

# ECONOMIC SUBSTANCE

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# Overview of the requirements

- \* The economic substance requirements apply to all companies that are tax resident in the Island and which have income from a relevant sector in any accounting period commencing on or after 1 January 2019.
- \* Income for the purposes of the economic substance requirement is gross income not taxable income/profit or accounting income/profit.
- \* If there is any indication that a company is seeking to manipulate or artificially suppress its income to avoid being subject to substance requirements the respective Tax Administrations will take the appropriate action.

# Relevant sectors

- \* The relevant sectors are:
  - \* Banking
  - \* Insurance
  - \* Shipping
  - \* Fund management (not including Collective Investment Vehicles)
  - \* Finance and leasing
  - \* Headquartering
  - \* Distribution and Service Centres
  - \* Operation of a Holding Company
  - \* Holding intangible property (Intellectual Property)

# Relevant sectors (2)

- \* The legislation includes a definition of the activity that falls within each of these sectors.
- \* Collective investment vehicles are out of scope if they are subject to regulation in the Island.

# Adequate substance

- \* All companies with activities and income in a relevant sector in an accounting period will be required to demonstrate that they have adequate substance in the Island.
- \* The adequate substance requirements, will generally require that a company:

# Adequate substance (2)

- \* is directed and managed in the Island;
- \* has an adequate number of (qualified) employees proportionate to the level of activity carried on in the Island;
- \* has adequate expenditure proportionate to the level of activity carried on in the Island;
- \* has an adequate physical presence in the Island; and
- \* conducts core income-generating activity ('CIGA') in the Island
- \* There are reduced requirements for (pure equity) holding companies, which will be outlined in later guidance.

# Sanctions

- \* If a company in a relevant sector does not meet the economic substance requirement in an accounting period, it will be subject to sanctions.
- \* These sanctions include exchange of information with Competent Authorities in other jurisdictions, financial penalties and, ultimately, striking off the companies register.
- \* Exchange of information with Competent Authorities in other jurisdictions will take place in respect of each period that the company fails to meet the economic substance requirement.

# Sanctions (2)

- \* Exchange of information will also take place in respect of all High-Risk IP Companies, whether the company fails the economic substance requirement or not.
- \* Exchange of information will take place with the Competent Authority in the jurisdiction where the immediate parent company, ultimate parent company and the ultimate beneficial owners are resident.
- \* Such exchange of information will be made in accordance with the existing international tax exchange agreements in place between the Island and the jurisdiction of residence.

# Sanctions (3)

- \* Financial penalties will be charged in respect of each period in which the company fails to meet the economic substance requirements, and will increase in cases of repeated periods of failure.
- \* Referring the company for strike off from the register is the ultimate sanction where there are repeated periods of failure.

# Reporting of information

- \* As part of its income tax filing process, companies carrying on relevant activities will be required to provide the following information:
  - \* business/income types in order to identify the type of relevant activity;
  - \* amount and type of gross income by relevant activity - this will generally be the turnover figure from the financial statements;
  - \* amount of operating expenditure by relevant activity - this will generally be the company's operating expenditure from the financial statements, excluding capital;
  - \* details of premises - business address;
  - \* number of (qualified) employees, specifying the number of full time equivalents;

# Reporting of information (2)

- \* confirmation of the Core Income Generating Activities (CIGA) conducted for each relevant activity;
- \* the financial statements; and
- \* confirmation of whether any CIGA have been outsourced and if so relevant details.
- \* net book value of tangible assets.
- \* It is expected that the carrying on of relevant activities will result in the generation of income.

# Reporting of information (3)

- \* The legislation in each Island also includes specific powers to request additional information in relation to any substance information provided on or with the income tax return.
- \* The legislation also includes specific sanctions to address circumstances where companies have acted so as to avoid or seek to avoid the application of the economic substance requirements.

# Cell companies

- \* Cell companies can be either Protected Cell Companies (PCC) or Incorporated Cell Companies (ICC).
- \* Whilst both PCCs and ICCs are subject to the economic substance requirements when they have income from a relevant activity, how the requirements are applied varies.

