

Corporate & Commercial

Impact of the new economic substance laws for offshore jurisdictions on Hong Kong shareholders

Introduction

Certain offshore jurisdictions such as the Cayman Islands, the British Virgin Islands (“**BVI**”) and Bermuda have introduced new economic substance legislations, which became effective from 1 January 2019, requiring an increased level of substance to be maintained in these jurisdictions for all entities that fall within the new regime.

Background

According to the Organisation for Economic Co-operation and Development (“**OECD**”), Base Erosion and Profit Shifting (“**BEPS**”) refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity. The BEPS Action Plan identified 15 actions to address BEPS in a comprehensive manner. In particular, the OECD’s BEPS Action 5 on countering harmful tax practices requires substantial core income-generating activities to be conducted in the jurisdiction where preferential tax regime is granted.

Following the work by the OECD under BEPS Action 5, the Code of Conduct Group (Business Taxation) of the European Union (“**EU**”) (“**COCG**”) put forward guidance in June 2018 (the “**COCG Guidance**”) addressing matters of economic substance which jurisdictions must adopt to avoid being included in the blacklist of non-cooperative jurisdictions for tax purposes.

In order to level the playing field and prevent no or only nominal tax jurisdictions from attracting profits from certain mobile activities without any corresponding economic activity, the OECD published the “Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions” (the “**OECD Document**”) in November 2018, which is similar to the COCG Guidance.

Upon the release of the COCG Guidance and the OECD Document, a number of no or nominal tax jurisdictions including the Cayman Islands, the BVI and Bermuda responded swiftly by introducing their own domestic economic substance legislation effective from 1 January 2019 to avoid being blacklisted by the EU and to meet their obligations as Inclusive Framework members under the OECD’s BEPS Action 5 initiatives.

Relevant Entities / Legal Entities

In general, entities (companies and other body corporates with separate legal personality) incorporated in the offshore jurisdictions or incorporated elsewhere but registered in the offshore jurisdictions, which carry on a relevant activity, are subject to the substance requirements.

The Cayman Islands

The International Tax Co-operation (Economic Substance) Law, 2018 (as subsequently amended, the “**Cayman ES Law**”) applies to a defined class of relevant entities, including:

- (a) a company, other than a domestic company, that is –
 - (i) incorporated under the Companies Law (2018 Revision); or
 - (ii) a limited liability company registered under the Limited Liability Companies Law (2018 Revision);
- (b) a limited liability partnership that is registered in accordance with the Limited Liability Partnership Law, 2017;
- (c) a company that is incorporated outside of the Islands and registered under the Companies Law (2018 Revision);

but does not include -

- (i) an investment fund; or
- (ii) an entity that is tax resident outside the Cayman Islands.

The BVI

The Economic Substance (Companies and Limited Partnerships) Act, 2018 (the “**BVI ES Law**”) applies to BVI companies and limited partnerships, and foreign companies and foreign limited partnerships registered in the BVI under the BVI Business Companies Act, 2004 or the Limited Partnerships Act, 2017, other than non-resident companies, non-resident limited partnerships and limited partnerships which have elected not to have a legal personality. An entity is a non-resident company or a non-resident partnership if the company or partnership is claiming tax residency in jurisdictions which are not included on the EU list of non-cooperative jurisdictions.

Bermuda

The Economic Substance Act 2018 (the Act) and the Economic Substance Regulations 2018 (as subsequently amended and together the “**Bermuda ES Law**”) apply to a company incorporated or an overseas company registered under the Companies Act 1981, a company formed under the Limited Liability Company Act 2016, or a partnership (exempted, exempted limited or overseas) which has elected to have separate legal personality under s.4A of the Partnership Act 1902, other than entities that are tax resident elsewhere.

Relevant Activities

Under the Cayman ES law, BVI ES Law and Bermuda ES Law, a relevant entity or legal entity is subject to the economic substance requirements if it conducts any of the following relevant activities:

- (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;
- (g) insurance business;
- (h) intellectual property business; and
- (i) shipping business.

Relevant entities or legal entities which carry on more than one relevant activity will be required to comply with the economic substance requirements in respect of each activity.

