

LEGAL GUIDE: Economic Substance (Companies and Limited Partnerships) Act, 2018

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1. Background

The Economic Substance (Companies and Limited Partnerships) Act, 2018 (**ESA**) was enacted in the British Virgin Islands on 31 December 2018. Its purpose is to fulfil the BVI's commitment to ensuring the highest standards of tax governance and to ensure that the BVI is not included in Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes (**List**). All key tax neutral jurisdictions (such as Bermuda, the Cayman Islands, Guernsey, Jersey, Isle of Man) have recently passed similar legislation.

The EU's Code of Conduct Group is responsible for preparing the List, the latest version of which was adopted by the ECOFIN Council on 12 March 2019. The Code of Conduct Group also produces at Annex II to the List a document (**State of Play**) setting out the state of play of the cooperation with the EU with respect to commitments taken to implement tax good governance principles.

The BVI tax regime is currently included in the State of Play as one that facilitates offshore structures which attract profits without real economic activity. The BVI, mindful of the need to ensure tax good governance, has made a commitment to address the EU's concerns relating to economic substance in the area of collective investment funds by the end of 2019. It is anticipated that the EU's Code of Conduct Group will provide technical guidance to the British Virgin Islands on the economic substance requirements for collective investment schemes by mid 2019.

The British Virgin Islands International Tax Authority produced on 22 April 2019 a draft Economic Substance Code (**Draft Code**) to set out various rules and guidance on the ESA.

2. Who does it apply to?

Companies and limited partnerships (with legal personality) incorporated in BVI or registered as foreign companies or limited partnerships in BVI which are tax resident in BVI and carrying on Relevant Activities.

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Essentially the ESA provides that companies and limited partnerships (with legal personality) which are tax resident in the BVI must, if they carry out a “Relevant Activity” (listed below) satisfy certain economic substance requirements. A company or limited partnership is tax resident in the BVI if it is not tax resident in another jurisdiction (other than a jurisdiction on Annex 1 of the List. As at 26 March 2019 those jurisdictions on the list are American Samoa, Aruba, Barbados, Belize, Bermuda, Dominica, Fiji, Marshall Islands, Oman, United Arab Emirates, Vanuatu, Guam, Samoa, Trinidad and Tobago and the US Virgin Islands).

The guidance in the Draft Code states that the ESA is aimed at BVI entities which carry on one or more relevant activities substantially outside the BVI but are unable or unwilling to establish tax residence outside of the BVI and are taking advantage of the BVI’s zero tax regime while carrying on their business substantially in another jurisdiction.

Rule 4 of the Draft Code provides that an entity which carries out a Relevant Activity and claims to be a non-resident company or limited partnership (i.e. tax resident outside the British Virgin Islands) must provide evidence of that, such as:

- A letter or certificate from or issued by a competent authority stating that the entity is resident for tax purposes in that jurisdiction;
- An assessment to tax, confirmation of self-assessment, tax demand, evidence of payment of tax or other document issued by a competent authority.

Where tax is charged other than by reference to residence, the guidance in the Draft Code states that what matters is that the competent tax authority accepts that the entity (or its participators) is chargeable to tax on its worldwide income in that jurisdiction.

3. Relevant Activities

The “Relevant Activities” are defined in the ESA as follows:

Banking Business which is defined under section 2(1) of the Banks and Trust Companies Act, 1990 as ‘the business of accepting deposits of money which may be withdrawn or repaid on demand or after a fixed period or after notice, by cheque or otherwise and the employment of such deposits, either in whole or part; (a) in making or giving loans, advances, overdrafts, guarantees or similar facilities; or (b) the making of investments, for the account and at the risk of the person accepting such deposits’;

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Insurance Business which is defined under section 3(1) of the Insurance Act, 2008 to mean ‘the business of undertaking liability under a contract of insurance to indemnify or compensate a person in respect of loss or damage, including the liability to pay damages or compensation contingent upon the happening of a specified event and includes life insurance business and reinsurance business’;

