

Alert

British Virgin Islands – Economic Substance Code

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It is anticipated that the International Tax Authority (the “ITA”) of the British Virgin Islands will soon issue its *Economic Substance Code* (the “Code”). The Code will provide guidance on interpreting the requirements of the *Economic Substance (Companies and Limited Partnerships) Act, 2018* (the “ES Act”).

This bulletin provides updated guidance on the requirements of the ES Act taking into account the rules set out in the Code. Reference is made to our earlier client bulletins regarding the introduction of “economic substance” requirements in the British Virgin Islands. This bulletin should be read in conjunction with those other bulletins.

Economic Substance Requirements

The ES Act requires all **Legal Entities** carrying on a **Relevant Activity** during a **Financial Period** to establish economic substance in the BVI. For Legal Entities incorporated before 1 January 2019, the Financial Period starts on 30 June 2019.

The bold faced capitalised terms in the previous paragraph are defined in the ES Act. Their definitions are not ‘standard’ definitions, but rather are precise definitions which determine the application of the ES Act. Reference is made to the ES Act and the Code for the definitions, which are also set out in Appendix 1 to this bulletin.

Irrespective as to whether included in the definition of Legal Entity or Relevant Activity, all BVI companies and all limited partnerships with legal personality will need to make a report under the ES Act starting in 2020 as to their compliance with the ES Act during the previous Financial Period.

- Distribution and service centre business
- Financing and leasing business
- Fund management business
- Headquarters business
- Holding business
- Insurance business
- Intellectual property business
- Shipping business

The definitions for each of these Relevant Activities are set out in Appendix 1 to this bulletin.

Legal Entity

In short, a BVI company or a limited partnership with legal personality is a Legal Entity unless (a) it is resident for tax purposes in a jurisdiction outside of the BVI and (b) that jurisdiction is not on Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes, the “EU blacklist”.

Relevant Activities

A Legal Entity is carrying on a Relevant Activity if it carries on any of the following activities:

- Banking business

Financial Period

Economic substance is assessed over a period of time, generally one year. The ES Act refers to this period as a Financial Period, although the period is unrelated to a Legal Entity’s accounting period.

For an entity incorporated before 1 January, 2019 the first Financial Period starts on 30 June, 2019. For all other entities, the first Financial Period starts on the date of incorporation or formation. The Financial Period repeats every year. It is possible for a Legal Entity to change the start date of future Financial Periods by applying to shorten its current Financial Period.

A Legal Entity must have economic substance in the BVI any time it carries on a Relevant Activity in a Financial Period.

Requirements on Entities Not Carrying on a Relevant Activity

All BVI companies and all limited partnerships with legal personality will need to make a report, irrespective as to whether they are a Legal Entity (as defined), as to their compliance with the economic substance requirements during their Financial Period. If an entity has not carried on a Relevant Activity at any time during its Financial Period, the report will be a simple statement to this effect. The first report will not be required until 2020. Please see Timing and Reporting below.

Requirements on Those Entities Claiming Tax Residence Outside of the BVI

If an entity is carrying on a Relevant Activity, it is not required to establish economic substance in the BVI if it is tax resident outside of the BVI. In this instance it is not a Legal Entity (as defined). However, in order to claim tax residency outside of the BVI, it will be necessary to provide evidence of this residency in the other jurisdiction. This evidence could be a letter or certificate from the foreign competent tax authority to this effect or could be an assessment for tax or other evidence that tax has been paid.

It is recognised that some entities are considered “transparent” for tax purposes. In this case, it will be necessary to demonstrate tax residency in another jurisdiction by reference to each of the participators (shareholders, partners or the like).

It is also recognized that some jurisdictions do not tax based on a concept of residency. In these instances, it will be necessary to demonstrate that the income of the entity is subject to tax in the other jurisdiction.

It is not possible to claim tax residency in a jurisdiction which is on the EU blacklist.

There are also provisions for provisional tax residency in a foreign jurisdiction in the event evidence is not available at the time of the BVI reporting as to the foreign tax residency but is expected at a later date.

Evidence of tax residency will not be required until 2020. Please see Timing and Reporting below.

Requirements on Legal Entities if carrying on Holding Business

Unlike the other eight categories of Relevant Activities, the ES Act looks only at the assets of the Legal Entity to determine if it is carrying on Holding Business. There is no analysis of the activities of the Legal Entity other than a review of its assets.

