Jersey's Economic Substance Law

December 2018

On the 6 December 2018, The States of Jersey passed the Draft Taxation (Companies – Economic Substance) (Jersey) Law 201- (Draft Law). The Draft Law, which will come into force on January 1st 2019, looks to meet the requirements of the EU Code of Conduct Group (Business Taxation) (COCG) in respect of economic substance and broadly ensure that Jersey is ready for the implementation of BEPS.

Among other things, the COCG are keen to ensure that jurisdictions "*should not facilitate structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction*". They are also concerned that the absence of a clear statutory requirement for economic substance "*increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence*".

In developing the Draft Law and Jersey's response to concerns raised by the COCG, the Government of Jersey has been closely engaged with a number of jurisdictions and organisations (including the COCG, the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, the Inclusive Framework on BEPS, the OECD's Forum on Harmful Tax Practices, individual EU member states, and the Crown Dependencies).

The Draft Law, published on 23 October 2018, follows a consultation carried out in August 2018. The 35 responses suggested that the Jersey finance industry perceives that good corporate governance and high professional standards mean that most Jersey companies within scope of the substance requirements will be able to demonstrate that they already meet the substance requirements.

Key aspects of the Draft Law are:

- its scope, and component elements of the economic substance test;
- circumstances in which the Comptroller of Taxes in Jersey will exchange information obtained in relation to economic substance with other jurisdictions; and
- the sanctions that will be applied where a company is determined to have failed the economic substance test.

Guidance notes are also to be published by the Comptroller which are expressly referenced in the Draft Law, and some initial high level guidance was published on 7 November 2018.

Scope

The Draft Law applies to "resident companies", being a company that is tax resident in Jersey; that generates gross income during the relevant financial period; where such gross income relates to a "relevant activity".

Such companies must meet the "economic substance test".

The Draft Law defines "relevant activities" as:

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- banking business
- finance and leasing business
- fund management business
- headquarters business
- holding company business
- insurance business
- intellectual property holding business
- shipping business
- distribution and service centre business

Fund management business

In a funds context, "fund management business" is defined in detail and includes managers that are licenced under the Financial Services (Jersey) Law 1998 for certain categories of fund services business as a manager, investment manager, trustee (unless there is a separate manager), and general partner (unless there is a separate manager).

Also included within the scope of the Draft Law is a general partner/trustee of an Unregulated Fund; and a general partner/manager/trustee of a private fund (including a Jersey Private Fund, Private Placement Fund and Very Private Fund).

Therefore, even general partners/managers who are exempt from regulation under the Financial Services (Jersey) Law 1998 must have regard to the Draft Law and where necessary ensure that the economic substance test is met.

Holding company business

A "holding company" is defined as a corporate that has, as its "primary function", the acquisition of "shares or other equitable interests in other companies", and does not carry on any commercial activity. Points to note are that (i) a limited partnership or other form of vehicle is not within scope; (ii) if a company does not hold shares in companies, but rather holds real estate or other assets, then it will not be within scope; (iii) to be in scope its "primary function" must be to hold shares in companies, therefore if it also carries on other activities (such as holding real estate or other assets directly), then a determination will be required as to whether its primary function is the holding of the shares; (iv) as above there must be gross income; and (v) the definition only captures companies that hold a majority interest in subsidiary companies/SPVs, and does not capture for example the holding of minority interests in listed companies (unless held via wholly/majority owned SPVs).

Finance and leasing business

Finance and leasing business means the business of providing credit facilities of any kind for consideration. Consideration may include consideration by way of interest. Therefore, interest free lending will be out of scope, but it would seem that intra-group lending will comprise finance and leasing business. Where a loan is assigned to another person, that other person is deemed to be providing the credit facility.

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Economic substance test

A Jersey tax resident company must satisfy the economic substance test in relation to any "relevant activity" carried on by that company. Companies will be assessed on their economic substance from the financial period starting on 1 January 2019.

A resident company meets the economic substance test in relation to a relevant activity if:

a) the company is "directed and managed" in Jersey in relation to that activity;

b) having regard to the level of relevant activity:

1. there are an "adequate" number of employees physically resident in Jersey, whether or not employed by the resident company or by another entity and whether on temporary or long-term contracts;
2. there is an "adequate" expenditure incurred in Jersey; and
3. there are "adequate" physical assets in Jersey;

c) the company conducts "Jersey core-income generating activity" (**CIGA**); and

d) in the case of Jersey core-income generating activity carried out for the relevant company by another entity, it is able to monitor and control the carrying out of that activity by the other entity.

Directed and managed

The Draft Law contains requirements of how a company can be "directed and managed" in Jersey, including board meetings being held in Jersey at an adequate frequency, at such meetings a quorum of directors are physically present in Jersey, board minutes record strategic decisions of the company at meetings, directors have the necessary knowledge and expertise, and the minutes of all board meetings and records of the company are kept in Jersey.

The initial guidance notes suggest that the number of meetings required will depend on the activities, but it is generally expected that the majority of meetings should be in Jersey and there should be at least one meeting held in Jersey each year even for companies with minimal activities.

CIGA

What will constitute CIGA varies slightly depending on the nature of the business carried on. In a funds context, for example, in respect of fund management business it includes (i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking hedging decisions; and (iv) preparing reports and returns to investors and the JFSC/other regulators; whilst for a headquarters business the focus is on (a) taking relevant management decisions; incurring expenditure on behalf of group entities; or (b) co-ordinating group activities. For holding companies, all activities related to the business comprise CIGA.