# PCC

- \* A PCC is a single legal entity.
- \* The tax treatment reflects this status, therefore a PCC will be required to satisfy the economic substance requirements at a whole entity level including the activities and resources of all its protected cells (ie each cell will need to demonstrate that it conducts CIGA in the island).
- \* The individual protected cell is not itself a corporate body and so its activities and resources form part of the overall substance information to be reported by the PCC, and it is not required to report any economic substance requirements on its own account.

# ICC

- \* An ICC is a legal entity; its incorporated cells are also legally separate entities.
- \* The ICC will only have to satisfy the economic substance test in relation to any activities it conducts itself, and not for any relevant activities conducted by its incorporated cells (IC), and not taking into consideration any resources of its ICs.
- \* Each IC will have to satisfy the economic substance test in relation to its own activities and referring to its own resources, without taking into consideration any resources of any other ICs or the ICC.

# Core Income Generating Activities (CIGA)

- \* CIGA are the key essential and valuable activities that generate the income of the company.
- \* It is not necessary for the company to perform all of the CIGA listed in the legislation for the particular sector, but it must perform the CIGA that generate the income it has.
- \* In order to meet the economic substance requirement the CIGA that generate the income must be performed in the Island.
- \* Where the CIGA involves making relevant decisions, then the majority of those making the decisions must be present in the island when the decision is made, otherwise the decision will not be considered to be made in the Island.

# CIGA (2)

- \* Activities undertaken outside the Island must not be core income generating activities.
- \* For example, general support functions such as IT support or HR functions are a necessary activity for the majority of companies, but they do not generate income for the company.
- \* The taking of decisions outside the Island would generally indicate performance of CIGA outside the island.
- \* However, isolated decisions may be taken outside the Island provided that it can be evidenced that the decisions taken and the CIGA undertaken in the Island are of a quality and quantity to clearly outweigh the question that the CIGA involving the decisions is undertaken outside the Island.

# Relevant sectors

- \* There follows for each relevant sector a summary of the scope, the applicable CIGA and some basic scenarios which meet the economic substance requirement and some basic scenarios which do not meet the economic substance requirement. The scenarios are not exhaustive, instead they are designed to demonstrate the principles that should be applied across each of the relevant sectors to companies within scope.

# Relevant sectors (2)

- \* The relevant sectors are as follows:
  - \* (Pure Equity) Holding Company
  - \* Banking
  - \* Finance and Leasing
  - \* Insurance
  - \* Distribution and Service Centre
  - \* Headquartering
  - \* Shipping
  - \* IP Company
  - \* High Risk IP Company
  - \* Group / connected person

# (Pure Equity) Holding Company

- \* A company will be regarded as a (pure equity) holding company if its sole function is to acquire and hold equities, and the equities in question are controlling stakes in other companies.
- \* If a company carries on any other relevant activity (whether or not for profit), then it would not fall within the definition of a (pure equity) holding company. It would remain subject to the higher substance requirements of that other relevant activity.
- \* If a company meets the criteria to be regarded as a (pure equity) holding company, the placing of dividend monies received on deposit or using them to acquire and passively hold other securities such as gilts, will not constitute a “commercial activity” and therefore the company will still be regarded as a (pure equity) holding company and subject to substance requirements.

# Holding company – example 1

- \* Midco Ltd is an intermediary (pure equity) holding company in a group structure, it holds 100% of the shares in three other companies and receives dividends annually. This is Midco Ltd's only activity.
- \* Question – Is Midco a (pure equity) holding company?

# Holding company – example 2

- \* Restaurant Ltd runs 2 restaurants, it also acquired all the shares in another company Bistro Ltd which is constructing a new restaurant.
- \* Question – is Restaurant Limited a (pure equity) holding company?

# Banking

- \* The companies within the scope of these activities are deposit taking businesses which are subject to regulation as banks in each of the Islands.
- \* All such companies should be easily identifiable as they are required in all 3 Islands to hold a licence issued by the financial regulator.

# Banking - example

- \* High Street Savings Ltd has a number of branches from which it offers current or savings accounts and other banking services.
- \* Question – is High Street Savings Limited a bank under these rules?

