Economic Substance changes – how bad is it for private clients and trustees?1

Introduction

The current introduction of “economic substance” laws and regulations in a majority of the international finance centres (“IFCs”) is a very hot topic. Many clients and advisers were initially pessimistic, proclaiming “the beginning of the end” for many traditional structures. However this is far from the case. But what exactly is proposed and what impact will it have on private clients?

The first thing to note is that there remains a large amount of uncertainty in what is being proposed and what will be expected. Much of the guidance is still in draft2 and further amendments to the primary legislation cannot be ruled out. As others have pointed out, the preferred course of action at present is to be aware and be prepared but, notwithstanding the deadline of 30 June in some cases, to hold off on drastic action until further clarity is obtained. That said, many clients are wanting answers!

The background to the global economic substance initiative is well-documented. In summary, the OECD Forum on Harmful Tax Practices set in motion an initiative to require certain companies in specified industries (with a particular focus on perceived harmful tax practices relating to IP holding) to have substantial activities in a particular jurisdiction. This was extended by the European Union (“EU”) to require geographically mobile activities to have substance -regardless of whether the activities are conducted in a no or nominal jurisdiction or in a preferential tax regime of a jurisdiction that has corporate income tax. The threat of being placed on an EU “blacklist” accelerated the implementation of suitable legislation in most IFCs by the end of 2018.

As a result, the majority of IFCs have passed primary legislation and many have issued accompanying guidance. We wait to hear whether the proposals of each such IFC are acceptable to the OECD / EU3. In addition, many IFCs have given commitments regarding investment funds and we expect separate substance requirements in respect of funds to be implemented by the end of 2019.

In summary, the economic substance requirements necessitate a series of questions to be asked in respect of a particular IFC:

1) Does the client have any “relevant entities”4?

2) If yes, (for each financial period) do they carry out one or more “relevant activities”?

3) If yes, do they earn income from each such relevant activity?

4) Are any relevant entities tax resident elsewhere, or could any relevant entities elect to be so tax resident?

Each of these will be looked at in turn from a private wealth perspective. If the answer to questions 1 to 3 is “yes” and the answer to question 4 is “no”, we then need to look at the

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1 This article does not constitute professional advice and should not be relied upon. As at 25 June 2019.
2 BVI being the major example.
3 Note for example that Bermuda were initially on the blacklist but then removed.
4 Other terms are used depending on the specific legislation.
required economic substance and the consequences for not complying. In any event, as 
shall be seen, all entities will have an element of reporting and compliance.

**Who is caught?**

Relevant entities (or the equivalent term in each IFC) is a relatively straightforward concept. Legal entities incorporated or registered in the IFC are included save in certain cases, exclusions for “local” operations. Entities which are tax resident elsewhere are excluded\(^5\). Thus in the British Virgin Islands ("BVI") a “legal entity” (the term used in BVI) means BVI incorporated companies, foreign companies registered in the BVI and relevant BVI limited partnerships (with legal personality). “Non-resident” companies and limited partnerships are excluded. In the Cayman Islands, a “relevant entity” is a company incorporated under the Companies Law (2018 Revision) (but not a “domestic company\(^6\)”), an LLC, an LLP and a foreign company duly registered in the Cayman Islands. “Investment funds?" and entities which are tax resident elsewhere are not included. Trusts are not relevant entities. Other IFCs have similar definitions. This article concentrates mainly on the BVI and the Cayman Islands. Such jurisdictions are the most familiar to the author and the most widely used by private clients in Asia (as well as other regions).

What is clear is that many private clients will have one or more relevant entities – whether owned by themselves or by trustees of family trusts. It is also evident that the vast majority of these will be in the BVI\(^8\). It is then necessary to consider whether or not any relevant entities are carrying out any “relevant activities”.

“Relevant activities” cover the same 9 activities in each IFC\(^9\). In alphabetical order, these are:

- (a) Banking business;
- (b) Distribution and service centre business;
- (c) Financing and leasing business;
- (d) Fund management business;
- (e) Headquarters business;
- (f) Holding company business or holding business\(^10\);
- (g) Insurance business;
- (h) Intellectual property business;
- (i) Shipping business.

