



# Economic substance requirements in Guernsey

November 2018



# Economic substance requirements in Guernsey

## Index

**Introduction** 3

**Stage 1 | Identify companies carrying on “relevant activities”** 4

— Banking

— Insurance

— Fund management

— Finance and leasing

— Headquarters

— Shipping

— Holding company

— Intellectual Property

— Distribution and service centre

**Stage 2 | Impose economic substance requirements on companies undertaking relevant activities** 7

**Stage 3 | Enforcement of the substance requirements** 9

— Reporting and Penalties

— Exchange of information

**How KPMG can assist your business** 10

Last year, the European Union (“EU”) Code of Conduct Group (Business Taxation) (“COCG”) investigated the tax policies of non-EU countries, including Guernsey, against the concept of “tax good governance” standards on tax transparency, fair taxation and anti-BEPS measures. Although the COCG had no concerns with most of the principles of tax good governance as they relate to Guernsey, Jersey the Isle of Man and a number of other jurisdictions that subject corporate profits to zero or near zero rates or have no corporate tax regimes, they did express concerns regarding the lack of economic substance requirement for entities doing business in and through these jurisdictions.

As a result of those concerns, Guernsey along with the other Crown Dependencies, made a commitment to address the concerns by the end of December 2018.

On **5 November 2018**, The draft Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance, 2018 (“Substance Requirements Law” or “SRL”) was published with a view to ensure that Guernsey addresses its commitment in relation to the lack of economic substance requirement for doing business in and through Guernsey.

In this document, we present a descriptive summary of the key features of what is proposed under the SRL, of which we highlight the following stages:

- **Stage 1:** Identify companies carrying on “relevant activities”
- **Stage 2:** Impose economic substance requirements on companies undertaking relevant activities
- **Stage 3:** Enforcement of the substance requirements



# Introduction

The COCG was set up in 1998 by the EU with a view to assess tax measures and regimes that may fall within the scope of the Code of Conduct for business taxation, which had been adopted in 1997 by the EU and was designed to detect measures that unduly affect the location of business activity in the EU by targeting non-residents and providing them with a more favourable tax treatment than that which is generally available in the jurisdiction.

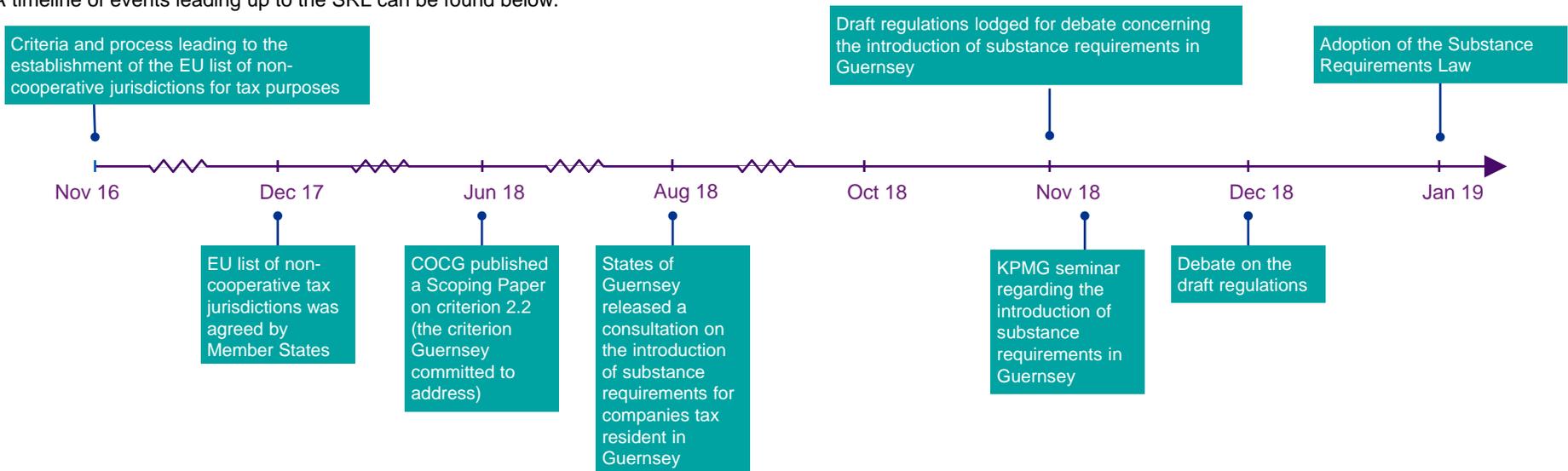
On investigating the tax policies of non-EU countries against the principles of tax good governance, the COCG expressed concerns regarding the lack of economic substance requirement for entities doing business in and through Guernsey requiring Guernsey to address such concerns by the end of December 2018.