# CIGA for banking

- \* The legislation sets out a list of CIGA for banking, which are described below.
  - \* **‘raising funds, managing risk including credit, currency and interest risk’** – these are the activities of ensuring the bank has an adequate capital base. Whilst raising funds clearly includes taking deposits it can also include going to the money markets, issuing bonds or new capital. The risks to be managed will be linked to ensuring that this capital base is not eroded.
  - \* **‘taking hedging positions’** – banks need to ensure that where there is risk they mitigate it, this is often done by taking hedging positions. In such situations the bank must be able to show that it has taken the decisions.

# CIGA for Banking (2)

- \* **providing loans, credit or other financial services to customers'** – banks will utilise the moneys they have received from deposits to provide other financial products and services, such as loans and mortgages, to customers. There is a wide range of products and services which may be offered. The term “customer” is not just limited to retail customers, but could also be corporate groups, or other financial institutions. The bank will need to be able to show it offers such financial products and services.
- \* **'managing capital and preparing reports and returns for bodies with supervisory and regulatory functions'** - The banking sector is highly regulated, and there are substantial reporting requirements made of the sector. The bank would need to perform this reporting.

# CIGA for banking (3)

- \* Whilst it is expected that regulated companies carrying on banking will already be able to demonstrate that they conduct the CIGA in the Island, those companies are still subject to the substance requirements.
- \* The regulatory environment in the Islands for banking activities is such that where there is a possibility that there is a failure relating to CIGA, this would indicate serious regulatory risk, and in such situations discussions with the regulators and the priority of actions to protect the local economy would need to be considered.

# Finance and Leasing

- \* The definition encompasses any company which offers credit or financing of any kind for consideration, such as loans, hire purchase agreements, long term credit plans, and finance leases in relation to assets other than land. This includes intra-group financing.
- \* The scope also extends to the situation where a loan advanced for consideration by one company, which is within the scope of this sector, is transferred to a different company which then receives the loan capital repayments and consideration.
- \* The scope does not extend to cases where credit is offered and there is no expectation of consideration from the credit when providing it. A lending fee would be consideration, whereas the grant of security in favour of the lender would not constitute consideration.

# Finance and Leasing (2)

- \* The scope does not extend to cases where the company has purchased debt securities as an investment, as opposed to providing a credit facility, for example, where the company has purchased gilts, quoted bonds or similar securities which are actively traded on one of the major security exchanges.
- \* In banking, insurance and fund management businesses it may be a normal part of their activities to provide credit, and so these sectors are excluded from being within the scope of Financing and Leasing, to prevent duplicate reporting.

# Finance and Leasing - example

- \* ABC Ltd lends £1,000,000 to its subsidiary, CDE Ltd, at a 5% interest rate. ABC Ltd's activities would come within the definition of financing and leasing.
- \* The loan of £1,000,000 to CDE Ltd, is transferred by ABC Ltd to another company 123 plc. 123 plc's activities in relation to the loan now come within the definition of financing and leasing.
- \* Question – is ABC Ltd still deemed to be carrying on the activity of finance and leasing?

# CIGA for Financing and Leasing

- \* The legislation sets out a list of CIGA for financing and leasing, which are described below.
  - \* **'Agreeing funding terms'** refers to funding of the lender or lessor itself and includes agreeing the type of funding (e.g. equity/preference shares/debt/bank borrowing etc.), the quantum of funding, the rates of interest payable, the security given (if any), and any covenants.
  - \* **'Identifying and acquiring assets to be leased'**, includes agreeing a suitable price or quantity, identifying sources of those assets, and negotiating the acquisition and the terms of supply.

# CIGA for Financing and Leasing (2)

- \* **‘Setting the terms and duration of any financing or leasing’** includes the financial terms, the parameters as to acceptable counterparties, the amounts, rates of interest, the legal agreements and the period for which financing or leasing is to be provided.
- \* **‘Monitoring and revising any agreements’** includes the acquisition of data about a borrower or lessee (or group of them), testing against covenants, extending durations of loans, and feeding back into decision making on writing new terms.
- \* **‘Managing risk’** includes instigating debt collection, considering spreading of risk across sectors or consumer groups. In leasing it includes monitoring and maintaining the underlying assets.

