

Economic substance laws: the private wealth context

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Recently as part of on-going international initiatives, a large number of international finance centres (including Jersey, Guernsey, BVI and Cayman) have passed new laws requiring companies which are tax resident in such centres and also conducting certain types of activities to demonstrate that they have an adequate level of physical substance and operations in those centres. The fundamental scope and principles are the same in each of the relevant centres, although there are some interesting areas of difference which are beginning to emerge in the application of certain specific aspects of the regimes between different centres.

The following article sets out a brief overview of the new substance regime with a particular focus on its application to private wealth structures. Although the article refers specifically to Jersey, the comments are directly applicable to Guernsey and the general principles can also be applied in relation to BVI and Cayman structures (albeit with some different nuances).

Further details on the economic substance regimes in each of Jersey, Guernsey, BVI and Cayman are available in our specific client briefings available here:

[Jersey](#)

[Guernsey](#)

[BVI](#)

[Cayman](#)

What is the economic substance law?

Certain international finance centres including Jersey have passed new laws relating to economic substance that are focused on requiring companies to demonstrate sufficient physical substance to justify their profits in the jurisdictions in which they are tax resident.

The move is a response to pressure from the EU Code of Conduct Group which is concerned about companies paying taxes on economic activity in low or zero-tax jurisdictions, with only a peripheral connection to that jurisdiction.

The law in Jersey has been in force since 1 January 2019, and has been approved by both the Privy Council and EU finance ministers, meaning that the Island has been "white listed" and is formally recognised by the EU as a co-operative jurisdiction on tax matters.

On 26 April 2019 the Jersey government (together with Guernsey and the Isle of Man) released a guidance note on the economic substance requirements (the Guidance). The publication of the Guidance follows the recent removal of all three Crown Dependencies from Annex II of the ECOFIN list of non-cooperative jurisdictions for tax purposes.

Is your company within scope?

Not every company is in scope. The economic substance legislation covers companies that are tax resident in Jersey and that conduct one or more of the nine defined relevant activities, of

which two will be particularly relevant from a private wealth perspective, namely pure equity holding and finance and leasing.

The law defines a holding company as one with the primary function of the acquisition and holding of shares or equitable interests – importantly, a company holding only real estate assets will not be in scope, and the law captures companies with a majority stake in subsidiaries, not those holding minority interests in private or listed companies.

As regards finance and leasing, the definition captures any company which offers credit or financing of any kind for consideration, such as loans, hire purchase agreements, long term credit plans, and finance leases in relation to assets other than land. This includes intra-group lending arrangements.

In a private wealth context it is common to encounter a situation whereby a company that is wholly owned by the trustee of a trust will make loans to beneficiaries of that trust on terms that are interest free, unsecured and repayable on demand. Given that finance and leasing involves the business of providing credit facilities of any kind for consideration (including interest), it would appear that the making of such "soft" loans would not in themselves bring a company within scope. However, this does not mean that the company in question would not fall within the scope of the legislation by virtue of it conducting one of the other 8 relevant activities.

For in-scope companies, what is the substance test?

If in-scope, a Jersey tax resident company will have to satisfy the economic substance test in relation to economic activity carried out by that company. To do so, it will have to demonstrate that it has adequate substance in the Island, namely that: it is directed and managed in the Island; it has an adequate number of (qualified) employees proportionate to the level of activity carried on in the Island; it has adequate expenditure proportionate to the level of activity carried on in the Island; it has an adequate physical presence in the Island; and it conducts core income-generating activity in the Island.

Unfortunately the Guidance did not provide a great level of detail on the meaning of the term "adequate". It did note however that what constitutes an "adequate" number of meetings in the Island will be dependent on the relevant activities of the company and that it is generally expected that the majority of board meetings will be held in the Island, with a quorum of directors physically present in order to meet the requirement.

There are reduced requirements for holding companies, which the Guidance has indicated will be outlined in more detail at a later date.

What happens if the test isn't met?

The penalties for non-compliance rise on a sliding scale. The penalties include action in relation to exchange of information, and include financial sanctions starting at £3,000 and rising to £100,000, and ultimately, the courts have the power to ensure the tests are met and to wind up a company or strike it off the companies register.

How does this affect Private Trust Companies (PTCs) or Registered Office (RO) only companies?

The Guidance appears to confirm (but only by way of an example scenario) our view established prior to release of the Guidance that PTCs would not be classed as holding companies. This is on the basis that PTCs are not the beneficial owner of the assets held, they typically have no gross income and their primary function is to act as trustee. Again, this does not mean that a PTC would not fall within the scope of the legislation be reason of conducting

one of the other 8 relevant activities. It is likely that Managed Trust Companies will also fall into the same bracket.

For RO business, the position is different. RO only companies are expected to be within scope if they are tax resident in Jersey and are carrying on any of the nine relevant activities. On the face of it RO companies, if in scope, are unlikely to meet the substance criteria because they are unlikely to be directed and managed in Jersey, or to be carrying out their Core Income Generating Activities here.

What are the next steps?

The position on record keeping and documentation may need to be reviewed and updated to demonstrate that the required standards are met, and additional information will likely need to be filed in respect of 2018 and 2019 tax returns and all tax returns thereafter.

Fundamentally, the new law requires a top-to-bottom review of structures, and legal advice about scope and whether tests are met.

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