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LEGAL UPDATE

Do you understand the offshore Economic Substance Requirements?

From 1 January 2019, various traditional offshore jurisdictions (such as the British Virgin Islands ("**BVI**"), Cayman Islands ("**CI**"), Jersey, Guernsey, Isle of Man, Bermuda, Barbados, etc.) have enacted economic substance (**ES**) requirements, although there are differences and local nuances in each of those respective jurisdictions involved. Generally speaking, the introduction of ES requirements in such traditional 'no or nominal tax jurisdictions' has raised concerns amongst individuals or corporations who have been using offshore companies, whether in the conduct of a trade or business, funds or investment management, family-owned businesses or trust structures using offshore companies for the holding of investments or real properties, multinational groups with an offshore listing vehicle and/or holding companies, and so forth. As such, the impact of the ES requirements on the use of entities in such no or nominal tax jurisdictions needs to be assessed, immediately and on an ongoing basis.

Here we provide an outline of the broad global context and the general ES requirements for information and discussion, while specific details of the ES requirements that may apply to specific entities in specific offshore jurisdictions should be considered in consultation with lawyers of the particular jurisdictions in question.

Background

In November 2018, the Organisation for Economic Co-operation and Development ("**OECD**") issued a document named "Resumption of Application of Substantial Activities Factor to No or only Nominal Tax jurisdictions" (the "**OECD document**"). Briefly put, the OECD document has imposed a global standard that requires no or nominal tax jurisdictions to introduce economic substance requirements in order to avoid that their tax regimes being regarded as constituting harmful tax practices. Reviewing this new global standard will be a key part of the OECD's Forum on Harmful Tax Practices work plan from 2019 onwards.

Consequently, many of the jurisdictions with no or nominal tax (yet (to be) compliant with the OECD) have enacted their ES law in response to requirements for geographically mobile activities to have ES developed (under the OECD's Base Erosion and Profit Shifting ("**BEPS**") Action 5 on harmful tax practices), consistent with the Council of the EU's timeframe to have such legislation in place on 1 January 2019. This is also to bring their tax regimes in line with the European Union ("**EU**")'s fair taxation principle that "a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction", and avoid being included in the EU's list of non-cooperative jurisdictions (i.e. the "**EU's blacklist**").

Scope of the new requirements

As an overview, although each of the no or nominal tax jurisdictions has independently drafted and enacted their own ES legislation, the requirements are broadly similar across each of the jurisdictions involved as they all generally follow the requirements and recommendations of the said OECD document. Broadly speaking, under the ES law:

- a (so-called) 'Relevant Entity' conducting a (so-called) 'Relevant Activity' has to report annually and maintain adequate ES on an ongoing basis;

- a 'Relevant Entity' which does not conduct a 'Relevant Activity' (only) has to submit notifications to the competent authorities in the offshore jurisdiction where it is incorporated and/or registered; and
- an entity that is not a 'Relevant Entity' is out of scope and, therefore, it has no obligations in this regard.

Relevant Entity

The scope of Relevant Entities is very broad and includes, in principle, both domestic and foreign companies and partnerships incorporated or registered in the relevant no or nominal tax jurisdiction. However, the following are generally **not** Relevant Entities:

- investment funds (including the fund entity itself and any company through which the fund directly or indirectly invests or operates);
- entities that are authorised to carry on business as domestic companies locally in the (no or nominal tax) jurisdiction at hand;
- entities that are tax resident in another jurisdiction (which is not a no or nominal tax jurisdiction) by reason of its domicile, residence or any other similar criteria.

Relevant Activity

For entities that are Relevant Entities, it will have to be determined if their activities are Relevant Activities. A Relevant Entity carrying on one or more Relevant Activity is required to satisfy the ES test in relation to each Relevant Activity. In principle, Relevant Activities for the purpose of ES legislation covers the following business activities: headquarters business, distribution and service centre business, finance and leasing, fund management, banking, insurance, shipping, holding company business[1], and intellectual property ("IP") holding business.

It is worth noting that, although investment funds (established in a no or nominal tax jurisdiction) are currently not being considered Relevant Entities (and thus are not required to comply with ES requirements), companies (incorporated in a no or nominal tax jurisdiction) carrying on any form of fund management business fall within the scope of Relevant Entity and Relevant Activity and are in principle required to comply with the pertinent ES requirements.

Relevant Entity carrying out Relevant Activity

Generally speaking, the ES that would have to be established and maintained by a Relevant Entity in relation to (one or more Relevant Activities) in the no or nominal tax jurisdiction include such as the following:

[1] There are less stringent ES tests for pure holding companies (i.e. companies engaged in the business of holding equity participations in other entities and only earning dividends and capital gains). Generally, it is assumed that their ES requirements are met if the holding company in question is compliant with the statutory obligations under the relevant companies legislation of that jurisdiction and has adequate human resources and premises for holding and managing the equity participation in other entities. Nonetheless, it remains to be seen (through guidance notes which are expected to be issued in the near future) to what extent those tests are actually reduced.

- the entity has to be directed and managed in that jurisdiction;
- the core income generating activities are undertaken in that jurisdiction;
- the entity has to maintain adequate physical presence in that jurisdiction;
- having adequate full-time (and suitably qualified) employees in that jurisdiction; and
- there has to be adequate operating expenditure incurred in that jurisdiction[2].

The new law on ES requirements have entered into operation since 1 January 2019, with a six-month grace period provided to existing Relevant Entities to ensure they are compliant. Relevant Entities incorporated on or after 1 January 2019 must satisfy the ES test from the date on which a Relevant Activity commences.