# Fund Management

- \* The definition of fund management encompasses companies which provide management services in relation to funds (i.e. Collective Investment Vehicles) but does not include the fund itself.
- \* Those activities which are caught are the provision of fund management services to a fund, in relation to its investment decisions, and its risk decisions. All companies that provide fund management services are subject to substance requirements. This includes when the fund manager and the CIV are part of the same legal entity.
- \* Other types of services which funds require such as administration, advisory services or custodian services are not within the activities defined.

# Fund Management - example

- \* Black Ltd is a company which undertakes fund management activities in relation to a number of funds which requires it to be licensed, as a fund manager, with the regulator.
- \* Question – is Black Ltd subject to the substance requirements?

# CIGA for Fund Management

- \* The legislation sets out a list of CIGA for fund management, which are described below.
  - \* **‘Taking decisions on the holding and selling of investments’** - The CIGA is concentrated on the taking of decisions. A company which is implementing decisions of another entity, by selling investments, does not perform the CIGA. It is a commercial reality that in some circumstances a committee of directors, or an investment committee will take decisions when not all the members are physically present. For a decision to be determined as being taken in a jurisdiction for the purposes of this CIGA, the majority of those making the decision should be physically present in that jurisdiction.

# CIGA for Fund Management (2)

- \* **‘Calculating risk and reserves’** - Funds are vehicles where capital is pooled and risks spread over a number of investments. In managing the fund consideration must be given to risk in a number of areas: market risk, credit risk (where applicable), liquidity risk as well as operational risks. The CIGA looks at risk as a whole, and so this CIGA will not be being performed if the calculations are limited to a marginal calculation for one area of applicable risk and do not encompass other areas of applicable risk. Rather this CIGA is calculating the overall risk across the fund and the reserves required on this strategic basis.

# CIGA for Fund Management (3)

- \* **‘Taking decisions on currency or interest fluctuations and hedging positions’**- The activities are those required to determine if 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, and take relevant decisions regarding those determinations. As with the other CIGA this is in relation to the whole fund’s position, and isolated decisions involving specific investments is not sufficient to meet the CIGA, it has to be a strategic approach.

# CIGA for Fund Management (4)

- \* **‘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’** – This CIGA does not necessarily involve the administrative task of compiling the various routine annual or quarterly returns, albeit it is expected that the company would have the ultimate responsibility for this. Rather it is ensuring that the systems and processes are in place, including the contractual arrangement with the administrator, together with the understanding and knowledge within the company, such that the company is well placed to timeously and accurately convey the position of the fund(s) at any time.

# Insurance

- \* The definition encompasses companies which undertake insurance business in or from the Island as an insurer, in both the life and non-life sectors, and this includes reinsurance. These companies will be regulated in relation to these activities.
- \* Other companies which undertake activities connected with insurance (for example insurance brokers or other intermediaries) or provide services to insurers (for example insurance managers), but which are not themselves insurers, do not fall within this definition.

# Insurance - example

- \* Insurance Example Co Ltd provides life insurance in and from the Island. Insurance Example Co Ltd undertakes all of its business in the Island and is regulated as an “insurer” for its own insurance business.
- \* Question – is Insurance Example Co Ltd subject to the substance requirements?

# CIGA for Insurance

- \* The insurance sector breaks down into two key areas, life insurance and non-life insurance. However both will be required to demonstrate that they undertake CIGA in the context applicable to their business area in the Island.
- \* The legislation sets out a list of CIGA for insurance, which are described below.
  - \* **Predicting and calculating risk** includes oversight of the determination of the quantification and likelihood of the insured event occurring and the likely costs, and ensuring that the premiums charged are commensurate with the risks accepted.

# CIGA for Insurance (2)

- \* **‘Insuring or re-insuring against risk’** includes insuring policyholders against specific risks and providing reinsurance to insurers insuring policy holders against risks.
- \* **‘Providing client services’** includes taking strategic decisions regarding the commissioning of client services relevant to insurance and ensuring oversight of systems and processes put in place for the provision of support services.

