

UPDATE

# Further clarity on economic substance issues for Channel Islands Fund Managers

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Joint Guidance Notes (JGNs) have been published setting out further detail on the application of the new economic substance legislation in each of the three Crown Dependencies of Jersey, Guernsey and the Isle of Man. This note considers key aspects from a fund management perspective.

## Background

The governments of Jersey and Guernsey, together with the Isle of Man, consulted with industry in summer 2018 with a view to demonstrating their cooperative policies with the EU's Code of Conduct Group on Business Taxation (the **Code Group**) and that the activities of Channel Islands tax resident companies carrying on certain relevant activities (including fund management) are carried out with an appropriate level of substance.

Consequently new legislation was passed by each of the Channel Islands which took effect from 1 January 2019: the Taxation (Companies – Economic Substance) (Jersey) Law 2019 in Jersey and the Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance, 2018 and Income Tax (Substance Requirements) (Implementation) Regulations, 2018 in Guernsey (together, the **Substance Laws**).

EU Finance Ministers signaled their approval of the Substance Laws by 'whitelisting' both Jersey and Guernsey on 12 March 2019 and removing them from the EU's so called 'grey list' of non-cooperative countries.

## Joint Guidance Notes

The JGNs were released on 26 April 2019 and are designed to help relevant companies interpret the Substance Laws. The JGNs are framed at a high level, as they will be applied across all three Crown Dependencies. It has been made clear that the JGNs will be updated and re-issued from time to time as a working document. The JGNs add to existing guidance which was contained in a 'Key Aspects Document' (KAD) most recently updated on 21 December 2018.

In preparing the JGNs, there has been a particular focus on fund management activities, being one of the areas that the Code Group and the OECD have focused on, from a policy perspective, in framing economic substance requirements.

This note summarises the impact of the Substance Laws on Channel Islands tax resident fund managers and the key guidance provided for Channel Islands fund managers in the KAD and JGNs.

## Who is in scope for fund management?

Jersey or Guernsey tax resident corporate managers to funds (which will include corporate GPs to fund partnerships) will be in scope of the regime. This will apply notwithstanding whether or not the fund is regulated and whether or not the fund is established in the relevant Island or elsewhere.

The Substance Laws and JGNs (together with previous guidance) provide that funds themselves (whether corporate or other structures) are out of scope. As are service providers to funds such as administrators, custodians and advisors (although advisory services, where provided in Jersey or Guernsey to a connected entity non-resident in the relevant Island, may fall within the relevant activity of 'distribution and service centre activities' – see our separate JGNs briefing on this).

In practice it is anticipated that the additional operational requirements of the Substance Laws will sit naturally with the regulatory regimes and governance procedures that Channel Islands managers are already subject to.

The details of the proposed new substance requirements for Channel Islands tax resident fund management companies are as follows:

## **The Substance Tests – three tests, plus additional reporting of information**

### **1 The Directed and Managed Test: governance requirements**

Channel Islands 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 'overarching strategic' 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.

In most cases the above requirements are likely to reflect the pre-existing operational arrangements for fund management boards, but in light of this new codification particular care will be needed to ensure that these areas are fully considered and documented.

The JGNs underline that where any substantive decision-making takes place in a forum without reference to, or oversight of, the board, it is unlikely that the board is making strategic decisions in accordance with the directed and managed test. However the JGNs recognise that in some cases board meetings may be held overseas, for example where linked to negotiations related to a transaction, which will provide helpful flexibility in practice. There are further details in the JGNs in relation to record-keeping, as well as measures that will apply to companies in liquidation (which will remain subject to the relevant substance requirements).

### **2 The Core Income Generating Activity Test: fund management activities and outsourcing**

Channel Islands resident fund management companies will also be required to demonstrate the carrying on of some of the following **four 'core income generating activities' (CIGA)** in the relevant Island.

The KAD and the JGNs helpfully clarify that it is not necessary for the company to perform **all** of the CIGA in the Island, but it must perform the CIGA that generate the income that it has.

The four fund management CIGA are:

- **'taking decisions on the holding and selling of investments'**. The JGNs emphasise that this CIGA is concentrated on decision-making, and recognise that implementation of these decisions by another entity (for example in a jurisdiction where fund assets are located) will not itself constitute CIGA and will not undermine the CIGA which is being conducted by the fund manager in the Island. In practice a measure of investment management discretion within the strategy set by, and under the supervision and monitoring of, the fund manager will be able to be delegated to advisers or other appointees in a jurisdiction outside the Island which is more closely linked to the underlying assets or to available expertise. This builds on previous guidance that advisory services from outside the Island are permitted, but is a welcome further clarification.

- **'calculating risks and reserves'**. The JGNs clarify that this CIGA should be construed widely as the calculation of risks across the fund portfolio on a strategic basis, with the examples of market risk, credit risk, (where applicable) liquidity risk and operational risk provided.
- **'taking decisions on currency or interest fluctuations and hedging positions'**. The JGNs provide that relevant activities in this area are decisions related to the determination of whether the fund is exposed to (or if it is in the best interests of the fund to enter into) hedging arrangements against currency or interest fluctuations. Again, as with the other fund management CIGA, the focus will need to be on the whole fund's strategic position:- and the JGNs provide that isolated decisions involving specific investments would not be sufficient to comprise CIGA.
- **'preparing reports and returns to investors and the relevant financial services regulator or any body or entity with equivalent functions relating to the supervision or regulation of such business'**. The JGNs provide that this CIGA involves ensuring that systems or processes are in place, including contractual arrangements with an administrator, such that the manager is well-placed to be able to timeously and accurately convey the position of relevant funds at any time. However the JGNs also provide that, although the fund manager will have ultimate responsibility, this CIGA will not necessarily involve the manager itself participating in the administrative task of compiling returns.

