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Tax jurisdictions with no or nominal rates of tax have enacted laws requiring companies established in those jurisdictions to have economic substance (ES) in the jurisdictions concerned

The ES laws of these jurisdictions, including the British Virgin Islands (BVI), Cayman Islands and Bermuda, mean that taxpayers may no longer be able to employ companies established in these jurisdictions to reflect the operating results of many of their active businesses. Such taxpayers may therefore need to consider restructuring their operations, and possibly relocating businesses and the residence of companies.

Background

The ES laws of these jurisdictions have been enacted in response to the work of the Organisation for Economic Co-operation and Development (OECD) and European Union on fair taxation.

Subject to local variations, these ES laws are all based on the global standard laid down by the OECD in its document titled "Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions – Inclusive Framework on BEPS: Action 5" published in November 2018.

Which entities will fall within the scope of the ES laws?

Generally, under the ES laws of a relevant jurisdiction, a "relevant entity" which carries on a "relevant activity" is required to satisfy the economic substance requirements in relation to that "relevant activity".

A "relevant entity" generally refers to a resident company or a limited partnership with legal personality that is incorporated or formed in the jurisdiction concerned (including a foreign company or a foreign limited partnership with legal personality that is registered in the jurisdiction concerned). Some jurisdictions e.g., the BVI and Cayman Islands provide non-resident exemption, under which where a relevant entity is a non-resident of the jurisdiction concerned, it will not generally be subject to the ES laws regime.

"Relevant activities" are defined under these ES laws as:

(i) Banking business;

(ii) Insurance business;

(iii) Shipping business;

(iv) Financing and leasing business;

(v) Fund management business (the activities of funds themselves generally not falling within the definition);

(vi) Headquarters business;

(vii) Holding business, i.e., a business of pure equity holding in other entities

(viii) Intellectual property business; and

(ix) Distribution and service center business.

How can a relevant entity satisfy the economic substance requirements?

Except for a pure equity holding entity (see below for further details), the economic substance requirements will be satisfied if:

- the relevant activity is directed and managed in the jurisdiction concerned;
- the relevant entity conducts core income generating activities (CIGA) as prescribed in relation to the relevant activity in the jurisdiction concerned; and
- having regard to the nature and scale of the relevant activity carried on, the relevant entity has (i) an "adequate" amount of operating expenditure incurred in the jurisdiction concerned; (ii) an "adequate" number of employees with "appropriate" or "suitable" qualifications in relation to that activity physical present in the jurisdiction concerned; and (iii) an "adequate" physical presence (including maintaining a place of business or plant, property and equipment) in the jurisdiction concerned.

The ES laws and the related guidance notes issued by the relevant authorities of the jurisdictions concerned generally do not define the terms "adequate", "appropriate" or "suitable" in the aforesaid context. This is because what constitutes "adequate", "appropriate" or "suitable" is fact sensitive. The indication is that relevant entities that genuinely conduct CIGA in relation to a relevant activity in a relevant jurisdiction need not be concerned about any specific thresholds or numbers.

In particular, the guidance on the ES laws issued by the Tax Authority of the Cayman Islands further states that "[g]iven the stringent regulatory requirements in the Cayman Islands, which result in significant overlap with the substance requirements, it is expected that relevant entities licensed to carry on banking business, insurance business or licensed fund management business will already generally be operating in the Islands with adequate resources and expenditure. However, those relevant entities will still be subject to the ES law (i.e., filing requirements, Cayman Island CIGA performed in the Islands, and monitoring by the Authority)".

Outsourcing of CIGA within a jurisdiction concerned is generally permitted provided that the relevant entity can monitor and control the performance of the outsourced activities. Furthermore, the economic substance of a service provider that is solely attributable to the relevant entity can generally also be counted as being part of the economic substance of the relevant entity.

Certain relevant activities are subject to a reduced or an increased economic substance test:

- ***Pure equity holding companies*** are subject to a reduced economic substance test, which could be satisfied if the relevant entity confirms that it has (i) complied with the company filing obligations applicable to it under the relevant laws of the jurisdiction concerned; and (ii) adequate employees and premises in the jurisdiction concerned for holding and managing its equity interests in other entities.

  In this regard, it is of note that the draft guidance on the ES laws issued by the International Tax Authority of the BVI states that "[t]he definition of pure equity holding company is deliberately framed in narrow terms. A legal entity will only fall within the definition if it holds nothing but equity participation, yielding dividends or capital gains. The ownership of any other form of investment (such as an interest bearing bond) will take the legal entity outside this definition".