COGC, in consultation with the Global Forum and the OECD, published a Scoping Paper on the matter of substance in June 2018, which provides technical guidance on how to comply with the commitments made by the jurisdiction on the matter of substance.

In August 2018 a consultation was issued by the States of Guernsey regarding the introduction of substance requirements and sought feedback from interested parties. Following the conclusion of the consultation, draft legislation – Economic Substance Law – was issued on 5 November 2018.

It is important to iterate that Guernsey has not been blacklisted by the EU. Guernsey has been included in a 'grey list', which included other jurisdictions that had made various commitments to implement all aspects of the tax good governance principles. In total 142 commitments have been made by 67 jurisdictions. The COCG has been monitoring these commitments ensuring that appropriate legislation is enacted. It is expected that following the enactment of the SRL, Guernsey will be fully compliant with all aspects of the tax good governance principles.

A timeline of events leading up to the SRL can be found below.



# Stage 1 | Identify companies carrying on “relevant activities”

The Substance Requirements Law applies to Guernsey tax resident companies. Companies are resident for tax purposes in Guernsey if they are incorporated in the island or if shareholder control is exercised in Guernsey. In accordance with the recent Guernsey budget, from 1 January 2019 where a Guernsey incorporated company is centrally managed and controlled outside Guernsey, in a jurisdiction with which Guernsey has an appropriate DTA and where the highest rate at which any company may be taxed is 10% or higher then the company is treated as resident for tax purposes in that jurisdiction.

Guernsey branches of non-Guernsey resident companies are outside the scope of the SRL.

All Guernsey resident companies will have to identify whether they carry on “relevant activities” in Guernsey. The term has been derived from categories of geographically mobile income identified by the OECD forum on harmful tax practices and include:



Each category of relevant activities is defined under the SRL as follows:

## *Banking business*

A Guernsey resident company regulated by The Banking Supervision (Bailiwick of Guernsey) Law, 1994 shall be treated as carrying on “banking business” in Guernsey for these purposes.

## *Insurance business*

Insurance business is defined as a Guernsey resident company undertaking insurance business within the meaning of the Insurance Business (Bailiwick of Guernsey) Law, 2002 carried on by a licensee within the meaning of that Law,

## *Fund management business*

The definition of “fund management business” is widely defined and includes all companies that are registered under the Protection of Investors (Bailiwick of Guernsey) Law, 1987 (“POI Law”) to carry on management within the meaning of the POI Law but also those companies that would be required to register if it was not for a specific exemption within the POI Law, such as where the company provides fund management services to a scheme that is not offered to the public.

Where there is no investment manager appointed, in or outside of Guernsey, the company acting as a trustee to the scheme or a corporate member of a partnership will be the entity carrying on fund management business.

# Stage 1 | Identify companies carrying on “relevant activities” (continued)

## *Finance and leasing business*

A Guernsey resident company will be viewed as carrying on finance and leasing business if it makes loans, provides credit or in any other way lends, for consideration to any person, including connected persons. In addition, the provision of credit may be by way of instalments for which a separate charge is made and disclosed to the customer in connection with:

- a) the supply of goods by hire purchase,
- b) leasing other than any lease granting an exclusive right to occupy land, or
- c) conditional sale or credit sale.

