

SUBSTANCE OVER STYLE

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Guernsey's new Substance Requirement Law is enhancing the island's international compliance even further, says [Trust Corporation International](#) Chairman Michael Betley in eprivateclient's 2019 Guernsey Report, A Global Island.

Guernsey, together with the other Crown Dependencies of Jersey and the Isle of Man, has implemented new legislation introducing economic substance requirements for tax-resident companies with effect from 1 January 2019.

The new requirements are relevant to all companies resident for tax purposes in Guernsey and for accounting periods commencing on or after 1 January 2019. Guernsey company tax returns will require all tax-resident companies to provide additional information concerning their activities together with relevant supplemental information.

Following European Union (EU) reaffirmation of Guernsey's compliant regime on 8 March 2019, it is anticipated that more comprehensive guidance will be issued to help navigate the new law and the economic substance requirements. The guidance will be rolled out in stages from April.

OECD and EU-mandated change

The OECD established the Forum on Harmful Tax practices (FHTP) as part of its ongoing project on Base Erosion and Profit Sharing (BEPS). The EU has, for some time, been working in parallel with the OECD and has been developing its own similar initiatives to reduce harmful tax practices and, through its Code of Conduct Group (COCG), has been influential in persuading a number of its trading partners and those it has jurisdiction over to adopt more harmonious tax regimes. The COCG undertook a screening process whereby jurisdictions were assessed in respect of:

1. Tax transparency;
2. Fair taxation; and
3. Compliance with anti-base erosion and profit shifting measures.

As part of this screening process, the Crown Dependencies were identified as jurisdictions which did not have a "legal substance requirement for entities doing business in or through the jurisdiction". The Crown Dependencies committed to address these concerns by the end of December 2018 and worked closely together to establish new best practice standards that meet the requirements.

This ultimately led to Guernsey introducing the Income Tax (Substance Requirements) (Guernsey) (Amendment) Ordinance, 2018 – known locally as 'Substance Requirements Law' (SRL).

The law and how to comply

The SRL is intended to address situations where companies could be used to artificially generate profits that are not commensurate with commercial activities and economic presence in Guernsey. As a consequence tax-resident companies undertaking certain types of economic generating activity need to show they have adequate physical presence in the island through a three-pronged test:

1. By showing the company is "directed and managed" in the island;
2. That the Core Income Generating Activities (CIGA) take place in the island; and
3. Demonstrating there are adequate people, premises and expenditure in the island.

A company which is either non-resident for tax purposes in Guernsey or is tax resident but has no 'relevant income' is out of scope of the SRL. It is anticipated that the majority of Guernsey tax-resident companies will fall outside the new rules or fall within the category of Pure Equity Holding Companies, which has a lower substance requirement. Nevertheless, analysis will need to be undertaken to identify whether a company is subject to the new rules or not.

A Guernsey-incorporated company will be treated as a tax resident unless it can be shown, to the satisfaction of the Revenue Service, that the company is tax resident elsewhere. A foreign incorporated company which is “managed and controlled” in Guernsey will (as from 1 January 2019) be treated as tax resident in Guernsey and will need to file a tax return and also initially complete the Registration of a Foreign Incorporated Company as Tax Resident in Guernsey form. There are many BVI and other foreign-incorporated companies which are managed and controlled in Guernsey which will have to register for the first time under the new rules.

Having identified that a company is resident for tax purposes, one should assess if there is any relevant activity being undertaken which generates income. If so, the SRL will require the company to satisfy the three-pronged ‘economic substance test’:

1. The Company is Directed & Managed in Guernsey

The ‘directed and managed test’ has been established by the SRL and is different to the tax residency test of ‘management and control’. One will need to take into account the following factors:

- Frequency of board meetings – It is expected that even for companies with a minimal level of activity, there will be at least one meeting per annum of its board of directors.
- Meetings held in Guernsey – that there is a quorum of directors physically present in Guernsey for the majority of the meetings held.
- Minutes and records – that the corporate records and minutes are kept and provide evidence that the board is a decision-taking body making the strategic decisions with those minutes and records being maintained in Guernsey.
- Knowledge and expertise of board - that the board has the necessary knowledge and expertise to fulfil its obligations.

2. The CIGA take place in Guernsey

Each relevant activity will have its own CIGA which will need to be undertaken in Guernsey. Not all CIGA have to be undertaken by the company itself and some aspects can be outsourced but there will be limitations on what can be outsourced off island. The level of income being generated should be commensurate with the company’s CIGA other wise this element of the test may fail.

3. There needs to be Adequate Resources on island

The company has to demonstrate that in relation to the level of relevant activity carried out in Guernsey, there needs to be adequate numbers of employees, expenditure and premises.

What is adequate for each company will depend on the circumstances and the nature of the business activity. Outsourcing or delegating functions on-island is permitted and in that regard, most trust companies will be providing the key resources to meet much of the infrastructure for their corporate clients, including staff and premises, to help support those activities undertaken in the island. It should be noted there must be no double counting if the services are provided to more than one company. It will be for the company and the service provider to maintain sufficient records to identify the resources employed.

Reporting and possible sanctions

As part of its income tax filing, a company carrying on relevant activities will need to provide the following information in its annual tax return:

- Business income types in order to identify the relevant activities;
- Amount and type of gross income by relevant activity;
- Amount and type of operating expenditure;
- Details of Premises;
- Number of (qualified) employees identifying the number of full-time equivalents;
- Financial statements;
- Details of the CIGA undertaken and what has been outsourced and to whom;

If a company is deemed to be non-compliant with the substance requirements following submission of its first return, a penalty not exceeding £10,000 can be imposed and, further, the revenue service will exchange information with any other competent authority to which the company (or its owners) are associated. The penalties will increase to £50,000 for non-compliance in the third relevant period and £100,000 for the fourth accounting period following which the company can be struck off the Register of Companies.

Guernsey stands to benefit from substance

For wealth management structures, trust companies and other services providers usually provide the infrastructure for companies they manage so there will be a thorough review undertaken to establish how the SRL

applies to each company which has Guernsey exposure to determine if it is resident (either through incorporation or the 'managed and controlled' test) and assess if any income is generated from 'relevant activity'.

This work and any changes or remediation to make a company SRL-compliant should be undertaken within the first part of the year so that the compliant modus operandi is demonstrably effective during the year and before the first tax filing deadline in November.

The review process will be more involved where it is a foreign incorporated company or where part of the management and resources for the company and its activity rests off-island. Migrating dual substance requirements will need to be considered. This is likely in some cases to lead to a shift of services and management from one jurisdiction to another to create substance certainty. Guernsey is well placed to concentrate the services and needs of its corporate clients on the island and the depth and range of professional personnel adds strength to its position.

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