The above, of course, are core fund management activities which have long been the preserve of many Channel Islands fund managers, but care will need to be taken to ensure that any income-generating CIGA which are being undertaken by the fund manager can be shown to be being undertaken by the manager, with input from a local administrator where necessary, and that income-generating CIGA are only outsourced to non-resident investment managers or advisors within the parameters of the KAD, the JGNs and applicable regulation.

### **Permissible Outsourcing:**

The KAD and JGNs confirm that the Substance Laws do not prohibit a company from outsourcing some or all of its activity. The KAD confirms that undertaking or outsourcing all or part of a 'non-CIGA' activity outside the Island and/or seeking expert professional advice or engaging the services of specialists in other jurisdictions, will not affect the company's ability to meet its substance requirements, however the company's income subject to tax in the Island must be commensurate to the CIGA undertaken in the Island.

The KAD and JGNs further confirm that where some or all of the company's CIGA is outsourced, the company must be able to demonstrate that it has adequate supervision of the outsourced activities. Where a CIGA is outsourced to a service provider in the Island, the resources of that service provider will be taken into consideration when determining whether the people and premises test is (see below).

Local regulatory restrictions on outsourcing must also be taken into consideration.

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

Channel Islands resident fund management companies will also be required to demonstrate that there are:

- **an adequate level of (qualified) employees in the relevant Island** proportionate to the level of activity carried out in the Island. The JGNs include clarification that directors should be included in the calculation of employees and staff of a service provider to the company (eg a fund administrator) within the Island (provided that there is no double counting of time-spent). Reflecting an element of commercial flexibility, there is also recognition that better qualified staff would be required to spend less time engaged in relevant activities, and also that increases in technology and automation of processes would be anticipated to lead to a lower amount of time spent in carrying out relevant activity;
- **adequate physical offices and/or premises in the Island**, or adequate levels of outsourcing to service companies (eg a fund administrator) in the Island, for the premises of the company; and
- **an adequate level of annual expenditure incurred in the Island**, or adequate level of expenditure on outsourcing to service companies (eg a fund administrator) in the Island, proportionate to the level of activity carried on in the Island.

## 4 Reporting to tax office

A number of references are made to 'reporting of information' in the Substance Laws. At this stage the forms of tax return to be completed and filed with the local tax offices in the relevant Island have not been issued, but it is clear that information to be reported by a Channel Islands fund management company will include:

- identification of the company's type of 'relevant activity' (ie fund management);
- amount/type of income derived from relevant activities (ie fund management) – anticipated to be based off a turnover figure contained in financial statements;
- amount of operating expenditure relating to the relevant activity – also anticipated to be based off a turnover figure contained in financial statements;
- details and address of the company's premises in the Island;
- number of (qualified) employees, specifying the number of full time equivalents;
- confirmation of each 'core income generating activity' (CIGA) conducted for each relevant activity;
- the company's latest financial statements; and
- confirmation and relevant details of whether and how any CIGA have been outsourced.

Relevant companies and their administrators should be implementing procedures now to ensure that information on these various items, from 1 January 2019, will be available to be included, with a view to reporting, in most cases, in the second half of 2020.

### **Mourants' View:**

#### **Evolution, not revolution**

Those familiar with the growth and continued development of fund management companies based in the Channel Islands will know that they have typically led offshore industry best practice across governance, regulation and management substance.

These arrangements have long been reflected in the local regulatory regimes, which have been recognised by international standard-setters, with the Guernsey and Jersey Financial Services Commissions generally requiring the appointment of experienced local directors on the boards of regulated fund managers and the appointment of a licensed local service provider to administer a Channel Islands fund.

In recent years, substance has been an increasingly important part of governance and regulatory arrangements. In many cases this has included fund managers bolstering local substance by employing their own dedicated employees and occupying their own premises in the relevant Island. In other cases this has been achieved through reliance on increasingly sophisticated support from local service providers across the areas of risk management, compliance, reporting, administration, governance and technology.

It is likely therefore that, in most cases, the effect of the Substance Laws, KAD and JGNs will be a modest and natural overlay across the substance and governance arrangements already largely adhered to by the local fund management industry. In light of the recent EU whitelisting of both Channel Islands and the fact that companies which are in scope are now required to conduct their business in compliance with the Substance Laws, this additional guidance will be welcomed by boards, shareholders and administrators of relevant Channel Islands companies. In some cases, however, current outsourcing arrangements may need to be revisited.

The JGNs as initially released are stated to be subject to further review and development over time, and this approach should provide flexibility to allow companies to adapt to the new rules.

#### **How Can We Help You?**

The Substance Laws took effect from 1 January 2019, so there are a number of actions which relevant companies must be undertaking to ensure compliance – from clarifying their tax residence and entity classification, to the structuring of contractual and outsourcing arrangements, the organisation of their corporate governance, their employment and premises arrangements and the capturing of relevant business information required in due course for the preparation and filing of reporting information to the relevant tax office. The penalties for non-compliance with the Substance Laws include financial penalties,

spontaneous exchange of relevant information with relevant EU Member States and (eventually) striking off the relevant Channel Islands companies register.

Mourant has experience of working closely with the boards of fund managers which are in scope of the Substance Laws, as well as shareholders and administrators of those Channel Islands companies, and can assist in navigating these issues.

To facilitate fund manager compliance with the Substance Laws, we can map, review and advise on existing fund management structures, contracts and governance arrangements, and provide template board papers and resolutions, contract updates, offering document disclosure and other documentation, to support economic substance compliance.

## 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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