If a Guernsey resident company carries on banking business, insurance business or fund management services, it will not be viewed as carrying on finance and leasing business, even where it undertakes any of the above.

## *Headquarters’ business*

Where a Guernsey resident company provides any of the following services to one or more foreign connected persons of a Guernsey resident company, it will be viewed as carrying on headquarters business.

- a) The provision of senior management;
- b) The assumption or control of material risk for activities carried out by, or assets owned by, any of those connected persons;
- c) The provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b).

If a Guernsey resident company carries on financing and leasing business, intellectual property holding business, insurance business, or banking business, it will not be seen to undertake headquarters business, even where it undertakes any of the above.

## *Shipping business*

Shipping business is defined as involving the operation of a ship anywhere in the world other than solely between Guernsey and Jersey:

- a) the business of transporting, by sea, persons, animals, goods or mail;
- b) the renting or chartering of ships for the purpose described in paragraph (a);
- c) the sale of travel tickets or equivalent and ancillary services connected with the operation of a ship;
- d) the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea;
- e) the management of the crew of a ship.

## *Holding company business*

A company will be viewed as carrying on holding company business activities if it is a Guernsey resident company which broadly, holds the majority shares in another entity, has as its primary function the acquisition and holding of shares or equitable interests in other companies, and which does not carry on any commercial activity.

## *Intellectual property (“IP”) holding business*

The definition of “IP holding business” is extensive and includes all Guernsey resident companies holding IP assets, such as copyright, patents, trade marks, brand, and technical know-how, from which identifiable income accrues to the business (such income being separately identifiable from any income generated from any tangible asset in which the right subsists).

The SRL further highlights a subcategory of IP holding business companies, referred to as “high risk IP holding companies”.

# Stage 1 | Identify companies carrying on “relevant activities” (continued)

## *IP holding business (continued)*

A high risk IP business company or an IP holding company that:

- did not create the IP in the IP asset which it holds for the purposes of its business;
- acquired the IP asset either from a connected person or in consideration for funding research and development by another person situated outside of Jersey, and that licences the IP asset to one or more connected persons or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by foreign connected persons; or
- does not carry out research and development, branding or distribution as part of its Guernsey core-income generating activities.

Clearly identifying whether a company falls within the definition of a high risk IP company is key as it will have a significant impact in stage 2, as explained later in this document.

## *Distribution and service centre business*

A company will be viewed as carrying on distribution and service centre business if its business consists of either or both of the following:

- purchasing from a foreign connected person component parts or materials for goods, or goods ready for sale, and reselling such component parts, materials or goods;
- providing services to foreign connected persons in connection with the business.



# Stage 2 | Impose substance requirements on companies undertaking relevant activities

Once a Guernsey resident company has been identified as undertaking relevant activities, the SRL requires the company to satisfy the 'economic substance test'.

The test is split in three parts. However a company is not required to meet the test if it has no gross income in relation to a relevant activity carried on by it.

## 1. It is directed and managed in Guernsey in relation to that activity

The first part of the test is that the company will be required to demonstrate that it is "directed and managed" in Guernsey.

This part of the test is met if:

- a) the company's board of directors meets in Guernsey at an adequate frequency having regard to the amount of decision-making required at that level. What constitutes adequate will depend on the relevant activities of the company. It is generally expected that the majority of Board meetings will be held in the Island and that even companies with a minimal activity level will hold at least one board meeting.
- b) at such board meetings described in sub-paragraph (a), there is a quorum of directors physically present in Guernsey;
- c) the minutes of such board meetings described in sub-paragraph (a) record the making of strategic decisions of the company at the meeting;
- d) the directors of the company have the necessary knowledge and expertise to discharge the duties of the board noting that where there are corporate directors, the requirements will apply to the individuals actually performing the duties; and
- e) the minutes of all board meetings and the records of the company are kept in Guernsey.

## 2. It conducts Guernsey Core Income Generating Activities ("CIGA")

The second part of the test for the company to demonstrate is that the CIGA associated with the specific relevant activity are undertaken in Guernsey (either by the company or a third party).

