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Regulators Go One Step Further with New Economic Substance Laws

Compliance and Ethics



The past few years have brought on a regulatory compliance boom in the corporate world, aimed at greater transparency on tax matters.

2019 was a cornerstone; international regulations were previously focused on the exchange of information. However, the newly introduced economic substance regulations focus on demonstrating actual proof of physical presence and activity on the jurisdiction's soil.

Responding to the concerns of the European Union and Organization for Economic Cooperation and Development (OECD) about facilitating offshore structures or arrangements aimed at attracting profits that do not reflect real local economic activity, key offshore jurisdictions have enacted what is known as "Economic Substance" legislation.

The Bahamas, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Curacao, Channel Islands, Aruba, and Mauritius (Mauritius' economic substance legislation applies only to entities holding a Global Business License, and the Financial Services Commission has identified clear criteria for them to meet in terms of local substance). The United Arab Emirates have also enacted economic substance legislations.

From 2019, any entity that qualifies as a "Relevant Entity" and that carries on a "Relevant Activity" must meet the full or, in some jurisdictions the reduced, economic substance test.

The challenge lies in the fact that each jurisdiction has its own:

- Scope of local vehicles that qualify as Relevant Entities;
- Definition of each Relevant Activity; and
- Expectations as to how to satisfy the test criteria and therefore, what information to annually report.

This reality multiplies the complexity of these enhanced requirements and the way to comply with them.

This article intends to provide a high-level overview of this new era of compliance obligations and highlight how multinational groups should use, manage, and operate their offshore companies. These new local obligations carry global stakes.

The full test

The economic substance requirements apply to the following Relevant Activities:

- Banking business
- Insurance business
- Fund management business
- Financing and leasing business
- Headquarters business
- Shipping business
- Distribution and service centers business
- Holding business (Except if the entity meets the Pure Equity Holding Company definition subject to the reduced test)
- Intellectual property (IP) business

While some businesses may be regulated in jurisdictions and therefore, be quite straightforward to identify (like banking, fund management, and insurance), some others may be trickier and make an entity fall within the economic substance scope quite easily, especially since such activities are

broadly defined.

For example, the intra-group lending arrangements may fall within the financing and leasing business category. The provision of senior management to an entity in the same group, or the action of incurring expenses on behalf of group entities, may fall within the headquarters business category.

Also, it is not necessary for the Relevant Entity to be actively engaged in a Relevant Activity to fall under the economic substance scope: The passive collection of income from one of the businesses may be a Relevant Activity. A Relevant Entity carrying on one or more of these Relevant Activities must cumulatively demonstrate, for each of them, that in the jurisdiction:

- It conducts a “core-income generating activity” (CIGA);
- It is “directed and managed”; and
- It has adequate operating expenditure, physical presence, and an appropriate number of full-time employees or other personnel with appropriate qualifications.

The Relevant Entity engaged in a high-risk IP business may only refute this presumption of non-compliance by producing further material demonstrating a high degree of control over the IP asset, exercised by an adequate number of full-time qualified resident employees. Examples of this material may be detailed business plans and/or local employees’ level of experience, qualifications, type of contracts, and duration of employment.

Economic substance requirements are even more stringent when it comes to the IP business; they have identified cases of “high risk” IP business, in which case the Relevant Entity is presumed to not meet the economic substance test.

The reduced test

A Relevant Entity carrying on a holding business that consists in only holding equity participations in other entities, and only earning dividends and capital gains from these participations, meets the definition of a Pure Equity Holding Company (PEHC) (Except in Jersey where the local legislation does not provide for a reduced test). A PEHC is subject to a reduced test that requires it to only cumulatively demonstrate that:

- It complies with local companies’ law filings; and
- It has adequate human resources and premises for holding and managing its equity participations in the jurisdiction.

As a PEHC is not required to be directed and managed in the jurisdiction, it can have its registered office with a service provider and passively hold equity interests in other entities, and still satisfy the reduced test.

However, this category is to be narrowly construed as holding equity interests must be the one and only activity of the Relevant Entity; holding any other type of assets or conducting any other type of activity — relevant or not for economic substance — excludes the Relevant Entity from the PEHC regime.