Each of the relevant activities is described in the appropriate legislation and guidance. The more sophisticated private wealth structures\(^11\) will have relevant entities caught by a

\(^5\) The BVI requires this not to be in a blacklisted territory.
\(^6\) Essentially one already with a local business operation.
\(^7\) The definition of “investment fund” is wider definition than in the Mutual Funds Law.
\(^8\) BVI has approx. 450,000 active companies which is at least 4 times more than others IFCs caught by economic substance rules.
\(^9\) Although note for example Bermuda has separated financing and leasing.
\(^10\) The term used in the BVI.
\(^11\) For example family office type structures.
number of the relevant activities\textsuperscript{12} but the vast majority, in the author’s view, will need only be concerned with (f) - holding company business / holding business\textsuperscript{13}.

Private clients (or their trustees) will in many cases use one or more companies to hold investments. Whilst there are no direct statistics in terms of private client use, it is evident that the vast majority of these are BVI companies. So, in the BVI, what constitutes “holding business”? This is defined as “the business of being a pure equity holding entity”\textsuperscript{14}. A “pure equity holding entity” is defined as “a legal entity that only holds equity participations in other entities and only earns dividends and capital gains”\textsuperscript{15}.

By way of reference, the definition used in the Cayman Islands\textsuperscript{16} is virtually identical save that “company” is used instead of entity. Jersey, on the other hand, uses a different definition\textsuperscript{17}. In Jersey, “holding company business” is defined as the business of being a holding company and “holding company” is defined as a resident company which is “(a) is a “holding body”; (b) has as its primary function the acquisition and holding of shares and equitable interests in other companies; and (c) does not carry on any commercial activity.” “Holding body” per the Jersey companies law is further defined as in effect owning a subsidiary via voting rights or other control. In other words, the Jersey definition is much narrower and catches only companies with subsidiaries.

Returning to the BVI, it should be easy to identify what is owned by each BVI company\textsuperscript{18}. Assuming none of the other relevant activities are being carried out by the BVI company, an assessment needs to be made as to whether the BVI company is a pure equity holding company (“PEHC”) or not. The BVI Guidance\textsuperscript{19} clarifies further: “the definition of pure equity holding company is deliberately framed in narrow terms. A legal entity will only fall within the definition if it holds nothing but equity participations, yielding dividends or capital gains. The ownership of any other form of investment (such as an interest bearing bond) will take the legal entity outside this definition.”

Many BVI companies will in fact own (or can acquire) investments to take them outside of the definition (real estate being a common example). Certain types of investment may lend themselves to easier record keeping and accounting than others so certainly an interest bearing bond is more convenient than, say, gold or a work of art. Whilst a bank account will also suffice, prudent advice would be that such account should be separate from any account used to receive dividends and capital gains. Insurance wrappers may also prove suitable. What is not stated is any element of proportion – one can anticipate a client with USD5million of equity participations in a PEHC asking “what value of interest bearing bonds does the company need to buy?”! There is no answer to this, suffice to say a purely nominal

\textsuperscript{12} Fund management and shipping for example.
\textsuperscript{13} For groups of holding companies, headquarters business will need to be closely considered.
\textsuperscript{14} See the Economic Substance (Companies and Limited Partnerships) Act 2018
\textsuperscript{15} The Economic Substance (Companies and Limited Partnerships) 2018 (as amended) (the “BVI Act”)
\textsuperscript{16} See the International Tax Co-operation (Economic Substance) Law, 2018 (as amended)
\textsuperscript{17} See The Taxation (Companies – Economic Substance) (Jersey) Law 2019.
\textsuperscript{18} Or other BVI legal entity as defined.
\textsuperscript{19} Draft as at 22 April 2019 – per paras 59-64
\textsuperscript{20} It is assumed that using a nominee does not change this analysis. See BVI Guidance 61.
amount should be avoided to avoid any argument that is not an investment! Note that a Jersey company owning a typical portfolio of equity investments is unlikely to be caught.

A number of clients have questioned the relevance of a regulating substance for a PEHC if in fact it is relatively easily to fall outside this definition. It is important to bear in mind that the BEPS initiative does not have holding companies as its primary target. Holding companies in the IFCs have been “targeted” over recent years by the Common Reporting Standard (and other forms of information exchange), beneficial ownership / significant control registers and heightened anti-money laundering requirements. Indeed the OECD Report from 2015\textsuperscript{21} at para 88 states: “Once these other policy considerations have been addressed, there should be less of a concern that [holding company] regimes are used for BEPS.”