Where Guernsey CIGA are carried on by another entity, the Guernsey company has to be able to *monitor and control* the carrying on of that activity by the other entity.

The expression "Guernsey CIGA" means relevant activities being carried on from within Guernsey. The legislation provides a list of the core activities a company operating in a particular sector could carry on but it is not necessary for the company to perform all of the CIGA listed in order to demonstrate substance.

Undertaking or outsourcing non CIGA activity outside of Guernsey will not affect the company's ability to meet the substance requirement nor are companies prohibited from engaging experts or specialists in other jurisdictions. However, the net profit subject to tax in Guernsey must be commensurate to the CIGA undertaken in Guernsey. Key aspects of CIGA for each sector are identified as follows:

### *Banking business*

Raising funds, managing risk including credit, currency and interest risk; taking hedging positions; providing loans, credit or other financial services to customers; and managing capital and preparing reports and returns to the Guernsey Financial Services Commission or any body or entity with equivalent functions relating to the supervision or regulation of such business.

### *Insurance business*

Predicting and calculating risk; and insuring or re-insuring against risk and providing insurance business services to clients.

### *Fund management business*

Taking decisions on the holding and selling of investments; calculating risk and reserves; taking decisions on currency or interest fluctuations and hedging positions; and preparing reports and returns to investors and the Guernsey Financial Services Commission or any body or entity with equivalent functions relating to the supervision or regulation of such business.

# Stage 2 | Impose economic substance requirements on companies undertaking relevant activities (continued)

## *Finance and leasing business*

Agreeing funding terms; identifying and acquiring assets to be leased (in the case of leasing); setting the terms and duration of any financing or leasing; and monitoring and revising any agreements and managing any risks.

## *Headquarters business*

Taking relevant management decisions; incurring expenditures on behalf of group entities; and co-ordinating group activities.

## *Shipping business*

Managing crew (including hiring, paying and overseeing crew members); overhauling and maintaining ships; overseeing and tracking deliveries; and determining what goods to order and when to deliver them, organising and overseeing voyages

## *Holding company business*

All activities related to that business.

## *IP holding business*

Taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income; taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset; carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of revenue from third parties and research and development, branding or distribution

There is a **rebuttable presumption** that a high risk IP company will fail the economic substance test, as the risks of artificial profit shifting are considered to be greater. To rebut the presumption the high risk IP company will need to demonstrate to the Director how the development, enhancement, maintenance, protection and exploitation functions of the IP have been under the Guernsey company's control, and that this has involved people who are highly skilled and perform their core activities in Guernsey.

## *Distribution and service centre business*

Transporting and storing goods, components and such materials; managing stocks; taking orders; and providing consulting or other administrative services.

### **3. It meets the adequate requirements with regard to the level of relevant activity carried on in Guernsey**

The final part of the economic substance test is to require the company to demonstrate that in relation to the level of relevant activity carried on in Guernsey:

- i. there are an adequate number of employees in relation to that activity who are physically present in Guernsey (whether or not employed by the resident company or another entity and whether on temporary or long-term contracts),
- ii. there is adequate expenditure incurred in Guernsey, and
- iii. there are adequate physical assets in Guernsey.

What is adequate for each company will be dependent on the particular facts of the company and its business activity. A company will have to ensure it maintains and retains appropriate records to demonstrate the adequacy of the resources utilised and expenditure incurred.

There is an expectation that companies carrying on the regulated activities of banking, insurance or fund management will already be operating with adequate resources and expenditure, as they will be meeting their regulatory obligations. However, this should still be confirmed on an individual basis.

# Stage 3 | Enforcement of the substance requirements

In order to demonstrate meaningful enforcement of the economic substance requirements, a formal hierarchy of sanctions for non-compliant companies is introduced with increasing severity of sanctions imposed for persistent non-compliance.