Fund Management Business which is defined as the ‘conduct of an activity that requires the legal entity to hold an investment business license pursuant to section 4 and category 3 of Schedule 3 of the Securities and Investment Business Act, 2010 (SIBA)’. Category 3 of SIBA 2010 reads as follows: Investment Management, Managing Segregated Portfolios, Managing Mutual Funds, Managing Pension Schemes, Managing Insurance Products and Managing Other Types of Investments;

Finance and Leasing Business which is defined as the business of ‘providing credit facilities of any kind for consideration’: and (a) consideration may include consideration by way of interest; (b) 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: (i) the supply of goods by hire purchase; (ii) leasing other than any lease granting an exclusive right to occupy land; and (iii) conditional sale or credit sale; and (c) where an advance or credit repayable by a customer to a person is assigned to another person, that other person is deemed to be providing the credit facility for the purposes of paragraph (a);

Headquarters Business which is defined as ‘the business of providing any of the following services to any entity in the same Group: (a) provision of senior management; (b) the assumption or control of material risk for activities carried out by any of those entities in the same Group; or (c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b)’;

Shipping Business which is defined as ‘any of the following activities involving the operation of a ship anywhere in the world other than solely within the BVI waters (as defined in section 2(2) of the Merchant Shipping Act, 2001): (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; and (e) the management of the crew of a ship’;

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Holding Business which is defined as ‘the business of a pure equity holding entity, which in turn is defined as ‘a legal entity that only holds equity participations and only earns dividends and capital gains’;

Intellectual Property Business which is defined as ‘the business of holding intellectual property assets’, with intellectual property assets defined as any intellectual property right in intangible assets, including but not limited to copyright, patents, trademarks, 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);

Distribution and Service Centre Business which is defined as ‘the business of either or both of the following: (a) purchasing from foreign affiliates: (i) component parts or

materials for goods; or (ii) goods ready for sale; and (iii) reselling such component parts, materials or goods; (b) providing services to foreign affiliates in connection with the business, but does not include any activity included in any other relevant activity except holding business’;

The ESA defines certain “core income-generating activities” (**CIGA**) in respect of each “relevant activity”.

Investment fund business excluded

The guidance in the Draft Code currently clarifies that although investment fund business is not specifically excluded from the legislation as is the case in the Cayman Islands economic substance law, the business of being an investment fund is not a Relevant Activity and is outside the scope of the economic substance requirements. Investment funds that only hold equity in other entities (for example an offshore feeder fund) may fall within the scope of Holding Business as defined in the legislation so we would advise that some caution is taken when considering these comments in the Guidance. We will provide further regulatory updates after the EU’s Code of Conduct Group publishes its technical guidance on collective investment schemes.

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FSC view followed on banking, insurance and SIBA license

The guidance in the Draft Code states that the International Tax Authority of the BVI (ITA) will follow the Financial Services Commission's interpretation of what does or does not fall within the definition of banking business, insurance business and investment business requiring a category 3 investment business licence under the Securities and Investment Business Act, 2010 (SIBA).

Finance and leasing business

The guidance in the Draft Code clarifies that the essence of finance and leasing business is the provision of credit facilities which must be a business in its own right and not incidental to a different sort of business. Entities operating a factoring business (where an entity purchases and then collects another's book debts) will be treated as carrying on finance and leasing business but holding debt or debt instruments for investment purposes will not.

Headquarters business

The guidance in the Draft Code clarifies that an entity's position at the apex of a group structure is not the determining factor as to whether or not it is carrying out headquarters business, but rather the question is entirely dependent on the services it provides to the group. If the senior management are employed by a service company subsidiary, that subsidiary will be providing headquarters services.

Shipping Business

The guidance in the Draft Code states that the ITA will always consider whether activities which appear to fall within the definition of shipping business do in fact constitute shipping business, or whether they are merely incidental activities forming part of a different business e.g. a general travel agent will not be regarded as carrying on shipping business merely because it sells tickets for passenger cruises. Similarly, a manufacturer will not be treated as carrying on shipping business only because it arranges for goods to be sent by sea.

