



UFG WEALTH MANAGEMENT

Effects of enactment of Economic Substance Act in offshore jurisdictions

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Starting July 1, 2019 economic substance rules became effective in offshore jurisdictions. According to such rules the companies registered in offshore jurisdictions had to bring the business in line with new economic substance requirements by June 30, 2019.

In December 2018 the Government of the British Virgin Islands (BVI), the Federation of Saint Christopher and Nevis, the Islands of Bermuda, the Isles of Man, Guernsey and Jersey, the Islands of the Bahamas and the Cayman Islands published the Economic Substance (Companies and Limited Partnerships) Act, 2018 (the “Act”), which came into effect on 1 January 2019. On April 30, 2019 similar regulations were adopted by the United Arab Emirates. Now, registering an offshore company only for doing a business is not enough: the mandatory condition is to pass the economic substance test.

In the first half of 2019 different countries issued Guidance (legislators’ clarifications), which provided some clarifications to the separate parts of the Act. For instance, in April 2019 the draft of Economic Substance Code (the “Code”) was published, which made additions to certain parts of BVI’s Act. Since the rules of economic substance themselves are unified and have similar consequences for companies on the territory of the above mentioned jurisdictions (except for the United Arab Emirates), the clarifications of the legislator in respect of each of the jurisdictions are similar.

I. Companies covered by the Act

Legislative requirements apply to limited liability companies, partnerships, and foreign companies operating in the jurisdiction. If a company or partnership has a certified tax resident status in any other foreign jurisdiction, it is automatically removed from the list of potential candidates for compliance with the substance requirements.

II. Types of business covered by the Act

As an example of BVI jurisdiction, the entities involved in the following types of activity shall fall within the scope of the Act:

- fund management business;
- holding business;
- intellectual property business;
- finance business;
- banking business;
- insurance business;
- leasing business;
- shipping business;
- distribution and service center business.

The main criteria for passing an economic substance test are:

- management and control must be carried on the territory of the country of incorporation: in practice, it means that company’s Director or members of the Board of Directors must have residential status of the relevant jurisdiction;
- business must be carried out using a real office and with a sufficient number of employees having appropriate professional qualification;
- main costs and expenses of the company must take place on the territory of the country of incorporation;
- if business is connected with the use of any equipment (e.g. intellectual property), such equipment must be also based on the territory of jurisdiction.

Compliance with the requirements will be confirmed by the provision of appropriate reporting documentation (declaration), which must be prepared within six months after the end of the first financial year. The end date of the financial period of the companies registered prior to January 1, 2019 is June 30, 2020. Thus, information on structures shall be provided before December 31, 2020.

III. Clarifications provided by legislator

The Code specifies the concept of “pure equity holding entity”. This holding entity considers that the company holds equity participations in other entities, earns dividends and capital gains, receives profit from subsidiaries or company’s structure, as well as from the sale of shares of such companies. Economic substance requirements apply to pure equity holding entities on a limited basis.

In practice, pure equity holding entities may be engaged in financial activity, e.g. finance their subsidiaries, for example, by granting intragroup loans or hold debt financing instruments for investment purposes. The Code stipulates that if such type of business considered as associated activity, then such company is not a company involved in “finance and leasing business” for the purposes of economic substance regulations, and retains the status of pure equity holding entity.

On the opposite, if a company is involved in finance business activity only, and such activity is principal, for example, a parent company reallocates financial flows within the group to meet the needs of subsidiaries, then such company shall be considered to be involved in “finance and leasing business” as its core operation activity and should comply with economic substance requirements.

The Code provides exceptions for investment funds to which the requirements do not apply; attention should be paid to the fund management company which is subject to economic substance requirements.

Companies that own private yachts or engaged in shipping business (on the assumption that such business is not principal), also subject to the exception. However, companies that own a vessel, lease it or otherwise carry out commercial activities, must comply with the economic substance requirements.

If a company carries out two or more activities, it is necessary to provide evidence of compliance with the rules of economic substance regulations for each of them.

For companies which ignored the requirements and did not meet the aforesaid conditions, for the first year of monitoring will be fined (in case of BVI it amounts to USD 20 000), for the next year – strike off from the Register of Companies. Currently, however, discussed the possibility of **extension of the transition period until October 1, 2019** and, accordingly, deferment of fine for the same period.