# Distribution and Service Centre

- \* The definition encompasses companies which purchase raw materials and finished products from other non-resident members of the same group<sup>4</sup> /connected persons and re-sell them for a profit.
- \* The definition also encompasses companies which provide services, consulting or other administrative services, to other non-resident members of the same group/connected persons.
- \* The scope does not extend to cases where the distribution and service centre activity is not the main activity of a company, but only if that other activity is recharged at cost or less. (For example, where a company seconds staff for a limited period recharging at cost rather than for a profit.)

# Distribution and Service Centre 2

- \* However, if there is any indication that a company is seeking to manipulate or artificially suppress its income to avoid being subject to substance requirements the respective Tax Administrations will take the appropriate action.
- \* The scope does not extend such activities to cases where a company purchases raw materials and finished products from, or provides services to third parties.
- \* In banking, insurance, fund management, financing and leasing, shipping or headquartering businesses it may be a normal part of their activities to provide such services, and so these activities are excluded from being within the scope of Distribution and Service Centre, to prevent duplicate reporting.

# Distribution and Service Centre - example

- \* ABC Ltd buys CDs from other group companies based in Asia and re-sells them to other group companies and customers in Europe.
- \* Question – is ABC Ltd subject to the substance requirements?

# CIGA for Distribution and Service Centres

- \* The legislation sets out a list of CIGA for distribution centres, which are described below.
  - \* **‘Transporting and storing goods, components and materials’**- refers to the movement and storage of raw materials or finished products and managing the risks associated with this.
  - \* **‘Managing stocks’**- includes considering minimum acceptable stock levels, managing frequency of stocktake, whether using storage space effectively, perishability of stock and ensuring security procedures are in place.
  - \* **‘Taking orders’**- includes the provision of the order processing element of the entire fulfilment process, whether that is manual or electronic.

# CIGA for Distribution and Service Centres (2)

This CIGA generally applies in relation to service centres.

- \* ‘Providing consulting or other administrative services’- includes providing such services, which are offered or solicited to other group companies, usually with a mark-up.

# Headquartering

- \* The definition encompasses companies which provide headquarters services to other non-resident members of the same group/connected persons<sup>5</sup>. A headquarters will take responsibility for the overall success of the group, or an important aspect of the group's performance, and ensure corporate governance. Such headquarters services include:
  - \* The provision of senior management
  - \* Taking responsibility or control of material risk for activities carried out by, or assets owned by, any of those persons
  - \* The provision of substantive advice in relation to such risks

# Headquartering (2)

- \* In banking, insurance, fund management, financing and leasing, shipping or distribution and service centre businesses it may be a normal part of their activities to provide headquarters services, and so these activities are excluded from being within the scope of Headquarters, to prevent duplicate reporting.

# Headquartering - example

- \* ABC Ltd based on Island, is part of a group, with subsidiaries around the world. The senior management team each have responsibility for a different region, and will regularly spend time at the subsidiaries with the senior management teams providing strategic direction and helping manage material risks.
- \* Question – Is ABC Ltd subject to the substance requirements?

# CIGA for Headquartering

- \* The legislation sets out a list of CIGA for Headquarters, which are described below.
  - \* **'Taking relevant management decisions'** refers to making decision on the substantive functions, and significant risks for other group/connected companies including strategic planning, marketing strategies, acquiring premises, etc. For a decision to be determined as being taken in a jurisdiction for the purposes of this CIGA, the majority of those making the decision should be physically present in that jurisdiction.

# CIGA for Headquartering (2)

- \* **'Incurring expenditures on behalf of group entities'** includes the taking of specialist advice or procuring technology on behalf of the group as a whole, or purchasing significant assets / specific services for / on behalf of a group entity.
- \* **'Co-ordinating group activities'** includes ensuring where there are specific advantages to the group, group entities activities are co-ordinated in a way that produces the best outcome for the group rather than the individual companies. E.g. If as a whole a group can get better terms from a supplier if they enter a Pan-European Deal, ensuring that all the group entities enter the deal, even if it is not the best deal for a specific company.