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Intellectual Property Business

The guidance in the Draft Code clarifies intellectual property business applies to holding an intellectual property asset from which identifiable income accrues. A business that owns intellectual property which does not earn specific amounts of revenue and is merely an adjunct to its business would not fall within the definition. What is being targeted are entities which receive income from intellectual property rights which they have not developed themselves or are not actively exploiting.

Distribution and service centre business

The guidance in the Draft Code clarifies that for an entity to carry on distribution and service centre business it must have a business that consists of purchasing assets from other entities in the same group and or providing services to entities in the same group. The purpose is to prevent legal entities paying zero tax in the British Virgin Islands from extracting profits from entities in other jurisdictions which are subject to substantial taxes on profits. Occasional transactions which are ancillary to a different business will not constitute distribution and service centre business.

4. Pure Equity Holding Entities

A pure equity holding entity which carries on no Relevant Activity other than Holding Business (i.e. just holding equity) will have “adequate substance” if it (a) complies with the BVI Business Companies Act, 2004 or the Limited Partnership Act, 2017; and (b) has adequate employees and premises for holding equitable interests.

The guidance in the Draft Code clarifies that for an entity that only carries out holding business there is:

- no requirement that the entity is directed or managed in the British Virgin Islands;
- no requirement that the entity carries out its core income generating activities in the British Virgin Islands;
- no restrictions on the extent to which it may outsource its activities provided the outsourcing is to a person in the British Virgin Islands.

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The guidance in the Draft Code notes states that “adequate” is not defined in the ESA and must be given its ordinary English meaning. The guidance goes on to state that what constitutes adequate employees or premises:

“will be a fact sensitive question, dependent on the nature of the activity being carried on. At one extreme the requirement for being a pure equity holding entity is simply holding equity participations. If this is all the legal entity does during a given financial period, the relevant activity will be entirely passive in nature and the requirements for adequate and suitably qualified employees and for appropriate premises will be applied accordingly. Any legal entity will of course retain the services of a registered agent, and the performance of those services will be taken into account when assessing economic substance for pure equity holding entities.

On the other hand, the entity may actively manage its equity participations, in which case it should have adequate and suitably qualified employees, and appropriate premises, in the BVI to carry out this function.”

5. What do you have to do if the ESA applies to your company or limited partnership?

A company or limited partnership which carries out Relevant Activities is required to: (1) either provide evidence that it is tax resident in a jurisdiction other than the BVI; or (2) establish economic substance in the BVI. Any entity that intends to establish economic substance in the BVI will need to provide additional information evidencing this to its registered agent which will be entered into the Beneficial Ownership Secure Search System (BOSS) (the current system through which beneficial ownership information is centrally uploaded in the BVI).

6. Economic substance requirements

The economic substance requirements for the Relevant Activities other than Holding Business are:

1. the relevant activity is directed and managed in the BVI (not the legal entity which carries on the relevant activity);
2. having regard to the scale and nature of the relevant activity:
 - a. there are adequate, suitably qualified staff located in the BVI;
 - b. there is adequate expenditure incurred in the BVI;
 - c. there are physical offices or premises appropriate for the “core income-generating activities”;
 - d. where an intellectual property business requires specific equipment, that equipment is in the BVI;

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3. the company or limited partnership conducts CIGA in the BVI;
4. if the income-generating activity is carried out by another entity it is done within the BVI and can be monitored and controlled by the original entity.