## Reporting

The SRL requires a Guernsey company to provide to the Income Tax Office any information reasonably required to assist the Director in determining whether or not a resident company has met the economic substance test. Although the legislation is currently silent on what type of information is required, it would seem from the EU Scoping Paper and the Guernsey consultation that the following is likely to be requested:

- Business activities;
- Amount and type of gross income;
- Amount and type of expenses and assets;
- Premises;
- Number of employees specifying the number of fulltime equivalent employees with necessary qualifications.

Furthermore, it is likely that such companies will be required to self-assess themselves as to whether or not they have passed the economic substance test.

## Penalties

Under the SRL, the Director will have the power to issue a notice determining that a company has failed the economic substance test, providing the company with reasons for the determination and applying a penalty of up to £10,000.

If the Director is of the view that the company fails the substance test in two or more years then the penalties increase to a maximum of £100,000. Furthermore, a report may be made to the Registrar of Companies applying for the company to be struck off.

## Exchange of information to competent authorities

Where the Director determines that a resident company has not met the economic substance test for a financial period, the Director must provide certain information relating to that company for that period to:

- a) the competent authority of the country or territory in the European Union in which resides a holding body, the ultimate holding body of the resident company and an ultimate beneficial owner; and
- b) if the resident company is incorporated outside Guernsey, the competent authority of the country or territory in which the resident company is incorporated.

In respect of a high risk IP company, regardless of whether or not the Director has made an assessment of whether the economic substance test has been met, the Director must provide the information provided to the Director in respect of that company for each financial period of the company starting on or after 1 January 2019 to:

- a) the competent authority of the country or territory in the European Union in which resides a holding body, the ultimate holding body of the resident company and an ultimate beneficial owner; and
- b) if the high risk IP company is incorporated outside Director, the competent authority of the country or territory in which the company is incorporated.

# How KPMG can assist your business

Members of the tax leadership team across the Crown Dependencies have been working closely with the relevant authorities to produce the law and guidance. As such, KPMG are in an ideal position to assist with understanding your requirements.

The Tax team at KPMG is a dedicated team of highly skilled professionals providing advisory services to groups, companies and individuals. Our comprehensive knowledge of local and international regulations, combined with extensive experience, allow us to serve our clients in a tailored, responsive and value-added manner.

## Our services can be customised to meet your needs



### Scalable services

We take a pragmatic and tailored approach to providing a comprehensive range of services that meet your requirements.



### Meeting your evolving needs

KPMG has developed a set of methodologies to assist with delivering and testing all requirements of the Economic Substance Law.



### Multi-jurisdictional

We use our KPMG network to source the correct team who are experts with the required experience to service your specific needs.

## Potential Benefits

KPMG's experience and **innovative** use of KPMG's global methodology and tools, tailored to the Channel Islands, combine to provide **insight** into your requirements and identify **deficiencies** that could impact your **reputation and credibility**.

## Why KPMG?

### A leader in its field

- KPMG have worked closely with the relevant authorities in the Crown Dependencies on the introduction of the substance requirements.
- KPMG is a leading provider of audit, tax and advisory services
- Through our clients, we have significant insight into your business
- KPMG in the Channel Islands has over 240 professionals working locally and links into one of the largest professional services firms in the world

## HOW KPMG can assist your business



Impact analysis

Identify the extent to which the law may impact on your business



Diagnostic reviews

Gap analysis and advice of the requirements for your business to ensure compliance with the law



Training sessions

Tailored training sessions for your staff



Implementation of the law

Assistance with the implementation of the law and review /assistance in completing the requirements of the tax return



**Antony Mancini**

*Tax Partner*

+44 (0) 1481 741845

amancini@kpmg.com



**Anderson Page**

*Manager, Tax*

+44 (0) 1481 755737

andersonpage@kpmg.com



**Paul Beale**

*Senior Tax Manager*

+44 (0) 1481 755798

paulbeale@kpmg.com



[kpmg.com/channelislands](https://kpmg.com/channelislands)



[kpmg.com/app](https://kpmg.com/app)

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2018 KPMG Channel Islands Limited, a Jersey company and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative, a Swiss entity.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.