

UPDATE

Economic substance in the BVI

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The Economic Substance (Companies and Limited Partnerships) Act, 2018 came into force on 1 January 2019 and imposes economic substance requirements on companies and certain limited partnerships in the BVI

Introduction

In December 2017, the British Virgin Islands (**BVI**) committed 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 Economic Substance (Companies and Limited Partnerships) Act, 2018 (the **Act**) is the BVI's response to those concerns and 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 5¹.

Whilst the Act came into force on 1 January 2019, the new economic substance regime will be implemented in accordance with regulations which are yet to be issued. We anticipate that those regulations will provide additional detail and depth to the framework introduced by the Act and will release a client Guide once more detail is available.

In-scope legal entities

The new economic substance regime applies to **legal entities**, the definition of which includes:

- 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 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 purposes²; 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.

¹ 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.

² Annex I to the EU list of non-cooperative jurisdictions for tax purposes. See <https://www.consilium.europa.eu/media/31945/st15429en17.pdf>

Relevant activities

A legal entity will fall within 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.

What is the 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.

The economic substance test has three limbs, and a legal entity complies with the economic substance requirements if:

1. the relevant activity is directed and managed in the BVI;
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 (whether or not employed by the legal entity and whether on temporary or long-term contracts);
 - (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, (referred to in this Update as the **adequacy test**); and
3. the legal entity conducts core income-generating activity (**CIGA**).

The Act lists certain core activities which are considered to be CIGA for the purposes of each relevant activity.

We anticipate that the regulations to be issued pursuant to the Act will provide more detail as to the meanings of the terms 'adequate' and 'appropriate' for the purposes of the adequacy test, as well as clarifying the kind and level of actions required for a relevant activity to be 'directed and managed' in the BVI.

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 entity³ does not conduct CIGA.

Pure equity holding entities

Pure equity holding entities⁴ are subject to a reduced economic substance test under the Act. 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.

As noted above, it is anticipated that the regulations to be provided under the Act will provide more detail as to what constitutes 'adequate' employees and premises for these purposes.

³ 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.

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

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 a service provider attributable to generating income for a legal entity may be taken into account when considering whether that legal entity meets the economic substance requirements applicable to it, provided that (amongst other things) the legal entity must be able to monitor and control the activity being carried out by the service provider or other entity.

When do the economic substance requirements apply?

The economic substance requirements apply to legal entities formed or incorporated on or after 1 January 2019 with immediate effect, and economic substance filing/reporting (see below) must be made by each such 'new' legal entity in relation to each financial period of that entity.

Legal entities existing prior to 1 January 2019 must comply with the economic substance requirements by 30 June 2019.

Reporting obligation

The Beneficial Ownership Secure Search 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 BVI's competent authority, the International Tax Authority (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 Act⁵.

The information to be filed by a legal entity with its registered agent in relation to economic substance primarily includes the following:

- any relevant activities carried on by that entity;
- where an entity carries on a relevant activity but is 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 amount of expenditure incurred on the relevant activity within the BVI;
- the total number of employees incurred in relation to that relevant activity;
- the address of any premises within the BVI used in connect with that relevant activity;
- the nature of any equipment located in the BVI which is used in connect with the relevant activity; and
- 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.

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). The minimum initial fine is US\$5,000. 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 additional fine is US\$10,000.

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.

⁵ For more information, see our Update [Mourant: Offshore Law Firm | BVI's beneficial ownership legislation](#)

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.

Contacts

To find out more, please get in touch with your usual Mourant contact or, alternatively, contact one of the specific contacts named below.



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