The guidance in the Draft Code states that:

- where a legal entity's only business is the Relevant Activity or Activities the entity itself must be directed and managed from the BVI.
- There must be an adequate number of board meetings held in the BVI having regard to the nature of the Relevant Activity and its importance to the overall business of the legal entity.
- For a board meeting to be held in the BVI there must be a quorum of directors physically present in the BVI and minutes of the meetings must be kept in the BVI.
- The directors attending the meeting must have adequate expertise to direct the Relevant Activity.
- "adequate", "suitable" or "appropriate" are to be given their ordinary English meaning.
- The ITA will apply criteria such as the "adequacy" of expenditure and employment, the "suitability" of employee qualifications and the "appropriateness" of premises with regard to the usual way in which businesses carrying on the relevant activity on a commercial basis are structured and operate.
- What is adequate for a small business will not be for a large business. The amount of expenditure incurred and the number of employees (and their qualifications) employed globally in the Relevant Activity will be relevant to whether or not expenditure and employment in the BVI is adequate.
- Account will be taken of flexible working practices (provided the homes or premises from which employees work when not in the office are in the BVI) in determining what are appropriate premises in the BVI for the CIGA of a Relevant Activity.
- Premises may be rented or used under licence.
- CIGA and other activities may be outsourced to third parties in the BVI but in respect of economic substance account will only be taken of work done by the entity to whom the work is outsourced which actually relates to the outsourcing entity.
- The activities listed in the definition of CIGA are non-exhaustive and what constitutes CIGA of a Relevant Activity is fact sensitive and can vary from business to business. It may be possible to be carrying out a Relevant Activity without conducting all the activities listed in the definition of CIGA.

There are specific rules in the Draft Code to clarify how the number of employees in the BVI will be calculated.

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7. New BOSS Information

The ESA has made various amendments to the BOSS Act so that each company and limited partnership carrying out one or more Relevant Activity is now required under the BOSS Act to provide additional information to the registered agent in the BVI, including: (i) details of any Relevant Activities that it carries on; (ii) details of its parent (iii) if non-resident in the BVI for tax purposes, details of where it is tax resident; (iv) if resident in the BVI for tax purposes, in respect of each Relevant Activity: total turnover; expenditure incurred in BVI; number of employees; address[es] in the BVI; equipment located in BVI; names of the persons responsible for the direction and management of the Relevant Activity; and the name of any entity that carries out a core income-generating activity for the company or limited partnership.

The ESA has also amended the BOSS Act so that limited partnerships now fall within the remit of that legislation, requiring beneficial ownership information to be provided by limited partnerships to the BVI registered agent. In addition, any exempt entity (under the BOSS Act), such as a listed company or a regulated fund, is required to provide beneficial ownership information to its registered agent (to be uploaded into BOSS) if such entity carries out a Relevant Activity.

8. Intellectual Property Business

The ESA provides that there is a rebuttable presumption that any company or limited partnership which carries on an intellectual property business does not conduct core income-generating activities in the BVI (and therefore cannot comply with the economic substance requirements in ESA) if:

- a) the activities carried on in the BVI do not include intellectual property business concerning intellectual property assets such as patents, research and development or non-trade, intangible assets such as brand, trademark and customer data, marketing, branding and distribution; or
- b) the company or limited partnership is a “high risk IP legal entity”.

A “high risk IP legal entity” is a legal entity which carries on an intellectual property business and which: (a) acquired the intellectual property asset: (i) from an affiliate; or (ii) in consideration for funding research and development by another person situated in a country or territory other than the BVI; and (b) licences the intellectual property asset to one or more affiliates or otherwise generates income from the asset in consequence of

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activities (such as facilitating sale agreements) performed by foreign affiliates. The guidance in the Draft Code provides that in determining if the presumption is rebutted there is a high evidential threshold and the ITA will need to be satisfied that the activity in the BVI is more than local staff passively holding intangible assets whose creation and exploitation is a function of decisions made and activities performed outside the BVI. The entity must employ local, permanent and qualified staff and show

that they make active and ongoing decisions in relation to the generation of income in the BVI.