Compliance with the Substance Requirements

The Cayman Islands

Under the Cayman ES Law, to pass the economic substance test, a relevant entity must:

- (a) conduct Cayman Islands core income generating activities (“**Cayman CIGA**”) in relation to that relevant activity;
- (b) be directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity; and
- (c) taking into account the level of relevant income generated from that relevant activity carried out in the Cayman Islands:
 - (i) have an adequate operating expenditure incurred in the Cayman Islands;
 - (ii) have an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
 - (iii) have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

A relevant entity must conduct an adequate amount of the appropriate elements under the Cayman CIGA for the particular type of relevant activity that it is undertaking in order to show economic substance. Cayman CIGA is defined to mean activities that are of central importance to a relevant entity in terms of generating income and that are being carried out

in the Cayman Islands. A relevant entity may satisfy the economic substance test by outsourcing the conduct of its Cayman CIGA to another person provided that the relevant entity is able to monitor and control the carrying out of the Cayman CIGA. Where Cayman CIGA is outsourced the resources of the service provider in the Cayman Islands will be taken into consideration when determining whether the people and premises test is met (but there must be no double counting if the services are provided to more than one relevant entity carrying out relevant activities).

The BVI

Under the BVI ES Law, to pass the economic substance test, a legal entity must be able to demonstrate that:

- (a) the relevant activity is directed and managed in the BVI;
- (b) the core income generating activity is carried out in the BVI;
- (c) having regard to the nature and scale of the relevant activity:
 - (i) there are an adequate number of suitably qualified employees in relation to that activity who are physically present in the BVI (whether or not employed by the relevant legal entity or by another entity and whether on temporary or long-term contracts);
 - (ii) there is adequate expenditure incurred in the BVI;
 - (iii) there are physical offices or premises as may be appropriate for the core income-generating activities; and
 - (iv) where the relevant activity is intellectual property business and requires the use of specific equipment, that equipment is located in the BVI.

Core income generating activities are defined as activities that are being carried out in the BVI and are of central importance to the legal entity in terms of generating income. The economic substance test is satisfied in relation to a relevant activity if the legal entity outsources its BVI core income generating activities, in relation to that relevant activity, to a third-party within the jurisdiction. The legal entity must, however, be able to prove that it is able to monitor and control the BVI core income generating activities being carried out. The expenditure on the outsourcing will be taken into account when assessing the adequacy of the legal entity's expenditure in the BVI, and the extent of the work done under the outsourcing arrangement will be taken into account when assessing the adequacy of the number of the entity's employees, and the suitability of their qualifications.

Bermuda

Under the Bermuda ES Law, to pass the economic substance test, an entity must:

- (a) be managed and directed in Bermuda;
- (b) undertake core income generating activities in Bermuda with respect to the relevant activity;
- (c) maintain an adequate physical presence in Bermuda;
- (d) employ adequate full-time employees in Bermuda with suitable qualifications; and
- (e) incur adequate operating expenditure in Bermuda in relation to the relevant activity.

Any arrangement outsourcing any or all of an entity's core income generating activities will be taken into account. However, the entity must be able to monitor and control the carrying out of the outsourcing arrangement.

Pure equity holding companies

The Cayman Islands

Under the Cayman ES Law, the test is satisfied if the pure equity holding company confirms that:

- (a) It has complied with all applicable filing requirements under the Companies Law (2018 Revision); and
- (b) It has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities.

The BVI

Under the BVI ES Law, the requirements are met if the pure equity holding company:

- (a) complies with its statutory obligations under the BVI Business Companies Act, 2004 or the Limited Partnership Act, 2017 (whichever is relevant); and
- (b) has adequate employees and premises for holding equitable interests or shares and, where it manages those equitable interests or shares, has adequate employees and premises for carrying out that management.

Bermuda

Under the Bermuda ES Law, the requirements are met if the pure equity holding entity:

- (a) complies with applicable corporate governance requirements set forth in the Companies Act 1981, the Limited Liability Companies Act 2016 and Partnerships Acts, including keeping records of account, books and papers and financial statements;
- (b) submits an annual economic substance declaration form; and
- (c) has adequate employees and adequate premises in Bermuda for holding and managing equity participations.

High risk intellectual property business

Under the Cayman ES law, BVI ES Law and Bermuda ES Law, there is an enhanced economic substance test for high risk intellectual property business. High risk intellectual property business means an intellectual property business carried on by an entity that (i) did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business; (ii) acquired the intellectual property asset from an entity in the same group or in consideration for funding research and development by another person situated in a country or territory other than that jurisdiction; and (iii) licences the intellectual property asset to one or more entities in the same group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same group.

The relevant entity must demonstrate that there is, and historically has been, a high degree of control over the development, exploitation, maintenance, protection and enhancement of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the jurisdiction.

