

UPDATE

More detailed guidance issued on Economic Substance for Channel Islands Companies

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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 summarises the key elements of the JGNs.

The Joint Guidance Notes were released on 26 April 2019. These add to existing guidance, which was contained in a 'Key Aspects Document' issued in November 2018.

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 are designed to help relevant companies interpret the Taxation ((Companies – Economic Substance) (Jersey) Law 2019 in Jersey (the **Jersey Law**) and the Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance 2018 in Guernsey (the **Guernsey Law** and, together with the Jersey Law, the **Substance Laws**). This note summarises the key guidance provided in the JGNs.

Update on Channel Islands position: EU Whitelisting

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. Guernsey's government approved the Guernsey Law on 28 November 2018 and the UK Privy Council granted formal approval to the Jersey Law on 13 March 2019. Both Substance Laws take effect from 1 January 2019. A number of areas of practical implementation of the Substance Laws have now been resolved in the JGNs, including reporting, scope of impact and outsourcing.

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 used with the Substance Laws and filed with the local tax offices in the relevant Island have not been issued (although guidance on the information to be included is in the process of being released), but it is clear that information to be reported by a relevant 'in scope' company, carrying on a 'relevant activity' will include:

- Identification of the company's type of 'relevant activity';
- Amount/type of income derived from relevant activities – 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.

Companies should be implementing procedures now to ensure that information on these various items will be available to be included in returns.

Further clarifications on the scope and requirements for substance

The JGNs also provide clarifications in determining how 'relevant activities' need to be undertaken by relevant companies.

- **(Pure Equity) Holding Companies.** The JGNs clarify that a company will be regarded as a Holding Company where its primary function is the acquisition and holding of controlling interests in other companies, as beneficial owner of the shares. To the extent that the company also carries out additional commercial activities then it will no longer be treated as a Holding Company, although the JGNs include anti-avoidance language to prevent scope-avoidance through adding minor incidental activities such as management of dividend proceeds. The JGNs also clarify that where a separate relevant activity caught by the relevant Substance Law is carried on in addition to the holding of equities, then the higher substance requirements relating to that separate activity would apply.

Helpfully the JGNs clarify that corporate trustees holding interests in other companies on trust are not within scope. In most cases it is also anticipated that general partners of 'non-fund' limited partnership structures holding interests in other companies would also be out of scope.

- **Banking.** In the context of deposit taking business, increased clarity has been provided in the JGNs as to where banking-related services will **not** fall under the 'relevant activity' of banking.
- **Finance and leasing activities.** The JGNs confirm that purchasing debt as an investment will not comprise the 'relevant activity' of financing and leasing, whereas the provision by a company of a credit facility will. In practice we believe careful analysis of the factual position will be necessary in order to determine whether a company's activity is in scope. Where a lender's rights to a loan are assigned to another company then the assignee will come within scope of the rules. Examples are provided which focus on the need to evidence and demonstrate the taking of decisions by the company's board in relation to an agreement to lend, setting the terms of the financing and the on-going monitoring and management of risk of the loan. It should be noted that intra-group lending activity, where any income is received, will be caught by the definition.
- **Fund management.** For corporate fund managers the JGNs provide a number of additional clarifications and examples. While some of the issues raised indicate that modifications to normal practice in this area might be required, the principal indication is that existing industry models will not be greatly affected. In particular, the JGNs clarify:
 - that fund companies are outside the scope of the law and that services such as fund administration will not be treated as fund management
 - that the critical measure will be to ensure that 'overarching strategic decisions' are made (and evidenced) by the fund manager's board, with examples provided to illustrate the extent to which this would be required
 - that the majority of directors taking a strategic decision should be physically present in the jurisdiction
 - that a measure of investment discretion within the strategy set by the fund manager can be delegated to advisers, managers or other appointees in a jurisdiction outside the relevant Island, which is more closely linked to the underlying assets; this builds on previous clarification that advisory services provided to a fund manager from outside the Island are permitted, but this is a welcome further clarification.
- **Distribution and Service Centre Business.** The JGNs have clarified that as well as 'distribution business', which broadly relates to the purchase and resale of raw materials and finished products, references to 'service centre business' will also have to be assessed on a stand-alone basis, distinct from distribution activity. This means that companies which provide services to non-resident members of the same group will be subject to the Substance Laws. Although the scope of services is not explicit, it appears that the tax office is likely to construe services widely, including, for example, consulting or administration services provided to non-resident group companies. We believe it is likely that this would include such services as advisory and employment services. It is worth noting that even where these activities may be exempted from regulation (given that, for example, there will often be

regulatory carve-outs for intragroup activities) particular care will need to be taken to ensure that these types of activity have been evaluated, and, if within scope, that activities are sufficiently mapped and quantified to provide for appropriate local decision-making and tax reporting, in accordance with the relevant Substance Law.

- **Headquartering activities.** Broadly this will comprise, in relation to a corporate group: the provision of senior management, the taking of responsibility, and/or control of material risk for activities carried out by, or assets owned by, any person within the group, and the provision of substantive advice in relation to these risks. The JGNs also clarify that whether or not a company is in scope will depend on the extent to which management or responsibility for subsidiaries by that company is in fact in place. To the extent that a company is out of scope as a headquarters business, then it would typically be in scope as a Holding Company, which would be a lighter burden to evidence/report on. A helpful carve-out has been included confirming that where companies carry out what would otherwise be headquarters business as part of another core activity (for example fund management or insurance, etc.) then that other core activity will be considered to take precedence.
- **High Risk Intellectual Property (IP).** Further detail is anticipated in relation to IP Holding Business in subsequent versions of the guidance.
- **Further detail expected re insurance, shipping and IP companies.** In relation to insurance, shipping, and IP companies (notwithstanding the comments made in relation to 'high risk IP' above), further guidance will be developed by the tax offices.

Further detail on 'directed and managed' test

The JGNs also contain more detail on a number of elements of the 'directed and managed' test which needs to be satisfied in addition to the requirement to undertake CIGA in the relevant Island, and which is differentiated from the case law 'central management and control' test derived from common law. In particular:

- It will generally be expected that the majority of board meetings will be held in the relevant Island, with a quorum of directors physically present (and even for companies with a minimal level of activity there will be at least one meeting of the board held in the Island each year). However there is a recognition that in some cases meetings may be held overseas, particularly where linked to negotiations related to a transaction.
- There is an emphasis on the need for a board to have the necessary knowledge and experience to act as a decision-making body. The JGNs emphasise that where any substantive decision making takes place in any forum without reference to, or oversight of, the board it is unlikely that the board is making strategic decisions.
- There are further details set out 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).

Outsourcing

There is a restatement that some or all of the activity of a company may be outsourced, but that where a CIGA is outsourced then the company must be able to demonstrate adequate supervision of the outsourced activities, which must be carried out in the relevant Island.

Employees

There is clarification that directors should be included in the calculation of employees and staff of a service provider within the relevant Island (provided that there is no double counting). Reflecting an element of commercial flexibility, there is also recognition that it is anticipated that better qualified staff would require less time engaged in relevant activities, and also that increases in technology and automation of processes may lead to less time being required in carrying out a relevant activity.

Mourant's View:

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.

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

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 entity classification, to the structuring of contractual and any delegation arrangements, the organisation of their corporate governance arrangements, their employment and premises arrangements and the capturing of relevant business information which will be required, in due course, for the preparation and filing of reporting information to the relevant tax office.

Mourant can assist boards, shareholders and administrators of those Channel Islands companies that are 'in scope' of the Substance Laws to navigate these issues.

Contacts

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