A Legal Entity is carrying on Holding Business if it **only** holds equity participations in other entities and **only** earns dividends and capital gains. The definition is deliberately narrow intending to capture Legal Entities which hold nothing but equity participations which yield dividends or capital gains.

If a Legal Entity holds any other assets or owns any other form of investment (such as an interest bearing bond) then it is not carrying on Holding Business. However, a Legal Entity which carries on any number of businesses could still be carrying on Holding Business if its only assets are equity participations.

To the extent a legal entity is carrying on Holding Business, then the economic substance requirements of the Act are less onerous. Specifically, the legal entity will need to have “adequate employees and premises for holding equitable interests or shares” and, where it manages those equitable interests or shares, it will need to have “adequate employees and premises for carrying out that management”.

For a Legal Entity carrying on a passive Holding Business (i.e. it is not “managing” the equity participations), the Code notes that the Legal Entity will have a registered agent and that this will be taken into account when assessing economic substance. It is also noted in the Code that it is not the function of the ES Act to require a Legal Entity to incur more expenditure or engage more employees than it really needs. As such, while the analysis will be fact sensitive, it appears that Legal Entities carrying on a passive Holding Business will likely fulfill the economic substance requirements with their BVI registered agent and their BVI registered office (and the BVI based secretary in the case of clients of Conyers Corporate Services). An annual filing will still be required starting in 2020. Please see Timing and Reporting below.

To the extent a Legal Entity is carrying on an active Holding Business (i.e. it is “managing” the equity participations), then it will need to establish economic substance in the BVI. If this is applicable to your Legal Entity, then we recommend seeking legal advice as soon as practicable.

Requirements on Legal Entities if Carrying on Other Relevant Activities

A Legal Entity carrying on one or more of the other eight Relevant Activities will need to establish economic substance in the BVI. This will require that (i) the Relevant Activity is directed and managed in the BVI, (ii) the Legal Entity has an adequate number of suitably qualified employees, appropriate premises and adequate expenditure in the BVI, and (iii) all the Core Income Generating Activity is carried out in the BVI. The Code indicates that the ITA will measure “adequate” and related terms having regard to the usual way in which businesses carrying on the relevant activity on a commercial basis are structured and operate.

It is beyond the scope of this bulletin to comment in detail on the other eight Relevant Activities or their Core Income Generating Activity. ***Rather, we recommend seeking legal advice as soon as practicable if you have a concern that your Legal Entity may be carrying on a Relevant Activity.*** However, we provide some analysis applicable to two Relevant Activities which may be of particular interest to our clients.

Finance and Leasing Business

Finance and leasing business means the business of providing credit facilities of any kind for consideration. A one-off transaction is not enough to constitute a business, but rather the provision of credit must be a business activity in its own right. Legal Entities which hold debt or debt instruments for the purposes of investment will not be considered as being in the business of providing credit facilities. Further, a non-interest bearing instrument will generally not involve consideration (although lack of interest is not definitive if there are other forms of consideration). However, to the extent a Legal Entity has issued more than one interest bearing loan, then we recommend seeking legal advice as soon as practicable.

Headquarters Business

Headquarters business refers to the business of the provision of senior management, the assumption or control of material risk, or the provision of advice with respect to such assumption or control of material risk by a Legal Entity to an entity in the same group. It is important to note that the position of the Legal Entity within the group is not relevant, rather whether a Legal Entity carries on Headquarters Business is entirely dependent on the services it provides to other companies in the group. The mischief that this definition is targeting is a BVI entity extracting income from another group entity through the provisions of these services. As such, to the extent a Legal Entity derives income from any of these services then we recommend seeking legal advice as soon as practicable.

Timing and Reporting

All BVI companies and all limited partnerships with legal personality will need to make a report, irrespective as to whether they are a Legal Entity or carrying on a Relevant Activity.

A report as to compliance with the economic substance requirements during the previous Financial Period must be submitted within six months of the end of the Financial Period. For Legal Entities incorporated or formed before 1 January 2019 this means the first report must be made no later than 30 December 2020, and for Legal Entities incorporated or formed on or after 1 January 2019, the first report must be made no later than 18 months from the date of incorporation or formation (in each case assuming the Legal Entity has not applied to shorten its Financial Period).

