Economic substance: what, where and how?

JURISDICTIONS INTERNATIONALLY ARE COMING TO TERMS WITH NEW ECONOMIC SUBSTANCE LEGISLATION. A RECENT STEP JOURNAL ROUNDTABLE, SPONSORED BY IQ-EQ, ASKED WHAT THE REGULATIONS WILL MEAN FOR PRIVATE CLIENTS

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In September 2019, 11 wealth management experts gathered in London for a STEP Journal roundtable discussion, sponsored by IQ-EQ, examining the new economic substance requirements in jurisdictions around the world, and asking what these regulations mean for both practitioners and their clients.

Economic substance requirements have thus far been introduced in the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Mauritius and Seychelles, in part to demonstrate that the jurisdictions are not facilitating base erosion and profit shifting (BEPS) activity.

Pointing to the permanent establishment, controlled foreign corporation, residency and other rules already in place around the globe, David Kilshaw, Senior Advisor at Rawlinson & Hunting and chair of the roundtable, opened the conversation by asking what the new economic substance rules add to international compliance, security and/or transparency.

From the outset, it was clear that the genesis of the substance requirements is somewhat contentious. ‘It’s political, and part of the much wider drama that emanates from the OECD’s BEPS project,’ commented Jonathan Burt TEP, Partner at Harbottle & Lewis. ‘The requirements can’t be looked at in isolation, because they are part of a wider strategy that’s been going on for 15 years, and it portrays a certain intransigence from the EU lawmakers. Nonetheless, it is also part of the understandable push for greater global transparency.’

Zoe Camp TEP, Partner at New Quadrant Partners, pointed out: ‘The economic substance rules are about creating a common standard, because if everyone doesn’t pull in the same direction it will undermine all the good work of jurisdictions that do have regulations and are following them.’

‘Some jurisdictions do have substance tests in place, and they are setting the bar,’ agreed Greg Limb, Partner and UK Head of Private Client Advisory at KPMG. ‘But it is a matter of equalising those standards. This will prove most complex for those jurisdictions where there is still a lot of work to do.’

However, while the rules are aimed at cracking down on aggressive tax planning and increasing transparency, Burt said that, in some contexts, structures have nothing to do with tax. ‘A client worried about succession planning who sets up a structure in a jurisdiction with anti-forced heirship rules may not necessarily have any substance in that jurisdiction. These rules will have a big impact on structures that have been established because a jurisdiction offers good anti-forced heirship or asset-protection rules.’

**WHAT THE REQUIREMENTS ENTAIL**

Speaking for the Crown Dependencies, Josephine Howe TEP, Partner at Ogier, outlined the three circumstances for an entity to be in scope for economic substance purposes: tax residency in the jurisdiction; any gross income in the jurisdiction, and conducting one of nine relevant activities (banking, insurance, shipping, fund management, finance and leasing, headquartering, distributing and service centres, operation of holding companies, and holding of intangible property (intellectual property)).

‘If an entity falls into the scope of the economic substance law, it must demonstrate that it is directed and managed in the jurisdiction and has adequate physical presence, expenditure, employees and premises in the jurisdiction proportionate to its activities, or has outsourced the same to a local provider;’ she explained. ‘Further, entities must look at their core income-generating activities and make sure they are being conducted in the jurisdiction as well.’

The repercussions of non-compliance can be severe. Entities not meeting these requirements will risk being subject to sanctions including, according to the official Crown Dependencies guidance, financial penalties and being struck off the companies register. ‘The fines increase over time: if an entity is not compliant after three years and it makes a false representation, criminal charges can be pursued,’ said Alasdair McLaren TEP, Head of Private Wealth, Guernsey, at IQ-EQ. ‘And a lot of companies will need to establish where they are resident before they even look at whether they are conducting any of the relevant activities. For example, the Crown Dependencies have had to change their rules as to what constitutes a resident company, particularly those incorporated in one jurisdiction but managed in another. We are likely to see an increase in domiciliation of companies to those jurisdictions best positioned to fulfil such substance requirements.’

A key question for the participants was that of attaining ‘adequate economic substance’ in a jurisdiction, and who judges or defines that adequacy.

Howe commented that adequacy will mean different things to different entities, and that, to date, more clarification is needed in the Crown Dependencies’ published guidance. ‘We need more clarity in areas such as private trust companies, which seem to be out of scope because they hold assets as trustees and not as beneficiaries – but it doesn’t explicitly say that in the guidance. Equally, there is a lot of information about what constitutes gross income, but there has been a slightly different approach to, for example, capital redemptions and debt buy-backs, and whether they could potentially be income. And each jurisdiction will have different points in its legislation where it will be expecting clarification.’

‘And who will be policing the police?’ asked Richard Wilson QC TEP, Barrister at Serje Court. ‘Every jurisdiction will be overseeing its own system, but there will be an external layer of intervention and enforcers from the EU CCG [EU Code of Conduct Group (Business Taxation)] to contend with.’

**THE PRACTICALITIES**

In light of this lack of guidance, Kilshaw asked the participants what changes companies will need to make to meet this scrutiny from the EU CCG.

‘They have to look contextually at what substance is required, but they also have to question what infrastructure they will now need in the jurisdiction,’ said Wilson. ‘The devil lies in the detail. Particularly for clients in Asia, advisors are being asked to simplify structures held in other jurisdictions, with economic substance being one of the factors. They are concerned that the requirements will expand in scope.’

