

# OFFSHORE ECONOMIC SUBSTANCE REQUIREMENTS – NEW IMPLICATIONS

*New economic substance regimes in Bermuda, the British Virgin Islands and the Cayman Islands give rise to new considerations for counterparties transacting with offshore entities*

**E**conomic substance requirements have been enacted in all leading offshore financial centres in response to the EU Code of Conduct Group (Business Taxation) reports issued in June 2018.

These set out the requirements for economic substance that relevant non-EU jurisdictions were required to adopt in order to avoid being blacklisted by the EU.

## Scope of new regimes

The economic substance regimes enacted in Bermuda, the BVI and the Cayman Islands generally cover the same ground and in materially similar terms, although there are certain nuances across the jurisdictions.

As of 1 July 2019, all ‘registered entities’ in Bermuda, ‘legal entities’ in the BVI and ‘relevant entities’ in the Cayman Islands carrying out or conducting certain prescribed ‘relevant activities’ must have and maintain adequate substance in such offshore jurisdiction.

Although not an exhaustive list, ‘relevant activities’ generally include banking business, insurance business, shipping business, regulated fund management business, finance/leasing business, distribution and service centre business, headquarters business, intellectual property business and certain holding company activities.

The exact scope of substance requirements varies by ‘relevant activity’ and offshore jurisdiction, although general requirements (in each case, being from or within the relevant offshore jurisdiction) include:

- Direction and management of the ‘relevant activity’;
- Having ‘adequate’ (an undefined and rather nebulous concept) premises and employees for the conduct of the ‘relevant activity’;
- Incurring ‘adequate’ expenditure in connection with the ‘relevant activity’;
- Conducting certain prescribed ‘core income-generating activities’.

## Non-compliance

With this in mind, what additional factors should counterparties transacting (or considering transacting) with an offshore entity consider?

Potential consequences for non-compliance with economic substance requirements could be significant, including monetary penalties and, in some instances, striking off (although we expect such drastic action to

be reserved only for the most serious and/or repeat cases of non-compliance).

## Regulatory information reporting

In addition, regulatory information reporting requirements have been introduced in line with the new substance regimes, some applying by reference to parent entities of the offshore entity (and potentially other group members in the context of outsourcing arrangements). Such information may be disclosed by the offshore regulator to overseas authorities in certain circumstances.

## Additional considerations

A potential acquirer of a significant interest in an offshore entity may wish to take specialist advice on such matters from local offshore legal counsel.

In the context of a corporate or financing transaction, the counterparty may also wish to consider:

- Requesting enhanced due diligence materials specifically in relation to (i) filings or submissions made by or on behalf of the offshore entity with the applicable regulator; (ii) notices and correspondence received by or on behalf of the offshore entity from the applicable regulator (including details of any assertions of potential non-compliance, regulatory information requests, monetary penalties and potential strike-off action); and (iii) legal advice the offshore entity has received, in each case pertaining to matters of economic substance or tax residency. Such disclosure materials should then be reviewed and considered by the counterparty’s local offshore legal counsel;
- Negotiating additional and specific representations, warranties and covenants in transaction documents covering compliance with relevant economic substance requirements.



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