For an entity that has not carried on a Relevant Activity at any time during the Financial Period, the report will simply be a statement to this effect. For an entity that has carried on a Relevant Activity at some point during the Financial Period but does not satisfy the definition of Legal Entity because it was resident for tax purposes in another jurisdiction during the Financial Period, the report will need to include evidence of the entity being resident for tax purposes in the other jurisdiction.

Otherwise, a Legal Entity carrying on a Relevant Activity at any time during a Financial Period will be required to report the following information:

- total turnover generated by the relevant activity
- the amount of expenditure incurred on the relevant activity within the BVI
- the total number of employees engaged in the relevant activity
- the number of employees engaged in the relevant activity within the BVI
- the address of any premises within the BVI which is used in connection with the relevant activity
- the nature of any equipment located within the BVI which is used in connection with the relevant activity
- the names of the persons responsible for the direction and management of the relevant activity, together with their relationship to the company and whether they are resident in the BVI

The ES Act and the Code rely on a self-reporting regime, pursuant to which registered agents are required to take steps to collect the economic substance information from clients, and clients are required to provide the information. It is anticipated that Conyers Trust Company (BVI) Limited will start reaching out to clients on or after 1 January 2020 (with most clients being contacted on or after 30 June 2020) with a series of questions, the first of which will be whether the client was carrying on any Relevant Activity at any time during its first Financial Period. Depending on the answer, additional questions will be asked. As part of managing this process, we may reach out to you sooner.

Monitoring and Enforcement

The ITA will be responsible for implementing, monitoring and enforcing the economic substance regime.

Failing to provide information or providing false information attracts criminal penalties. The penalties can be severe, including in the case of conviction on indictment to a fine not exceeding US\$75,000 or imprisonment for a term not exceeding five years.

Otherwise, a Legal Entity carrying on a Relevant Activity which fails to comply with the ES Act is subject to penalty, strike off or both (although not a criminal penalty). It is anticipated that there will be a three step approach to enforcement. On a first determination of non-compliance, the ITA will issue a notice along with a penalty (which is likely to be the minimum penalty of US\$5,000 provided there is no deliberate or egregious breach). The ITA will also indicate what actions it considers are necessary to comply with economic substance. After that, it is anticipated that the ITA will issue a second and third enforcement notice with escalating fines. The fines can be up to US\$200,000 (or up to US\$400,000 for a "high risk IP legal entity") for non-compliance, with strike off being the ultimate remedy.

It is noted that the ITA has reserved the right not to follow the guidance in the Code if an entity has engaged in artificial transactions to avoid the application of the economic substance requirements or an entity has supplied false or misleading information.

Investment Funds

Investment funds are not carrying on one of the eight Relevant Activities. However, it is possible that a fund may be carrying on Holding Business if it only holds equity participations in other entities and only earns dividends and capital gains. This may be the case for feeder funds, although feeder funds who do not “manage” the shares of the master fund would generally be considered to be carrying on a passive Holding Business. The treatment of investment funds is still under review by the European Union, and it is anticipated that further requirements and/or guidance will be provided by the ITA in due course.

How can we help?

We recognise that this legislation will in some cases require changes to existing business models. Conyers Dill & Pearman is ready to assist clients in understanding their obligations under the legislation and in implementing any such changes that may be required. For further information please contact one of our lawyers listed below or your usual Conyers lawyer.

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For further information please contact: media@conyers.com

