



Economic substance: It's time for a health check

In 2016, the EU Code of Conduct Group on Business Taxation – in line with the OECD Base Erosion and Profit Shifting (BEPS) initiative – committed to coordinated policy efforts in the fight against tax fraud, evasion and avoidance. One consequence of this has been increased scrutiny on tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.

Within the EU, the Anti-Tax Avoidance Directive (ATAD) now lays down the minimum standards for EU member states. In response to developing EU and international standards, a number of non-EU jurisdictions, including the Cayman Islands, Bermuda, BVI and the British Crown Dependencies, have also recently introduced local legislation to ensure adequate 'economic substance' rules are in place. Jurisdictions that fail to meet the EU's requirements risk being deemed uncooperative and blacklisted.

What substance means in practice

Broadly speaking, companies wishing to claim tax residence in a jurisdiction that has introduced substance legislation are required to satisfy an 'economic substance test' in order to do so. General considerations regarding economic substance typically include, but are not limited to:

- Activities undertaken
- Registered office location
- Location of management and control, including where relevant decisions are made, and central administration
- Frequency and location of board meetings
- Location and number of employees
- Operating expenditure and location of physical assets.

Substance requirements are typically directed towards businesses that are tax-resident in the relevant jurisdiction and which carry out business activities that are categorised as 'geographically mobile'. These activities, originally identified by the OECD forum on harmful tax practices, include:

- Banking
- Insurance
- Shipping
- Fund management (this does not include companies that are collective investment vehicles)
- Financing and leasing
- Headquartering
- Distribution and service centres
- Operation of a holding company
- Intellectual property (for which there are specific requirements in high-risk scenarios).

The legislation applies to companies, with partnerships and trusts (including unit trusts and LLPs) generally falling out of scope.

If your business is engaged in one or more of the above geographically mobile activities, then substance may be required in the jurisdiction of incorporation.

However, each jurisdiction has its own application of the EU substance rules, with varying scope and specific requirements. An economic substance and tax status 'health check' is therefore advisable for all legal entities that conduct relevant activities.



Jurisdictional requirements

British Crown Dependencies: Guernsey, Jersey and the Isle of Man

Substance has been a core element of the service proposition in the Crown Dependencies for many years, and the new legislation is, in many ways, merely a codification of the best practice already being applied.

The governments of Guernsey, Jersey and the Isle of Man have worked closely together in developing legislation that meets the EU's requirements, which is reflected in the similarities of each jurisdiction's substance requirements.

Entities in scope – in other words, those that are engaged in any of the aforementioned 'geographically mobile' activities – are required to:

- Be directed and managed in the jurisdiction
- Carry on applicable core income generating activity (CIGA) in the jurisdiction
- Have an adequate level of appropriately qualified employees in the jurisdiction (whether or not employed by the entities or another entity and whether on temporary or long-term contracts), proportionate to the level of activity
- Have an adequate level of expenditure within the jurisdiction that is proportionate to the level of activity
- Have an adequate physical presence (including offices and/or premises) in the jurisdiction, again proportionate to the level of activity carried on in the jurisdiction.

Reduced requirements apply to pure equity holding companies (i.e. companies that perform no commercial activity and that, as their primary function, hold controlling interests in other companies):

- They must be in compliance with their obligations under applicable corporate law
- They must have adequate persons
- They must have adequate premises.

British Overseas Territories

A number of other jurisdictions have also introduced, or are in the process of introducing, similar legislation. The Cayman Islands, Bermuda and BVI have all enacted legislation similar to that of the Crown Dependencies, focusing on relevant geographically mobile activities and requiring that in-scope entities demonstrate economic substance by satisfying the economic substance test in the relevant jurisdiction.

Curaçao

Economic substance in Curaçao is generally determined by the number of employees and amount of operational expenses that are proportionate to the economic profile and income generating activity. This allows companies incorporated and/or resident in Curaçao to use specific tax regimes available under the local tax code. Moreover, in order to access the treaty benefits available under the Netherlands–Curaçao tax arrangement, entities that have share capital held 50% by Curaçao residents; are traded regularly on the Curaçao stock exchange; or have headquarter functions in Curaçao, are automatically deemed to have economic substance.