Certain BVI companies may be in a position not to receive fees, dividends or capital gains in a particular financial period or periods and thus have no income from relevant activities. This would usually be by virtue of owning interests in other holding entities\textsuperscript{22} rather than a portfolio of investments. These companies would not necessarily need to go and acquire interest bearing bonds (or similar) for any financial period in which no dividend was to be received. However this does require a certain degree of fortune telling as dividends are often used for such matters as payment of annual fees.

What about trustees? Acting as trustee is not a relevant activity. Trust companies will need to see whether or not they are carrying out any other relevant activities. Assuming they are not carrying out any other relevant activities, a trust company should be out of scope. What is clear that many trust assets are held by a trustee via one or more underlying companies\textsuperscript{23}. Underlying companies would need to be examined in the same way as other legal entities. However could such a corporate trustee (including a private trust company (“PTC”)) itself be a PEHC?

The BVI and Cayman Islands are silent as to this point. The Guidance from the Crown Dependencies\textsuperscript{24} (at page 7) states that a trustee which is carrying on commercial trustee services and is not the beneficial owner of the assets, will not be a pure equity holding company. However it should be noted that the definition of pure equity holding company is different in the Crown Dependencies.

So what about a BVI trustee? In the BVI, a PTC\textsuperscript{25} must not “carry out any business that is not trust business” and must not “carry on any trust business which is not either unremunerated trust business or related trust business as the case may be”\textsuperscript{26}. “Holding business” is defined as “the business of being a pure equity holding entity”. Most BVI PTCs rely on the unremunerated trust business exemption and thus won’t earn income. However a trustee’s “business” is far more than owning the assets – there is the administration of the


\textsuperscript{22} Care being needed to avoid carrying on headquarters business.

\textsuperscript{23} A BVI VISTA trust being the most obvious.

\textsuperscript{24} Guernsey, Isle of Man and Jersey have issued joint guidance on 26 April 2019.

\textsuperscript{25} There are over 1000 in the BVI.

\textsuperscript{26} Per the Financial Services (Exemptions Regulations) 2007.
trust for a start. It seems counter-intuitive for a trustee to be a “holding entity” but even here owning a non-equity investment may be advisable.

The other option to avoid an entity being caught by economic substance rules is if such entity is a “non-resident company” which is defined in the BVI as “a company which is resident for tax purposes in a jurisdiction outside the [British] Virgin Islands” (other than a non-cooperative jurisdiction on the EU list). The competent authority in the BVI will require evidence to this effect. This is stated as a letter or certificate from the competent authority in the relevant jurisdiction or a tax assessment/tax demand/ proof of payment of tax. Many BVI companies are managed and /or controlled by directors outside the BVI and potentially are (or can be) tax resident in another territory. It remains to be seen how many such companies will deliberately bring themselves into the fold of another jurisdiction (which perhaps they already should have been!). It also remains to be seen how cooperative competent authorities will be to issue satisfactory proof particularly in the case of jurisdictions where there is no tax or no tax due (for example a BVI company tax resident in Hong Kong with say non-Hong Kong source income). The BVI Guidance sets out the procedure the process and deadlines for this.

What are the substance requirements for PEHCs?

But what about clients who have pure equity holding entities which receive income and which are not tax resident elsewhere? What are the economic substance requirements? The 2015 Report states that “[holding companies] may not in fact require much substance in order to exercise their main activity of holding and managing equity participations”. Pure equity holding entities have a lower requirement of substance than in respect of other relevant activities but there are still requirements to be satisfied. The BVI Guidance Notes has a separate section for pure equity holding entities.

First, “there is no requirement that the entity is directed or managed in the BVI.” This is different to the other relevant activities. In other words, there is no requirement for a BVI PEHC to have BVI directors and / or board meetings in the BVI.

A pure equity holding entity has adequate substance if it: “(a) complies with its statutory obligations under the BVI Business Companies Act (“BCA”)... and (b) has, in the [British] Virgin Islands, adequate employees and premises for holding equity participations and, where it manages those equity participations, has, in the [British] Virgin Islands, adequate employees and premises for carrying out that management.”