# Shipping

- \* The definition of ship for this relevant sector excludes:
  - \* fishing vessels and harbour craft,
  - \* vessels used for sport or recreation (e.g. pleasure yachts), and
  - \* any vessel under 24m in length overall
- \* To be within the shipping relevant sector a company must operate one or more ships in international traffic, for the transport of either passengers, cargo or both.
- \* **Other** activities where they are also conducted will be included within this sector, but **only** if they are undertaken by a company in connection with its trade of operating ships in international traffic, as above.

# Shipping (2)

- \* These other activities include:
  - \* the rental on a charter basis of other ships
  - \* the sale of tickets or similar documents
  - \* the use, maintenance or rental of containers
  - \* the management of crew of other ships.
- \* A company which undertakes any of these other activities where the company does not also operate a ship, or ships, in international traffic is not within the shipping relevant sector.
- \* The chartering of ships on a bareboat basis does not fall within this sector because the company which charters the ship is not operating the ship, however the bareboat charter may fall within the financing and leasing sector.

# Shipping - examples

- \* FerryBoat Limited owns a passenger ship and its business is to operate that ship in international traffic to carry passengers from port A in Spain to port B in Greece.
- \* Question – is FerryBoat Limited within the shipping sector?
- \* CrewManCo provides and manages the crew of FerryBoat Limited's ship as part of its crew management business, but it does not operate ships.
- \* Question – is CrewManCo Limited within the shipping sector?

# CIGA for Shipping

- \* **'managing crew'** includes the crew sourcing, recruitment, selection, deployment, scheduling, training, and on-going management of seafarers engaged on vessels and administrative aspects, such as payroll services, travel arrangements, insurance etc.
- \* **'hauling and maintaining ships'** involves lifting vessels from the water for maintenance and the general maintenance of ships.
- \* **'overseeing and tracking deliveries'** includes the logistical aspects of the transportation of cargo

# CIGA for Shipping (2)

- \* **‘determining what goods to order and when to deliver them’** these are the activities to determine how a ship is to be utilised, the types of cargo acceptable and the scheduling of voyages with the delivery of such cargos, and ensuring any contingency arrangements are in place.
- \* **‘organising and overseeing voyages’** includes the logistical aspects of the operation of ships, determining which routes to use, when and making adequate contingency arrangements

# IP Company

- \* This sector applies to companies with intellectual property. For the purposes of this guidance, the term “IP Company” will be used to describe such companies.
- \* A company which has an intangible asset that is not intellectual property is not within the scope of this sector.
- \* For example: A milk quota is an intangible asset but is one which is not intellectual property.
- \* IP Companies’ income comes from the holding or exploitation of intellectual property (“IP assets”) and are within the scope of this sector. If there is any indication that a company is seeking to manipulate its income to avoid being subject to substance requirements, for example by disguising royalties as part of the sales income, the respective Tax Administrations will take appropriate action.

# IP Company (2)

## IP Assets

- \* The key IP assets are:
  - \* 1. patents and assets that share the same features of a patent including copyrighted software, technical know-how and other similar novel, useful and protected assets.
  - \* 2. trademarks, brands, customer lists and similar marketing intangible assets
- \* Accountants may aggregate various intangible assets together under the heading 'Goodwill', where on analysis this includes IP assets, as above, the company will be an IP company.
- \* An IP company may hold and receive income from an IP asset in a number of different scenarios.

# IP Company - examples

- \* BrandCo holds a brand, the rights for which are licensed to others in return for a licence fee.
- \* Question – is BrandCo an IP company within this sector?
- \* DrinkCo has a trademarked range of fizzy beverages, which it manufactures and markets to unrelated third parties.
- \* Question – is DrinkCo an IP company within this sector?