‘In order to keep pace with increasing regulation and compliance, it is more expensive these days to do business,’ which means that in order to stay viable global scale is more and more important in the industry; this is yet another step in the direction of consolidated,’ said Steve Sokic TEP, IQ-EQ’s Group Head of Private Wealth. ‘Further, with families and their assets increasing in complexity, and with clients trying to simplify their affairs and protect their assets, this is reinforcing such global consolidation in our industry.’

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'Structures will have to be credible and authentic without any sort of contrivance: corporate governance and transparency will be an extremely high level'
Jennifer Le Chevallier, I-QE's Head of Private Wealth, Jersey, concurred that given the tide of legislation around BEPS, substance and increased transparency, the safest and most cost-effective way to manage the increasing cost and complexity is for families to consider consolidation of their structure to ensure it is handled by those jurisdictions that have strong governance frameworks in place.

She said: ‘Greater collaboration will be required: fiduciaries working closely with the board, shareholders and family offices to navigate the issues and to support meeting economic requirements’.

Le Chevallier added that pure equity holding companies will require close monitoring to ensure sufficient core income-generating activities are carried on in order to demonstrate compliance. Participants noted that the EU is placing significant focus on structures that avoid double taxation and has affirmed that there should be no expectation of correlation between income-generating activities and benefits.

‘From a commercial perspective, structures will have to be credible and authentic without any sort of contrivance: companies will need to be transparent and prove their worth at an extremely high level,’ agreed Camilla Wallace TEP, Partner and Head of the Private Client Group at Wedlake Bell.

‘And to get adequate substance, directors on the board must be appropriately qualified, and the board as a whole must have the necessary knowledge and expertise to guide the strategy,’ said Howe.

Sokić, too, pointed to the likely growth in governance and perhaps sector segment specialists on boards to ensure that these governance standards are met.

Camp pointed out that business infrastructure costs will be an issue for many entities: whether having another jurisdiction involved will simply cost more, especially when finding employees with appropriate expertise in that jurisdiction to maintain adequate presence there.

The participants agreed that with this added cost for clients, firms need service providers to demonstrate added value and quality. ‘But even if providers are adding value, the question of cost and complexity will encourage some clients not to set up structures like this,’ noted Christopher McLemore, Partner at Butler Snow. ‘Alternatively, they will want to do it from their home jurisdictions.’

BEHAVIOURAL CHANGE

Although the practical elements of entities falling into line with the new regulations are clear requirements, Kishshaw asked if the economic substance rules will bring about a change in behaviour, citing the example of US clients post-Foreign Account Tax Compliance Act (FATCA).

There has been a lot of behavioural change due to FATCA, which has brought in awareness of some of the issues,’ McLemore responded. ‘Previously, people weren’t looking at the trustees or beneficiaries. So, FATCA has had some knock-on effects, encouraging US citizens to think about their US tax issues and residency complexities. They are planning for succession and asset protection, and for that they want a neutral vehicle, not something that is going to add more layers of tax to their US obligations.’

This change in behaviour is adding to the wider perception of private client activities, with Howe commenting: ‘From a political and public point of view, companies need to justify where their profits are, and if their activities and decision-making are not consistent with their income-generation and profit declarations, then that is going to be seen as poor practice.’

‘Everyone who wants to be seen to have high standards will adhere to these rules and – especially where value is being added – that can only be a good thing,’ Wallace agreed.

Nonetheless, despite changing perceptions positively, there are privacy concerns. ‘One of the main issues for private clients is that this is a major information-gathering exercise,’ warned Camp, ‘the sort of information that has never before been given to administrative bodies, and [there is] uncertainty as to what will happen when that information is exchanged between those bodies. Private clients will have a lot of questions.’

However, Limb and McLaren both suggested that reporting and economic substance regulation requirements are likely to expand to cover the greater majority of jurisdictions globally - and that clients will simply need to adjust their compliance levels accordingly. Wilson agreed: ‘It would be a mistake for us to focus only on the here and now, because it’s not a stretch to think that rules will start to expand to encompass private trust companies, for example, and look at their tax residence and economic substance.’

FUTURE PLANNING

‘So, in terms of the near future, what are practitioners doing right now to notify their clients and roll this out?’ asked Kilshaw.

Some clients and their advisors are well versed and challenging us in terms of understanding the requirements to ensure that they would meet obligations under the law going forward,’ said Le Chevallier. ‘As an organisation we performed an assessment of our client base to understand which clients were in scope for economic substance and those clearly not in scope and, on the strength of that assessment, wrote to clients accordingly. The delay in the availability of the guidance was particularly challenging from a timing perspective for the industry as a whole. The year-end deadline for entities to meet the requirements created some urgency to review and restructure, including in some instances re-domiciliation of companies, recalibration of boards and review of activity in order to make client entities fully compliant with Jersey economic substance requirements.’

Nevertheless, Limb pointed out, ‘This is just the start of the journey. We’re moving towards a more globalised tax system, and over the next decade I personally think the world could be looking at moving towards a more citizen-based tax system, and simplified tax from a more [global] perspective.

Although Burt believes that far more assets in the next decade will be owned onshore to mitigate the complexities and costs of the regulations, Sokić suggested that there would also be an emergence of ‘midshore jurisdictions’, as well as the consolidation of providers into more ‘global’ set-ups to attain the scale needed and provide the requisite skills and manpower to manage cross-jurisdictional structures. Finally, Sokić reiterated that these substance rules are, in effect, an attempt at codification of best practices, and those jurisdictions and providers best equipped to meet them will survive and prosper.

The positive thing from an industry perspective is that change is always a good thing. It allows us to look at what we do and to add value,’ concluded Wilson. ‘It’s going to drive up standards around the world: given that the industry can get an unfairly bad press, it will provide transparency for structures and prevent abuse.’

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