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27 This is the term in the BVI. In the Cayman Islands, entities which are “tax resident outside the [Cayman] Islands” are excluded. Bermuda has recently added this exception.
28 On the assumption that in Rule 5 of the BVI Guidance, (a) and (b) are alternatives.
29 There is another rule for tax transparent entities but this is outside of the scope of this article.
30 Or others.
31 Assuming no other relevant activities.
32 Para 87.
33 Part 9 – paras 100-104.
34 Or the Limited Partnership Act as appropriate
35 Section 8(2) of the BVI Act.
Let us consider each in turn. Requirement (a) would not seem that onerous. All BVI companies have to comply with the BCA and have a licensed registered agent who also has statutory obligations under the BCA and the BOSS.

Requirement (b) is more difficult to define and the guidance is set out at paragraphs 103 and 104. The substance requirements are stated to be fact sensitive and there is a distinction between “holding” equity participations (let’s call this “passive”) and “holding and managing” equity participations (let’s call this “active”).

If “passive” activity only “the requirements for adequate and suitably qualified employees and for appropriate premises will be applied accordingly.” The services of the registered agent are taken into account. For such companies, the substance requirements will most likely be satisfied by the registered agent providing a registered office in the BVI and ensuring that all mandatory filings are completed.

However for “active” activity, the entity should have “adequate and suitably qualified employees, and appropriate premises, in the BVI to carry out this function”. What does this mean? In the author’s view, further clarification is needed.

With a certain degree of poetic licence for emphasis, let us examine this in more detail with an example.

The most common “equity participation” held by a BVI company (“BVICO”) will be a share in another company (“Investment Limited”). A share is a bundle of rights in a company relating to matters such as voting, receipt of dividends, redemption or repurchase, transfer, rights on a winding up etc. “Holding a share in Investment Limited will be based on the location of a share register maintained by (or on behalf of) Investment Limited. Aside from sending contact details and KYC documents to Investment Limited, there is nothing which needs to be done by BVICO. So it seems difficult to see how any resources in the BVI (or anywhere) assist with this. The economic substance requirements for “passive” activity are consistent with this.

But what about where there are multiple equity participations and such participations are bought, sold or redeemed throughout a financial period? This would seem to be “active” and clearly in this case the BVI substance rules require certain resources to be present in the BVI.

Let us assume that BVICO has a director in Hong Kong and wishes to sell shares in Investment Limited via a broker in Singapore during the Singapore trading hours. How can this be done with any assistance from the BVI? As the equity participation is being sold, this may result in BVICO “managing” the equity participation. As the director is in Hong Kong, the sell instruction cannot come from the BVI and no one in the BVI can sign a sale and

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36 Per para 102 of the Guidance.
38 Adequate and appropriate being given their ordinary meanings.
39 Share certificates being only evidence of this and bearer shares being used very seldomly.
40 Other than perhaps the occasional vote.
purchase agreement or transfer form. For the BVI to assist with such management, it would seem necessary, notwithstanding the Guidance, to have a BVI director or other “Authorised Person” in the BVI to effect these matters. In this case, it would perhaps be easier to subcontract the investment management to a third party (which may not be the client’s preference) or to acquire a non-equity investment or even to make the company Hong Kong tax resident. Further clarification is needed as to the substance requirements for such PEHCs.

That said, all relevant entities have obligations to analyse their activities and make necessary returns (including nil returns). There are penalties for not so doing or not doing so correctly. In the BVI, the BOSS Act is amended to increase the amount of information which the Registered Agent is required to hold. This includes (where appropriate) details of relevant activities and foreign tax residence. This information may be shared outside the BVI in certain cases. Third parties will also be interested in terms of representations and warranties in commercial contracts and legal opinions as to whether an entity has complied with its obligations. We also await the details of the initial deadlines which clearly will not be 30 June!

In conclusion therefore, all private clients and trustees will need to examine all of their structures in the various IFCs. It may be that they do not have substantive obligations and can simply carry on with few, if any, changes to their operations. However, as described above, further guidance is needed in respect of a number of issues to give additional clarity.

41 Time difference notwithstanding!
42 See paragraph 141 of the BVI Guidance.
43 And registered agents in the BVI and elsewhere.
44 In addition to the substance requirements for investment funds.