGA;
- (k) 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;
- (l) implementing procedures now to ensure that information required to be provided to the Director will be available to be included in future returns; and
- (m) documenting policies and procedures to improve decision making, implementation and oversight.

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