For instance, a Relevant Entity that only holds shares in a subsidiary that owns real estate qualifies as a PEHC while the entity that directly holds a real estate asset does not qualify as such. Similarly, a Relevant Entity that only/also holds bank accounts for another purpose than receiving the fruits of an equity participation, or a portfolio of investments through a brokerage account, does not qualify as PEHC and falls out of the scope of the economic substance regulations.

Notification and reporting

From 2020 onward, a Relevant Entity must annually file a detailed report demonstrating how each of the test criteria has been met during the past financial year (Depending on the jurisdiction, first reporting is due between June and December 2020, and in the British Virgin Islands, the reporting may straddle two different financial years depending on the entity's 2019 financial year-end date). The Cayman Islands and Bermuda require an additional prior notification informing the local authorities whether the Relevant Entity carried on a Relevant Activity during this same period of time (Notifications are due by January 31, starting January 31, 2020). In the Cayman Islands, not complying with this notification obligation prevents the entity from obtaining its "Certificate of Good Standing."

Even if a Relevant Entity may have grounds to be exempted from complying with the economic substance test, it still must locally file under this regime to confirm and explain why the requirements do not apply.

This is the case when a Relevant Entity did not carry on any Relevant Activity, or when the Relevant Activity carried on did not generate any income. Funds and their special purpose vehicles are also required to make a filing under economic substance (in the Cayman Islands only).

When a Relevant Entity is incorporated in an economic substance jurisdiction but is not a resident there for tax purposes, the Relevant Entity has the obligation to provide local authorities evidence to substantiate the non-residency claim, such as a foreign tax residence certificate for instance. In the absence of such evidence, the entity will be regarded as a Relevant Entity in the jurisdiction of incorporation and be subject to the local economic substance requirements.

With some variations between the jurisdictions, a Relevant Entity will annually have to disclose the adequate number of full-time employees or other personnel with appropriate qualifications engaged in the Relevant Activity. The CIGAs can be outsourced to a corporate service provider in the jurisdiction, subject to oversight (e.g., monitoring and control) by the Relevant Entity.

Each reporting information is required at the level of the island but some jurisdictions, like the British Virgin Islands, also ask for worldwide figures. Details about the ultimate parent company may also be required in some cases.



Relevant Entities subject to the full test will additionally have to disclose at least the following type of information, with respect to each of its Relevant Activities:

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- Amount and type of relevant income;
 - Amount and type of expenses and assets;
 - Address of the place of business;
 - Information showing the CIGA;
 - Information on whether the Relevant Entity is directed and managed from the island, including the number of board meetings; and
 - A declaration as to whether the economic substance test is satisfied.

Consequently, resident entities that are currently remotely managed with minimum local presence must meet the challenge of finding experienced personnel and available premises in labor and rental markets that are already constrained.

While the “adequate,” “appropriate,” and “directed and managed” concepts are not defined by any of the regulations, it is already accepted within the industry that palliative or half measures will not be enough to satisfy the tests.

The sanctions

Non-compliance with economic substance obligations, whether it is not satisfying the tests requirements and/or not filing the required report, constitutes an offense and is sanctioned in various ways:

- Both the Relevant Entity and its officers are subject to several thousands of US dollars in fines;
- A non-diligent officer could be imprisoned for up to several years; and
- Ultimately, the Relevant Entity could be struck off from the local companies’ registers.

Needless to listing the reputational repercussions such sanctions would have on any business, not to mention how a multinational group could see its overall group structure disrupted if banned from operating from a key offshore jurisdiction.

In conclusion

Changes to corporate and operational practices are to be expected.

If a local entity has not yet examined its economic substance obligations, it is of the utmost importance it prioritizes this task without further delay.

Among other things, it should undertake a review of its current human resources profile and governance model to identify whether improvements or enhancements are necessary to satisfy the test.

For instance, (a) making sure that the number of directors and other strategic employees, as well as their level of expertise are sufficient; (b) including strategic business decisions within the board minutes; and (c) documenting the discussions and conclusions held on these decisions.

In the face of an increasing regulatory compliance environment, we can’t stress enough how working

with the right service provider is key; partnering with a local yet global expert who is able to provide customized integrated solutions is the way to go.

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