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BVI: Economic Substance Update

MAY 2019

The draft Economic Substance Code (**Code**) has now been published by the International Tax Authority (**ITA**) and contains rules and guidance from the ITA with regard to the application of the Economic Substance (Companies and Limited Partnerships) Act 2018 (**ESA**). The final form of the Code is expected in early May. While the Code does not have the force of law, the ITA intends the guidance given in the Code to be relied upon. The key areas of the ESA and the Code have been set out as follows:

Relevant Activity

The ESA specifies the following relevant activities, which if carried on by an entity during a financial period will mean that such entity will be subject to the economic substance requirements set out in the ESA:

- **Holding Business**
  This means the business of being a pure equity holding entity (PEHE). In order to be classified as an PEHE, that entity must hold equity participations ***only***. Essentially this means shares or other forms of investment affording a right to participate in the profits of a company. Therefore the holding of other assets by an entity, either solely or in conjunction with equity participations, would preclude it from being classified an entity carrying on holding business for the purposes of the ESA.

- **Finance and Leasing Business**
  This category is intended to encompass the provision of credit facilities. The provision of such facilities must be the entity's ***business***. Therefore, the Code makes it clear that where the provision of credit is simply an incidental part of a different form of business, this would not constitute finance and leasing for the purposes of the ESA. The Code also clarifies that the reference to leasing means leasing in the sense of credit provision, rather than leasing in the sense of hiring out physical assets such as cars, boats, etc.

- **Distribution and Service Centre Business**
  This category encompasses (i) the purchase of parts or finished goods from ***foreign affiliates*** and reselling such goods and/or (ii) the business of providing services to ***foreign affiliates***. Therefore, where the goods or parts in question are purchased from an unrelated third party or a BVI situate entity such activity would not fall within this category. Similarly, where the provision of services to a foreign affiliate do not form part of an entity's business (but are undertaken on an incidental or occasional basis), are provided to an unrelated third party or are provided to a BVI situate affiliate such services would not fall within this category.

- **Intellectual Property Business**
  The Code clarifies that the type of business which is intended to be caught here is merely holding an

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intellectual property asset and deriving income from that asset in the form of royalties, capital gains, franchising income and income from licensing. An IP asset is an IP right in an intangible asset including but not limited to copyrights, patents, trade marks, brand and technical know how from which identifiable income accrues (such income being **separately identifiable from any income generated from any tangible asset in which the right exists**). Therefore, sale of a product or service which constitutes many components other than IP rights should not constitute intellectual property business for the purposes of the ESA.

- **Banking Business**
  "Banking business" has the same meaning as that specified in Section 2(1) of the Banks and Trust Companies Act 1990, and effectively covers entities carrying on the traditional banking activities of receiving and holding deposits.

- **Insurance Business**
  "Insurance business" is self explanatory and, as one would expect, the definition should catch entities genuinely carrying on the provisions of insurance as their business.

- **Headquarters Business**
  This category is deigned to encompass businesses providing headquarter-type services such as senior management, risk management and risk advice particularly where the entity charges for such services across other entities in the group. The Code clarifies that a company need not necessarily sit at the top of a group structure to be classified as carrying on headquarters business but rather its classification is contingent on the form of services provided to other group members.

- **Shipping Business**
  This category sets out a substantive list of shipping activities including transportation, renting/chartering selling travel tickets, rental of containers and management of shipping crews. The activity must actually involve the "*operation of a ship*" and the ITA has confirmed that it will take into consideration whether the activities are the entity's primary business or are merely incidental to its other business. For example, the carrying on of shipping activity by a business purely in order to transport goods sold by that business would be clearly incidental.

- **Fund Management Business**
  The ESA defines fund management business as the conduct of an activity that requires the legal entity to hold an investment business licence pursuant to section 4 and category 3 of the Securities and Investment Business Act 2010 (**SIBA**). Category 3 of Schedule 3 of SIBA contains the following activities:

  Investment Management

- Sub-category A: Managing Segregated Portfolios (excluding Mutual Funds)
- Sub-category B: Managing Mutual Funds

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- Sub-category C: Managing Pension Schemes
- Sub-category D: Managing Insurance Products
- Sub-category E: Managing Other Types of Investment

Importantly, the Code has clarified that the business of being an investment fund is not a relevant activity and is therefore outside the scope of the ESA. This is on the basis that the business of being an investment fund has not been specifically mentioned as a relevant activity. As noted above, an entity may carry on several types of relevant activity so it is important to review the nature of the activities undertaken.

Non-Resident Entities

Where an entity is not tax resident in the BVI, and provided that the jurisdiction where it is tax resident is not on Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes, then that entity will not fall within the scope of the ESA. The entity will have to confirm details of its tax residence to its registered agent within 6 months of the end of the relevant financial period together with evidence as to its tax residence (broadly speaking this will be a letter or certificate confirming its tax residence or an assessment to tax from the competent tax authority in the jurisdiction where the entity claims tax residence).

Substance Requirements

Where an entity falls within the scope of the ESA, then it must meet the substance requirements applicable to the relevant activity carried out by that entity. The substance requirements can be broadly split into three headings (i) direction and management (ii) expenditure, employees and premises and (iii) core income generating activities (**CIGAs**).

The nature of substance requirements differ depending on whether an entity is a PEHE, carrying on intellectual property business or carrying on one of the other forms of relevant activity specified above.

Substance requirements for entities carrying on relevant activities which are neither holding business nor IP business are as follows:

- **Direction and management in the BVI**
  The relevant activity must be directed and managed in the BVI. This effectively means a number of physical board meetings taking place in the BVI which are minuted and such minutes kept in the BVI.