Luxembourg

While many jurisdictions' substance requirements have been implemented through single pieces of legislation in response to the recent developments in international standards, other jurisdictions such as Luxembourg have existing – and in some cases complex – legislation built up over a longer period of time, with conditions specific to the entity in question or tax benefit being sought.

Luxembourg substance requirements come from a variety of sources in law. The founding text of the substance notion in Luxembourg is contained in the law of 10 August 1915 concerning commercial companies: any company whose central administration (head office) is the Grand Duchy of Luxembourg shall be subject to Luxembourg law.



The law of 22 September 2011 – regarding access to commercial activities, craft and industrial activities and certain liberal professions – enacted criteria to establish commercial companies, including:

- The existence of a business place showing an appropriate installation adapted to the nature and size of the activities
- An infrastructure comprising the administrative and technical equipment necessary for the conduct of the activities
- The permanent exercise of management and staff work
- The archiving of the social affairs.

It further prescribes that a domiciliation contract is not sufficient.

Various circulars issued by Luxembourg authorities contain requirements for specific types of business. For example, a Luxembourg finance company must meet the following conditions in order to be considered to have a real presence in the jurisdiction:

- The majority of board members, directors or managers with binding power are resident or at least professionally resident in Luxembourg
- The majority of board members, directors or managers have sufficient background and knowledge to exercise their function
- The company has qualified employee(s) and an appropriate organisation to monitor executed transactions (with the caveat that certain functions may still be outsourced as long as they are supervised by the company's managers/directors and there is no impact on the risk control)
- Decisions regarding social affairs are taken in Luxembourg and at least one shareholder meeting is held per year, depending on the legal form of the company
- A nominative bank account is opened and maintained with a Luxembourg bank
- Equity is appropriate in relation to the level of activity.

Similarly, a circular issued on 23 August 2018 formalised the approval process and organisation of Luxembourg fund management companies and outlined substance requirements applicable to those companies. The circular specifies that an alternative investment fund manager (AIFM) shall have its central administration in Luxembourg, meaning a decision-making centre as well as an administrative centre. 'Central administration' is understood in a broad sense, including direction and management as well as execution and control. An AIFM must also have its own premises, and a minimum of three full-time staff employed and located in Luxembourg with sufficient skills and professional experience.

The Netherlands

Netherlands substance requirements consist of general rules and additional requirements structured around specific types of companies and the rules under relevant tax regimes and treaties. General rules for Dutch entities include:

- At least 50% of the company's statutory directors authorised to represent it are Dutch residents
- The Dutch resident directors have sufficient professional expertise to properly fulfil their duties
- The company has qualified personnel to execute and administer its transactions
- Board decisions are made in the Netherlands
- The company's main bank accounts are held in the Netherlands
- The company's bookkeeping is prepared in the Netherlands
- The company's business address is in the Netherlands
- The company is not, to the best of its knowledge, considered tax resident in another country.



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Additional requirements apply to financial service companies (FSCs); companies whose activities consist 70% or more of providing (mirroring) group financing activities, whereby the entity must incur a 'real risk' and have equity appropriate to this risk.

At this moment in time, Dutch holding companies are not required to fulfil minimum substance requirements. However, the requirements for FSCs are expected to be extended to international holding companies in due course.

Reporting and penalties

Under new substance legislation, entities will generally be required to provide additional relevant information to tax authorities in order for an assessment to be made. The penalties for non-compliance vary across jurisdictions, ranging from fines through revocation of licences/authorisations to even being struck off from local registers.

How IQ-EQ can help

Businesses established in jurisdictions that have introduced specific substance legislation or which otherwise impose substance requirements will need to assess the impact on their structures and take appropriate measures.

At IQ-EQ, we have the global presence and expertise to ensure compliance with economic substance requirements and across multiple jurisdictions. Combining a global client relationship management approach with in-depth local insight, our teams work closely with our clients to provide practical guidance and tailored solutions to meet the substance requirements in each relevant location.

Through our comprehensive range of corporate secretarial and governance services, including regulatory/tax compliance services, outsourced business solutions and financial accounting and reporting, we are able to take care of most substance elements in-house – including the provision of local directors to bring a company within the scope of a certain jurisdiction. Where required, we also have extensive experience of re-domiciliation and have processes in place to achieve this quickly and cost effectively.

To find out more about how IQ-EQ can support the economic substance requirements of your business, please get in touch with any of our key jurisdictional contacts listed overleaf.



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