# CIGA for IP Companies

- \* The legislation sets out a list of CIGA for an IP Company:
  - \* **‘research and development’** - for patents and similar assets. These activities include advancing the understanding of scientific relations or technologies, addressing known scientific or technological obstacles, increasing knowledge or developing new applications, etc.
  - \* **‘marketing, branding and distribution’** – for marketing intangibles, such as trademarks, brands and similar. These activities should be directly linked to the specific marketing intangible.
  - \* Marketing and branding could include marketing, advertising, seeking endorsements, artistic design, developing consumer awareness and developing customer loyalty.
  - \* Distribution could include securing market access to allow the intellectual property to be exploited efficiently, this includes allowing on demand services, such as video demand, and in business to business sectors, integrating into complex IT systems.

# High Risk IP Company

- \* Where a company receives income from IP, it will also have to consider if it is a “high risk IP company”, which is defined in the legislation.
- \* There is a rebuttable presumption that a high risk IP company has failed the substance requirement as the risks of artificial profit shifting are considered to be greater. As a result the competent authority will exchange all of the information, provided by the company, with the relevant EU Member State competent authority where the immediate parent company, ultimate parent company and/or ultimate beneficial owner is resident. Such exchange of information will be in accordance with the existing international tax exchange agreements.

# High Risk IP Company (2)

- \* To rebut the presumption and not incur further sanctions (see below), a high risk IP company will have to produce materials which will explain how the DEMPE (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 the Island.
- \* The high evidential threshold requires:
  - \* Detailed business plans which clearly lay out the commercial rationale for holding the Intellectual Property asset(s) in the Island;
  - \* Concrete evidence that the decision making is taking place in the Island, and not elsewhere; and
  - \* Information on employees in the Island, their experience, the contractual terms, their qualifications, and their length of service.

# Directed and Managed

- \* Tax resident companies undertaking relevant activities are required to be directed and managed in the Island in addition to undertaking CIGA in the Island.

# What is the directed and management test?

- \* The requirement to be directed and managed in the Island is a separate test to the case law “central management and control” test used in determining the tax residence of a company.
- \* Companies which meet the ‘management and control’ test for tax residence will still need to ensure that they also meet the directed and managed requirement in order to have adequate substance.
- \* This requirement consists of the following parts, ***all of which*** must be complied with for each accounting period:

# Directed and managed requirements:

- \* The Board of Directors must meet in the Island at an adequate frequency given the level of decision making required;
- \* During the meetings in the Island, 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; If a company has one director, then they should evidence that written resolutions were passed by that director when he is physically present in the Island;
- \* The Board of Directors, as a whole, must have the necessary knowledge and expertise to discharge their duties as a board; and
- \* All minutes and company records must be kept in the Island.

# Meetings of the Board of Directors

- \* It is expected that any commercially run company will need to have meetings of its board of directors in line with the levels of activities it conducts, and it is at those meetings that the decisions required to run the company are made.
- \* The directed and managed test is designed to ensure that there are an adequate number of such board meetings held and attended in the Island, and that at each of those meetings there is a quorum of directors physically present in the Island.
- \* Quorum in this context will be determined in accordance with Companies Law and the company's Articles.
- \* It is recognised that at times for any company, directors may be abroad for non-business reasons when they are required to make a decision, or meetings may need to be held overseas, for example when completing certain transactions where face to face negotiations might be vital to a successful outcome.

# Meetings of the Board of Directors (2)

- \* The test does not require every board meeting to be held in the Island, or for a quorum of directors to be physically present at every meeting that is held in the Island.
- \* However, it does require those conditions to be met in relation to each meeting that the company considers to count towards demonstrating that board meetings are held in the Island at an adequate frequency given the level of decision making required.
- \* Where company law permits the company to have a sole director, that sole director will conduct the board business by written resolution instead of holding a board meeting. In such cases, the director must be physically present in the Island when they consider the points and sign each resolution. In these specific circumstances, this will be taken to be equivalent to a quorate board meeting for the purposes of the test.
- \* What constitutes an adequate number of meetings in the Island will be dependent on the activities of the company. However, it is generally expected that the majority of board meetings will be held in the Island in order to meet the requirement.

