

The impact of economic substance rules on family offices in the Channel Islands

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The economic substance legislation that came into force in Guernsey and Jersey in January 2019 requires companies that are tax resident in either island, and that conduct one or more of the defined activities, to demonstrate that they meet threshold levels of physical substance in their respective jurisdictions.

How do the rules apply to family structures?

The rules will only apply to family offices with Guernsey- or Jersey-based companies whose activities fall into one of the nine statutory categories ("relevant activities"). In practice, private wealth structures are only likely to engage in two of these, namely pure equity holding and finance and leasing.

While the legislation defines a holding company as one whose primary function is the acquisition and holding of shares or equitable interests (noting that a company holding only real estate assets will not be in scope), and captures companies with a majority stake in subsidiaries (but not those holding minority interests in private or listed companies), the guidance appears to confirm by way of an example scenario that PTCs would not be classed as holding companies. This distinction is drawn on the basis that PTCs - a common feature of family offices - are not the beneficial owners of the assets held and typically have no gross income, their primary function being to act as trustee of various family trusts. However, a PTC may be caught if it carries out one of the other relevant activities.

Turning to finance and leasing, a company will be caught if it offers credit or financing of any kind, whether to individuals or intra-group, for consideration. Therefore a company held by a family trust which provides loans to beneficiaries will not be within scope if the loan is interest free, unsecured and repayable on demand, but the inclusion of commercial terms may render it a relevant activity.

What should families be looking at when it comes to structuring their affairs?

The first question for families looking to set up structures in the Channel Islands will be whether any proposed family office would engage in activities that fall within the scope of the legislation. To the extent that it would, the relevant companies would need to demonstrate that they have adequate substance within the chosen island, specifically that each company:

- is directed and managed in the island
- has an adequate number of qualified employees proportionate to the level of activity carried on in the island
- has adequate expenditure proportionate to the level of activity carried on in the island
- has adequate physical assets or premises in the island
- conducts core income-generating activity in the island

Many family offices will need to make few, if any, changes to existing models, as it is already good practice (and often necessary to avoid the jurisdiction of other tax regimes) for the majority of board meetings to be held on the island, with a quorum of directors physically present. Similarly, most family structures that employ staff will choose local personnel with the requisite understanding of the local laws and regulatory framework. However, families should carry out a thorough review of any proposed or established structures and obtain appropriate advice to ensure they are compliant, as the penalties for infringement include financial sanctions ranging from £3,000-£100,000, as well as strike-off by the courts.

Are there implications in terms of governance and oversight?

A family office which carries out a relevant activity will need to ensure that its operations, policies and procedures meet the thresholds and reflect the models imposed by the legislation. It will be vital to ensure that each company's compliance is carefully recorded and documented so that it can demonstrate that it meets the required standards, and additional information will likely need to be filed in respect of 2018 and 2019 tax returns and thereafter. Fundamentally, entities will need to evidence that they have a substantial connection to the relevant island.

How have families reacted to the rules and what do they mean for jurisdictions as centres for family offices in the future?

In our experience, local family offices are sophisticated structures, with such of their companies as are resident in the Channel Islands already meeting the substance criteria and therefore causing the respective families no concern. Insofar as foreign entities within those structures are concerned, we are seeing an increase in inward company migrations as family offices seek to take advantage of the islands' excellent reputation and attractive private wealth offering.

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