Notification and Reporting Obligations

The Cayman Islands

Starting from 2020, all relevant entities must notify the Cayman Islands Tax Information Authority (“TIA”) annually:

- (a) whether or not they are carrying on a relevant activity;
- (b) if the relevant entity is carrying on a relevant activity, whether or not all or any part of the relevant entity’s gross income in relation to the relevant activity is subject to tax in a jurisdiction outside of the Cayman Islands and, if so, shall provide appropriate evidence to support that tax residence as may be required by the TIA; and
- (c) the date of the end of its financial year.

Relevant entities carrying on relevant activities that are required to satisfy the economic substance test must also prepare and submit to the TIA a report for assessment detailing particulars including, but not limited to, income, expenses, assets, management, employees and physical presence. The relevant entity is required to file the report no later than 12 months after the last day of the end of each financial year.

The BVI

All legal entities must file information on their tax residency status and any relevant activities to ensure that the BVI International Tax Authority has sufficient information to monitor compliance with the BVI ES Law. Such filings will be made through the legal entity’s

registered agent in the BVI into the BVI's existing Beneficial Ownership Secure Search (“BOSS”) system.

Bermuda

A registered entity that is subject to the Bermuda ES Law will be required to file an economic substance declaration and supporting information with the Bermuda Registrar on an annual basis confirming that the entity complies with the Bermuda ES Law.

Effective Dates

The Cayman ES Law and the BVI ES Law came into force on 1 January 2019. The Bermuda ES Law came into effect on 31 December 2018.

The Cayman Islands

All relevant entities that existed prior to 1 January 2019 must comply with the economic substance requirements by 1 July 2019 while relevant entities formed on or after 1 January 2019 are subject to the requirements from the date they commence a relevant activity.

The BVI

Existing legal entities that fall in scope of the BVI ES Law are required to comply with the economic substance requirements by 30 June 2019 and to meet the BOSS reporting obligations by 30 June 2020. New legal entities formed on or after 1 January 2019 are required to comply with the requirements immediately and to meet the BOSS reporting obligations within one year of formation.

Bermuda

All existing entities that fall in scope of the Bermuda ES Law are required to comply with the economic substance requirements by 30 June 2019. New entities formed on or after 31 December 2018 are required to comply with the requirements from incorporation.

Penalties

The Cayman Islands

If a relevant entity fails to fulfil the economic substance requirements, the penalty is USD12,200, rising to USD122,000 for repeated failure in the subsequent financial year. The Cayman authority shall also notify the registrar of any such failure after two consecutive years, and the registrar can apply to the Grand Court for an order requiring the relevant entity to take rectification action, or to strike them off the register. There are also criminal penalties (including imprisonment) for failure to provide information or knowingly providing false or misleading information.

The BVI

Penalties will be imposed for failure to provide required information or for operating an entity in breach of the economic substance requirements, which may include substantial fines (up to USD400,000 for high risk intellectual property legal entities and up to USD200,000 for all other entities), imprisonment and the entity may be struck-off.

Bermuda

There are penalties of up to USD250,000, subject to the discretion of the Bermuda Registrar of Companies. The Registrar may apply to the court for order for remedial action or strike-off the entity. There are also criminal penalties (including imprisonment) for failure to provide information or knowingly providing false or misleading information.

Implications

Many businesses and corporate groups have been using entities in no or nominal tax jurisdictions for various purposes including investment holding (real property or equity), intellectual property holding and listing vehicles. The economic substance requirements are new to the market and further guidance is pending from the relevant jurisdictions. In the meantime, any entity that appears to be in scope of the economic substance legislation of any of these jurisdictions should undertake an internal review by adopting part or all of the steps below:

- (a) Revisit and review the existing holding and operating structures;
- (b) Consider fulfilling the economic substance requirements (including the level of substances and whether the substance can be outsourced);
- (c) Consider the costs and benefits of maintaining the entity in the no or nominal tax jurisdiction;
- (d) Consider relocating their tax residency;
- (e) Consider replacing those offshore entities with companies in alternative jurisdictions; and
- (f) Consider disposing of unnecessary entities.

For enquiries, please contact our Corporate & Commercial Department:

E: cc@onc.hk
W: www.onc.hk

T: (852) 2810 1212
F: (852) 2804 6311

19th Floor, Three Exchange Square, 8 Connaught Place, Central, Hong Kong

Important: The law and procedure on this subject are very specialised and complicated. This article is just a very general outline for reference and cannot be relied upon as legal advice in any individual case. If any advice or assistance is needed, please contact our solicitors.

Published by **ONC** Lawyers © 2019