Economic substance – What does it mean for international financial centres?

Graham Collis of Conyers Dill & Pearman on the EU's substance requirements

The latest move by the European Union to address perceived harmful tax practices takes the form of imposing economic substance requirements on international financial centres (IFCs). In response, rather than face EU blacklisting, the majority of IFCs have recently introduced legislation mandating substance requirements for certain entities based in their jurisdictions.

THE DRIVE FOR SUBSTANCE

Notwithstanding the fact that the majority of the affected jurisdictions have already met the OECD standards for transparency, Base Erosion and Profit Shifting (BEPS), FATCA, Common Reporting Standards (CRS) and country-by-country reporting, by imposing economic substance requirements the EU has once again taken aim at low-tax jurisdictions.

The push for economic substance began in 2017 when the Council of the EU established a Code of Conduct Group for business taxation, which investigated the tax policies of both EU member states and third countries. Following that assessment, the EU published a list of 13 IFC jurisdictions which were required to address their concerns relating to demonstrating economic substance, or be placed on an EU blacklist.

In June 2018 the EU issued a scoping paper which set out the economic substance requirements that the targeted IFCs were required to adopt before 2019 with regard to relevant entities based in those jurisdictions. It is now anticipated that these economic substance requirements will become a global OECD standard as they were recently endorsed by that body's Forum on Harmful Tax Practices.

SCOPE OF LEGISLATION

After several months of discussion and negotiation with the EU, all of the major IFC jurisdictions, including Bermuda, the Cayman Islands, the BVI, Jersey, Guernsey and the Isle of Man, enacted broadly similar legislation on economic substance to meet the EU's 31 December 2018 deadline. The EU is keen to avoid any jurisdictional arbitrage and no jurisdiction wants to find itself at a disadvantage, so where there are material differences in legislation, it is likely that amendments will be made to ensure a level playing field for all IFC jurisdictions.

Pursuant to the legislation passed in each jurisdiction, an 'adequate' level of economic substance is now required for entities carrying out the following 'relevant activities':

- Banking
- Insurance
- Fund management
- Finance
- Leasing
- Headquarters
- Shipping
- Intellectual property
- Distribution and service centres
- Holding entities

In general terms, an adequate level of economic substance means that the activities are actually directed and managed in the jurisdiction and core income-generating activities are performed in the jurisdiction. Taking into account the features of each specific industry or sector, requirements include an adequate level of suitably qualified people, operating expenditure and premises in the jurisdiction. Entities holding intellectual property, however, have been singled out for particular attention. The EU identifies such entities as having a 'higher risk of artificial profit shifting' and if the IP is acquired from and licensed to an affiliate, the entity will be presumed not to comply with economic substance requirements unless *inter alia* it can prove that all its income is generated from activities in the relevant jurisdiction.

Reporting, enforcement and sanction mechanisms have been put in place in each jurisdiction to ensure compliance by the relevant entities.

THE FUTURE OF IFCS

The introduction of substance requirements undoubtedly marks a significant change for IFCs and some entities will have a choice to make between changing their business model or relocating.

The extent of the impact for individual jurisdictions is likely to remain unclear for some months to come. However, IFCs have a long history of adapting to change based on the important role they play in the global economy, which extends far beyond the tax benefits upon which the EU is so focused. IFCs provide efficient, useful platforms for facilitating cross-border activities and enable significant investment to flow around the globe, supporting economic growth, jobs and tax revenues in onshore jurisdictions.

When parties from different countries with different laws, regulatory regimes and tax systems wish to do business with each other, a secure, neutral venue for undertaking a joint venture offers many benefits. IFCs are geared to meet the needs of international commerce and investments, with specialised and efficient regulatory regimes for specific types of financial sector activity. Furthermore, jurisdictions such as Bermuda, the Cayman Islands and BVI, which have legal and judicial systems based on English common law with final appeal to the Privy Council of the United Kingdom, provide ideal neutral locations with a strong tradition of the rule of law in the event of disputes, along with deep pools of arbitration expertise.

Each IFC will be looking to handle the effects of this new challenge in its own way and to make the most of any opportunities afforded. Strong, transparent IFCs which already meet existing global compliance standards should be well-placed to manage the introduction of the new substance requirements. In Bermuda, for example, many entities already meet the requirements: the EU has expressly recognised the substantive nature of certain key industries such as insurance and reinsurance, and compliance with their existing regulatory requirements will satisfy the new economic substance regime. The Bermuda Government has also recently announced concessions in respect of work permits and payroll tax to facilitate establishing substance in the jurisdiction.

The EU is now reviewing the legislation and accompanying regulations each IFC has put in place and is expected to release an updated blacklist of non-cooperative tax jurisdictions by the end of March 2019. Only at that time will the full scope of the EU's substance requirements become entirely clear. It is possible that some IFCs' legislation will fall short and indeed that some may ultimately choose not to comply. Jurisdictions doing the bulk of their business with non-OECD countries in Asia, for example, may decide it is in their best interests not to submit to the new substance regime. The next few months will certainly prove interesting.

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