

# 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)

# 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.

# 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.