- **Adequate expenditure, number of suitably qualified employees and appropriate premises in the BVI.**
  The legislation is not framed such that a company must incur more expenditure or engage more employees than it actually needs. However, the ITA will be concerned as to the balance between expenditure in the BVI and elsewhere in the world.

  Entities are entitled to outsource part of their activity and this will count towards compliance for substance purposes provided that the entity to which the activity is outsourced is BVI resident, and only activities which are specifically carried on for the entity which is doing the outsourcing can be counted

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towards it compliance for ESA purposes.

The Code clarifies that an employee for the purposes of the ESA need not be employed by the legal entity, but it must be an employee of somebody and must be managed as an employee by the legal entity in question. The Code has also clarified that premises need not be owned they can be rented or used on licence.

- **CIGAs**
  The Code recognises that the type of specific CIGAs carried on by businesses are fact sensitive. As such, the Code has clarified that the specific GIGAs which are listed for each relevant activity are not exhaustive nor are they necessarily prescriptive. CIGAs will be carried on in the BVI if they are carried on by employees in the BVI or if they are outsourced (subject to the above outsourcing requirements) to a person whose own employees work in the BVI.

Substance requirements for entities carrying on IP businesses are as follows:

The substance requirements for an entity carrying on IP business incorporate the above but also contain an additional layer of obligations. Whilst the Code clarifies that an entity may be in compliance with the substance requirements, even though the activities it carries on are not the specific CIGAs which are mentioned in Section 7 of the ESA, with regard to IP business there is a presumption that the entity is not in compliance with substance where it does not carry on the specific CIGAs set out in Section 7. Broadly, this presumption may be rebutted where the strategic decisions are taken and principal risks are borne relating to development and exploitation of the IP assets within the BVI.

In addition, entities which are classified as "high risk IP legal entities" are also subject to a presumption of not conducting CIGAs in the BVI. The classification of high risk IP legal entities has been designed to capture IP profit shifting and generally speaking applies to entities which acquire IP assets from affiliates and then license such IP assets to other affiliates. In order for a high risk IP legal entity to rebut this presumption it must have suitably qualified employees on long term contracts in the BVI who exercise a high degree of control over the development, exploitation, maintenance, enhancement and protection of the IP asset.

Substance requirements for PEHEs are as follows:

- **Direction and management in the BVI**
  There is no requirement that a PEHE must be directed and managed in the BVI.

- **Adequate employees and premises for holding equity participations in the BVI.**
  PEHEs are required to have, in the BVI, adequate employees and premises for holding equity participations and where it manages those equity participations, to have, in the BVI, adequate employees and premises for carrying out that management.

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What constitutes "adequate" is not explicitly defined and the Code states that an entity's compliance with this requirement will be *"a fact sensitive question, dependent on the nature of the activity being carried out."* Where the holding of equity participations is passive in nature, the requirement for adequate employees and premises may be satisfied by the BVI registered agent and existing registered office.

- **CIGAs**
  There is no requirement that a PEHE carries on CIGAs in the BVI, recognising that it is broadly a passive activity.

Financial Periods

Compliance with the ESA will be by reference to one year financial periods. The first financial period will, for companies incorporated on or after 1 January 2019, be one year from the date of incorporation (unless that entity applies to the ITA for a shorter period to apply). Where the company is incorporated prior to 1 January 2019 the company's first financial period shall commence from 30 June 2019 (unless the entity applies to the ITA for an earlier commencement date, being no earlier than 1 January 2019) and shall run for a period of one year. In each case the entity's relevant financial period shall thereafter run for successive periods of one year from the date of termination of the first such period. An entity can always apply to the ITA to amend the dates of its financial period provided that the revised financial period does not exceed 12 months.

Reporting Obligations

In addition to existing obligations under the Beneficial Ownership Secure Search System Act, legal entities will be required in respect of each financial period to ascertain and confirm to their registered agent whether or not the entity carries on a relevant activity and, if so, details relating to such relevant activities. These details should be provided by the entity to the registered agent within 6 months of the end of the relevant financial period.

Enforcement and Penalties

Enforcement under the ESA is within the remit of the ITA. Penalties under the ESA are divided into two categories, (i) Failure to comply with the economic substance requirements and (ii) Failure to provide accurate information.

- **Failure to comply with the economic substance requirements:**
  The ITA may issue a determination that an entity has not complied with the economic substance requirements in respect of a financial period at any time within 6 years from the end of that financial period (this 6 year period may be extended in the case of fraud or deliberate misrepresentation). Where the ITA issues a first such determination it will specify, among other matters, the reasons for the determination, the amount of the penalty, the actions required to bring the entity into compliance and the fact that it has a right of appeal. The penalty imposed in conjunction with a first determination is, at a minimum $5,000 and at a maximum, $20,000. However, where the entity is a high risk IP legal entity the maximum penalty is

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$50,000. Where the entity does not comply with the requirements set out by the ITA in the first determination, then the ITA will issue a second determination. The second determinations shall be accompanied by a further penalty at a minimum of $10,000 and at a maximum, $200,000 and in the case of a high risk IP legal entity, $400,000.

- **Failure to provide accurate information:**
  A person who fails to provide accurate information in response to a request from the ITA is liable (i) on summary conviction to a fine not exceeding $40,000 or to 2 years in prison or both and (ii) on conviction on indictment, to a fine not exceeding $70,000 or to 5 years in prison or both.

What Next?

Companies will be required to confirm the above details to their Registered Agent within 6 months of the end of the first applicable financial period, as above. It is therefore key that companies have received professional advice in good time as to whether or not they fall within the scope of the ESA and if so what their reporting and compliance obligations are. For assistance determining the classification for your entity and any other advice you may need in connection or to ensure compliance with ESA, please contact one of the team.

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