The guidance notes confirm that it is not necessary for the company to perform all of the CIGA listed in order to demonstrate substance. An example the guidance notes give is a company that holds a patent does not have to carry on the CIGA of marketing, branding and distribution as well as the research and development.

Outsourcing

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It is notable that the Draft Law specifically refers to third party service providers, in relation to employees "…*whether or not employed by the resident company or by another entity*"; and also CIGA "*carried out for the relevant company by another entity*" (provided that the relevant company can monitor and control the carrying out of that activity by the other entity).

Our view is that in a financial services context, most holding companies and general partners/managers to investment funds (for example) will be able to rely on the substance already being provided by their Jersey resident directors, corporate services providers and fund administrators to demonstrate compliance with the economic substance test. This is supported by the initial guidance notes, which confirm that:

- Outsourcing outside the Island is permitted, and expert professional advice and services can be sought from other jurisdictions, but the income subject to tax in Jersey must be commensurate to the CIGA undertaken Jersey.
- If some or all of the CIGA is outsourced, the company must be able to demonstrate that it has adequate supervision of the outsourced activities and, to meet the substance requirements, that those activities are undertaken in the Island.
- Where a CIGA is outsourced the resources of the service provider in the Island will be taken into consideration when determining whether the people and premises test is met. However, there must be no double counting if the services are provided to more than one company.
- The company remains responsible for ensuring accurate information is reported on its tax return and this will include precise details of the resources employed by its service providers, for example based on the use of timesheets.

Adequate employees, expenditure, physical assets

The Draft Law provides that the Comptroller may issue guidance including as to the meaning of "adequate", and specifies that "*regard must be had to any guidance*" that is so issued.

The guidance notes provide that "adequate" is not a defined term, and therefore has its ordinary meaning, and notes that "*the dictionary definition of "adequate" is: "Enough or satisfactory for a particular purpose".*"

The guidance goes on to provide that what is adequate for each company will be dependent on the particular facts of the company and its business activity. A company will have to ensure it maintains and retains appropriate records to demonstrate the adequacy of the resources utilised and expenditure incurred.

IP holding companies

A higher standard is set for "high risk IP holding companies" (in summary companies that hold intellectual property (**IP**) on behalf of a group without having independently generated that IP). Whilst generally the Comptroller may make a determination that any Jersey company does not meet the substance test, the Draft Law places a positive obligation on high risk IP holding companies to produce sufficient evidence to show that it does meet the substance test.

Filings with Comptroller of Taxes

The form of tax return is currently being amended so that the necessary information will be supplied to the Comptroller of Taxes as part of the usual tax return process for Jersey resident companies.

A Jersey resident company must provide any information reasonably required by the Comptroller in order to assist the Comptroller in making a determination as to whether the substance test is met. This will generally be in the form of information provided on the

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company's tax return. The Comptroller may also serve notice on any person requiring them to provide, within a period of time specified in the notice, any documents and information the Comptroller may reasonably require.

The Comptroller (or any person authorised by the Comptroller) may, at any reasonable time, enter business premises and take copies of any business document located on the premises for the purposes of investigating compliance with the Draft Law.

Exchange of Information with competent authorities

Generally, where the Comptroller determines that a Jersey resident company has not met the economic substance test for a financial period, the Comptroller must provide all information provided to it by the company pursuant to the Draft Law to:

a) the competent authority in the country or territory in the European Union in which the following entities relating to the company reside:

1. its holding body;
2. its ultimate holding body; and
3. its ultimate beneficial owner; and

b) if the Company is incorporated outside Jersey, the country in which the company is incorporated.

In respect of high risk IP companies, the Comptroller must provide any information it has received pursuant to the Draft Law to the parties listed above, regardless of whether or not it is determined to have met the economic substance test.

The Comptrollers' obligation to disclose information to any competent authority under the law overrides any other duty of confidentiality that may exist in respect of the information provided, be that imposed by contract, statute or otherwise.

Sanctions

If the Comptroller determines that the economic substance test has not been met for a financial period, the Comptroller will issue a notice to the company notifying it:

a) that the Comptroller has determined that the Company does not meet the economic substance test;

b) the reasons for that determination;

c) the amount of any fine imposed and the date on which is due (up to a maximum of £10,000 increasing to £100,000 if the test is not met for consecutive financial periods);

d) what action needs to be taken to ensure that the Company does meet the economic substance test; and

e) the company's right of appeal.

A fine of up to £3,000 is payable if a person fails to provide information to the Comptroller when required. Similarly, a fine of up to £3,000 is payable where inaccurate information is provided where (i) the person knew the information provided was inaccurate at the time it was provided; or (ii) the person subsequently discovers the information is inaccurate and fails to take reasonable steps to inform the Comptroller.

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A person who (i) obstructs; or (ii) fails to provide reasonable assistance to the Comptroller or any person authorised by the Comptroller when they enter a business premises to take copies of documents, is guilty of an offence and is liable to a fine and/or imprisonment for up to 6 months.

A person who intentionally alters, suppresses or destroys any business document that has been requested by the Comptroller pursuant to the Draft Law is also guilty of an offence and liable for a fine and/or imprisonment for up to 2 years.

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