DEFINITIONS - General

<u>Defined Term</u>	<u>Definition</u>
Financial Period	<p>means</p> <ul style="list-style-type: none"> (a) in the case of a company incorporated on or after 1 January 2019, such period of not more than one year from the date of incorporation as the company shall notify to the competent authority and thereafter each successive period of one year running from the end of that period; (b) in the case of a limited partnership formed on or after 1 January 2019, such period of not more than one year from the date of formation as the limited partnership shall notify to the competent authority and thereafter each successive period of one year running from the end of that period; (c) in any other case such period of one year commencing on a date no later than 30 June 2019 as the legal entity shall notify to the competent authority and thereafter each successive period of one year running from the end of that period.
Legal Entity	<p>includes</p> <ul style="list-style-type: none"> (a) a company within the meaning of Section 3(1) of the <i>BVI Business Companies Act, 2004</i>; (b) a foreign company within the meaning of Section 3(2) of the <i>BVI Companies Act, 2004</i> which is registered under Part XI of that Act, <p>but does not include a company which is resident for tax purposes in a jurisdiction outside the Virgin Islands which is not on Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes; and</p> <p>includes:</p> <ul style="list-style-type: none"> (a) an existing limited partnership within the meaning of Section 2 of the Limited Partnership Act, 2017; (b) a limited partnership within the meaning of Section 2 of the Limited Partnership Act, 2017; and (c) a foreign limited partnership within the meaning of Section 2 of the Limited Partnership Act, 2017 which is registered under Part VI of that Act, <p>but does not include a limited partnership which is resident for tax purposes in a jurisdiction outside the Virgin Islands which is not on Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes, or a limited partnership where the general partners have elected pursuant to either section 8(2)(b) or section 67(1)(c) of the Limited Partnership Act, 2017 that the limited partnership shall not have legal personality, or where the limited partnership does not have legal personality for any other reason.</p>
Relevant Activity	<p>mean any of the following activities:</p> <ul style="list-style-type: none"> (a) banking business; (b) insurance business; (c) fund management business; (d) finance and leasing business; (e) headquarters business; (f) shipping business;

	<p>(g) holding business;</p> <p>(h) intellectual property business;</p> <p>(i) distribution and service centre business.</p>
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DEFINITIONS – Relevant Activities

Defined Term	<u>Definition</u>
Banking business	<p>means the business of accepting deposits of money which may be withdrawn or repaid on demand or after a fixed period or after notice, by cheque or otherwise and the employment of such deposits, either in whole or in part.</p> <p>(a) in making or giving loans, advances, overdrafts, guarantees or similar facilities; or</p> <p>(b) the making of investments,</p> <p>for the account and at the risk of the person accepting such deposits.</p>
Distribution and service centre business	<p>means the business of either or both of the following:</p> <p>(a) purchasing from foreign affiliates;</p> <p>(i) component parts or materials for goods; or</p> <p>(ii) goods ready for sale; and</p> <p>(iii) reselling such component parts, materials or goods;</p> <p>(b) providing services to foreign affiliates in connection with the business,</p> <p>but does not include any activity included in any other relevant activity except holding business.</p>
Financing and leasing business	<p>means the business of providing credit facilities of any kind for consideration, where consideration may include consideration by way of interest, and where an advance or credit repayable by a customer to a person is assigned to another person, that other person is deemed to be providing the credit facility.</p>
Fund management business	<p>means the conduct of an activity that requires the legal entity to hold an investment business license pursuant to Section 4 and category 3 of Schedule 3 of the <i>Securities and Investment Business Act, 2010</i>.</p>

Headquarters business	<p>means the business of providing any of the following services to an entity in the same Group:</p> <ul style="list-style-type: none"> (a) the provision of senior management; (b) the assumption or control of material risk for activities carried out by any of those entities in the same Group; or (c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b), <p>but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business.</p>
Holding business	<p>means the business of being a legal entity that only holds equity participations in other entities and only earns dividends and capital gains.</p>
Insurance business	<p>means the business of undertaking liability under a contract of insurance to indemnify or compensate a person in respect of loss or damage, including the liability to pay damages or compensation contingent upon the happening of a specified event, and includes life insurance business and reinsurance business.</p>
Intellectual property business	<p>means the business of holding any intellectual property right in intangible assets, including but not limited to copyright, patents, trademarks, brand, and technical know-how, from which identifiable income accrues to the business (such income being separately identifiable from any income generated from any tangible asset in which the right subsists).</p>
Shipping business	<p>means any of the following activities involving the operation of a ship anywhere in the world other than solely within Virgin Islands waters (as defined in Section 2(2)(a) of the <i>Merchant Shipping Act, 2001</i>):</p> <ul style="list-style-type: none"> (a) the business of transporting, by sea, persons, animals, goods or mail; (b) the renting or chartering of ships for the purpose described in paragraph (a); (c) the sale of travel tickets or equivalent, and ancillary services connected with the operation of a ship; (d) the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea; (e) the management of the crew of a ship.