# Meetings of the Board of Directors (3)

- \* It is also expected that even for companies with a minimal level of activity there will be at least one meeting of its board of directors held in the Island in each year.
- \* The requirement also looks to ensure that the board is a decision making body, in that it has the necessary knowledge and experience, and is not simply giving effect to decisions taken outside the Island - whether those decisions are taken by the directors or others.
- \* If there is evidence that substantive decision making is taking place in any forums, or by any persons, without reference to or the oversight to the board of directors, it is unlikely to be accepted that the board of directors is making the strategic decisions.
- \* The minutes of the board meetings should refer to all the relevant decisions taken, even those where the board considers courses of action and rejects them.

# Company Records

- \* Where a company is incorporated in the Island, the company records include those which must be kept and retained in line with the applicable Company Law in the Island.
- \* Where a company is incorporated outside of the Island, the company records must accord with both the applicable laws of that jurisdiction and those in the Island.
- \* Where it is not legally possible to hold a document, for example the share register in the Island, there must be a mirror copy, or access to the original, available in the Island.

# Company Records (2)

- \* The minutes of the board meeting held in the Island should include all the supporting documents for such meetings, and other major documentation required by the Board of Directors to make their decisions. For example major funding documentation and mortgages.
- \* It is expected that generally the original/ signed physical copies would be held in the Island. Where records are held electronically, it is sufficient that such records are maintained and accessible in the Island, and not that the relevant data centre is necessarily located in the Island.

# Companies in Liquidation

- \* If a company in liquidation is still carrying on a relevant activity, for example it continues to generate income from financing and leasing, then it is subject to the substance requirements.
- \* As generally when a liquidator is appointed all powers of the directors cease, it will be the liquidators of the company that are required to demonstrate that the company is directed and managed in the Island and for the directed and managed test the board of directors should be taken to be the liquidator.

# Employees

- \* For the purposes of the substance requirements, the term “employees” is not limited to individuals that are legally employed by the company itself.
- \* Employees for this purpose includes:
  - \* (a) employees;
  - \* (b) persons working for the enterprise being subordinated to it and deemed to be employees under Island law; and
  - \* (c) owner-managers and directors
- \* Apprentices or students engaged in vocational training with an apprenticeship or vocational training contract are not included,

# Employees (2)

- \* The employee count will be based on the number of full time equivalents (FTEs), i.e. the number of persons who worked full time within the company in question, or on its behalf during the entire period under consideration.
- \* If the company outsources, contracts or delegates some or all of its activity, then the resources of the service provider in the Island will be taken into consideration when determining whether the adequate people test is met. However, there must be no double counting if the services are provided to more than one company. The company remains responsible for ensuring accurate information is reported on its return and this will include precise details of the resources employed by its service providers, for example based on the use of timesheets.
- \* The work of persons who have not worked the full year, the work of those who have worked part-time, regardless of duration, and the work of seasonal workers are counted as fractions of an FTE. For this purpose, a standard working week will be considered as 35 hours.

# Employees (3)

- \* Directors should be counted as a fraction of an FTE commensurate with the time commitment of the role.
- \* In most circumstances better qualified staff are more efficient and, as such, fewer may be required. Increases in digitalisation and automation of processes may, however, also mean that fewer staff are required.
- \* When considering what an adequate number of qualified employees is, this must relate to the employees needed to be able to conduct the relevant activity as a whole (not just the CIGA).
- \* The qualifications that are considered to be adequate will depend on the relevant sector that the company has activity in, the CIGA undertaken on the Island and the duties performed by those employees.
- \* Qualifications taken into account could include academic qualifications, vocational qualifications, relevant industry technical qualifications and also qualification by relevant experience.

# Outsourcing

- \* The legislation does not prohibit a company from outsourcing some or all of its activity. Outsourcing, in this context, includes outsourcing, contracting or delegating to third parties or group companies.
- \* If some or all of the CIGA is outsourced, the company must be able to demonstrate that it has adequate supervision of the outsourced activities and, to meet the substance requirements, that those activities are undertaken in the Island.
- \* Where a CIGA is outsourced the resources of the service provider in the Island will be taken into consideration when determining whether the people and premises test is met.