  As such, on the basis that the holding of an interest-bearing bond as an investment would not render such an investment a business falling within the definition of any other relevant activities, it appears that BVI holding companies could easily fall outside the ES laws regime of the BVI.

- ***High-risk intellectual property (IP) companies*** are, in contrast, subject to an increased economic substance test. High-risk scenarios would include cases where (i) the relevant entity has acquired the IP asset from related parties or through the entity funding research and development activities which took place outside the jurisdiction where the entity is located; and (ii) the IP asset is licensed to affiliated entities or exploited by affiliated entities outside the jurisdiction where the entity is located. In such high-risk scenarios, there is a rebuttable presumption that the economic substance test is not met. Such a presumption can be rebutted if the relevant entity can demonstrate by evidence that there was, and historically has been, a high degree of control over the development, exploitation, maintenance, enhancement and protection of the IP asset, exercised by an adequate number of employees with the necessary qualifications that permanently reside and perform their activities within the jurisdiction where the relevant entity is located.

When will the economic substance requirements apply?

Relevant entities formed or incorporated on or after 1 January 2019 are required to meet the economic substance requirements immediately upon their commencing a relevant activity.

As a transitional rule, existing relevant entities that were incorporated or formed before 1 January 2019 will have to meet the economic substance requirements by 1 July 2019.

What are the obligations of in-scope entities and consequences of non-compliance?

Reporting and filing obligations

Commencing in 2020, entities subject to the economic substance requirements are required to notify the relevant authorities annually of whether they are carrying on a relevant activity and report the prescribed substance information for each financial period in the form and the manner specified by the relevant authorities.

Penalties

Failure to meet the economic substance requirements may lead to financial and criminal penalties. In addition, certain information of a relevant entity that cannot comply with the economic substance requirements will be exchanged by the relevant authority of the jurisdiction concerned with the jurisdictions where the immediate parent, ultimate parent and ultimate beneficial owners of the relevant entity are located.

Persistent non-compliance of the economic substance requirements may ultimately lead to a relevant entity being struck off from the register of companies applicable to the entity in the jurisdiction concerned.

What actions taxpayers employing such companies should take?

Taxpayers who employ companies in no or nominal tax jurisdictions as part of their holding and operating structures should immediately assess whether the ES laws apply to the companies concerned, and, if so, whether and how they can satisfy the economic substance requirements, weighing the costs and benefits involved.

Holding companies

For holding companies, taxpayers can explore whether a company might engage in activities such that the company is not a "pure" equity holding company, and thereby is not subject to the ES laws regime. One approach might be to have a company make a non-equity investment, especially where the said company is a BVI company (see discussion above).

Otherwise, taxpayers can consider whether they can make use of the reduced substance requirements for holding companies, e.g., by way of outsourcing the holding and management of their equity participation in other entities to service providers located in the jurisdictions concerned, especially where the participation is passive in nature.

For Hong Kong-based groups, depending on the facts of a case, it may also conceivably be possible to claim the residence of their holding companies as being Hong Kong, thereby, where applicable, causing the companies to fall outside the scope of the ES laws.

It however remains to be seen whether the Inland Revenue Department (IRD) of Hong Kong would issue a certificate of tax residence (CoR) to such holding companies to facilitate their non-resident claims in the jurisdictions concerned, especially given that the IRD's current practice is to only issue CoRs for tax treaty purposes. Alternatively, companies may explore whether the jurisdictions concerned would accept business registration as a proof of residency in Hong Kong.

A related issue is that many such holding companies have not obtained a business or company registration in Hong Kong, despite their central management and control possibly being exercised in Hong Kong. As such, whether such holding companies were required to comply with Hong Kong's registration requirements in prior periods, but have failed to do so, could also be an issue which may arise if they apply for a CoR in Hong Kong.

Active business companies

If the economic substance requirements for the relevant activities cannot be met, taxpayers may need to consider restructuring their operations, including possibly relocating the relevant businesses to jurisdictions such as Hong Kong where the tax rate is comparatively low across the board.

Alternatively, taxpayers may consider relocating the relevant businesses to places including Hong Kong where the jurisdictions concerned offer preferential tax regimes applicable to the relevant businesses and where taxpayers can meet the necessary conditions to avail themselves of the preferential tax regimes so offered.

The above assessments, and possibly restructuring exercises, are by their nature complicated processes and taxpayers should seek professional advice where necessary.

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