9. When do you have to comply by?

The ESA came into force on 1 January 2019 and applies to companies and limited partnerships which carry on a Relevant Activity during any financial period. “Financial Period” for companies and limited partnerships formed before 1 January 2019 is defined as a period of one year commencing on a date no later than 30 June 2019 and every following period of one year. The “Financial Period” for companies and limited partnerships formed after 1 January 2019 will commence on the date of their incorporation or formation and will ordinarily terminate a year later. Such entities may give notice to the ITA that they wish to shorten their first Financial Period within three months of their incorporation or formation or within three months of 30 June 2019.

Entities formed before 1 January 2019 may give the ITA notice that they wish their first Financial Period to commence on a date prior to 30 June 2019 but after 1 January 2019 provided they do so before 31 December 2019. Such entities may also apply to the ITA to shorten their Financial Period so that it coincides with their accounting or financial year.

The ITA may determine that a company or limited partnership has not complied with the economic substance requirements during any financial period of the relevant entity ending on or after 31 December 2019.

The guidance in the Draft Code clarifies that where an entity’s fiscal year or accounting year is different from its Financial Year for the ESA purposes an entity may need to provide evidence from two accounting years to demonstrate the ESA requirement in one Financial Period. The ITA may treat an entity as provisionally resident in a jurisdiction pending the issuance of suitable evidence by a local competent tax authority.

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10. How is it enforced?

The ITA can require a company or limited partnership to provide information to assist it in making its determination. This is in addition to the additional information requirements for BOSS.

The guidance in the Draft Code states that:

“an entity which does not take steps either to take its relevant activity outside the scope of the legislation, or to bring it into compliance with the legislation, can expect to be the subject of enforcement proceedings.”

Where a legal entity notifies the ITA of its intention to re-locate a Relevant Activity to the British Virgin Islands to comply with the ESA, the ITA may agree a compliance plan setting out a timetable to ensure that the re-location happens as soon as practicable.

Exchange of information will take place between the ITA and the tax authority of any jurisdiction in which an entity claims to be tax resident as well as with the EU where the entity has one or more beneficial or legal owners resident in the EU.

11. Offences and Penalties

On a first determination of failing to satisfy the economic substance requirements the ITA can impose a penalty of between \$5,000 and \$20,000 or \$50,000 for certain high-risk intellectual property companies or limited partnerships. On a second determination the ITA can impose a penalty of between \$10,000 and \$200,000 or \$400,000 for certain high-risk intellectual property companies or limited partnerships.

The ESA creates an offence of failing to provide or providing false information which is punishable on summary conviction with a fine of up to \$40,000 or 2 years imprisonment and for a conviction on indictment of up to \$70,000 and 5 years in imprisonment.

The ITA can recommend to the BVI Financial Services Commission that the relevant company or limited partnership is struck off the relevant register.

12. Regulations and Guidance Notes

The ESA also provides for regulations to be issued expanding on the meaning of terms defined in ESA and providing how the economic substance requirements can be met.

We anticipate that the Code will be issued shortly and that the Draft Code is likely to be largely adopted in the final Code.

We will provide further guidance once the final Code comes into force and if any further regulations or guidance notes are issued.

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13. What you need to do now

1. If you have a previously BOSS exempt entity, such as a listed entity or limited partnership, liaise with your registered agent to ascertain what beneficial ownership information needs to be provided (this provision is already in force so any entity that has not complied is in breach).
2. Consider whether your BVI company or limited partnership carries out any Relevant Activities.
3. If your BVI company or limited partnership carries out any Relevant Activities, consider whether such entity is tax resident outside the BVI and obtain evidence of this.
4. If your BVI company or limited partnership carries out any Relevant Activities and is not tax resident outside the BVI, consider what is required for such entity to establish economic substance in the BVI.
5. Start contingency planning for complying with and or demonstrating compliance with the economic substance requirements or restructure.

14. How can Oxford Management Ltd help you?

1. We can advise you on applicability of and compliance with the ESA and each of the above points.
2. We can provide BVI based directors, secretaries and other officers to help you establish economic substance in the BVI.

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