Compliance

Relevant Entities carrying out Relevant Activities are required to make an annual declaration to the local tax authorities relevant in the no or nominal tax jurisdiction in relation to their compliance with ES requirements during the preceding financial period. Failing to submit the information required may result in penalties.

For operating an entity failing to meet the ES requirements, the Relevant Entity can expect to be notified on such determination and directed on action(s) to be taken or, if the Relevant Entity continues to fail the ES requirements, to be struck off from the register of companies or partnerships at hand. Moreover, it may also be expected that (under an exchange of information mechanism) tax authorities of the relevant no or nominal jurisdictions may share information spontaneously (i.e. without having received a request from the treaty partner) with tax authorities of the jurisdiction(s) where the immediate parent company, the ultimate parent and ultimate beneficial owner(s) of the Relevant Entity are located.

If false or misleading information is knowingly or willfully supplied, it is an offence subject to sanction which generally includes (upon conviction) the imposing of a fine or imprisonment of the relevant director(s) in the worst case scenario.

What's next

Review existing holding and/or operating structures

Where no or nominal jurisdictions have been used in existing structures, it should be assessed whether the ES requirements can be satisfied in respect of their Relevant Entities in those jurisdictions.

Where a Relevant Entity is (and may remain) unable to meet these, it is recommended to evaluate the impact, and it should be noted that there is a requirement that such information of non-compliance shall be shared with tax authorities of the jurisdiction(s) in which the parent entity, ultimate parent entity and ultimate beneficial owner(s) are located. Available options should be considered, although it should not be a rush to discontinue the use of the offshore entity in question, but a careful analysis be undertaken on the possible options involving the jurisdiction(s) of primary business or economic activities or other friendly (yet not a no or nominal tax) jurisdiction(s) instead.

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[2] Some third party agents are offering physical premises, and potential use of employees by sharing of resources within a group or through resources provided by a third party agent are being suggested, which may be subject to further guidance for satisfying ES requirements.

Furthermore, more changes may be in the pipeline as some no or nominal tax jurisdictions have already indicated that additional guidance notices and regulations are expected to be issued in view of implementing the new ES rules.

Consider tax residency in alternative jurisdictions

It is generally accepted that where a Relevant Entity carries on a Relevant Activity through an overseas branch and the branch is subject to tax in that overseas jurisdiction, the Relevant Entity may not have to meet the ES requirements in the offshore jurisdiction where it was initially incorporated or registered. Therefore, a potential remedial action could be to establish, incorporate in or relocate the Relevant Entity (or its activities carried out through a branch) to a jurisdiction which has a friendly tax regime but not with nil or nominal tax rates. On aside, for the BVI, there is a requirement that the jurisdiction where the entity is (or will become) resident is not on the EU's blacklist.

Generally, from Hong Kong's perspective, the Inland Revenue Department ("IRD") may issue a 'Certificate of Resident Status' (i.e. a tax residency certificate) to a company incorporated in a no or nominal tax jurisdiction if it can be proven to the IRD's satisfaction that the company in question is normally controlled and managed in Hong Kong. As such, Relevant Entities incorporated in a no or nominal tax jurisdiction may become eligible for the double tax agreement ("DTA") network of a tax jurisdiction (for example Hong Kong) after 'moving' the tax residency (to Hong Kong). Therefore, similar to Hong Kong incorporated companies, Relevant Entities can potentially also enjoy tax treaty benefits (e.g. reduced withholding tax rates with respect to the receipt of overseas dividends, interest and royalties, as well as protection against capital gains tax in the relevant investee country), provided that the relevant conditions are satisfied.

Having said that, companies should carefully consider and examine the potential tax implications that may arise under the applicable tax legislation or framework that may now apply, prior to seeking a "relocation" and also consider the feasibility of obtaining a tax residency certificate.

Hong Kong funds

As mentioned above, investment funds (or entities through which investment funds directly or indirectly invest or operate) are currently not within scope. However, in some jurisdictions it is still being considered whether investment funds should become in scope and, for jurisdictions where investment funds are currently not in scope, there is some expectation that a review may follow in this regard. Regardless, companies established as carrying a fund management business in an offshore jurisdictions are likely to be subject to the ES requirements in the (no or nominal tax) jurisdiction where they are incorporated.

With respect to the funds industry in Hong Kong, the following (legal and tax) developments are worth noting:

- As of 1 April 2019, Hong Kong has a new profits tax exemption regime for (privately offered) investment funds operating in Hong Kong, regardless of their location of central management and control, their size or the purpose that they serve, to be able to enjoy tax exemption for transactions in specified assets subject to meeting certain conditions. Previously, offshore funds may benefit from the Hong Kong profits tax exemption subject to being non-resident (having central management and control outside Hong Kong). With this change, it opens up the option for offshore funds to "relocate" tax residency to Hong Kong and still eligible to enjoy the profits tax exemption.

- Essentially, a fund can also enjoy the tax exemption in connection with its investment in both overseas and local private companies without jeopardizing the application of the tax exemption, provided that (i) the fund does not hold (directly or indirectly) more than 10% of its assets in immovable property in Hong Kong and (ii) the shares in the private companies have been held for at least two years. If the fund were to dispose of its shares in a private company within two years, the fund may still avail of the tax exemption where (a) the fund does not have a controlling stake in the private company or (b) the latter does not hold more than 50% of its assets for less than three years (for details, please refer to our legal update dated 11 December 2018[3]);

- Following the enactment of the Securities and Futures (Amendment) Ordinance in June 2016, Hong Kong licensed investment managers may now set up a fund (not only in the form of a unit trust but also) in the corporate form with legal personality (as an incorporated company with limited liability) in Hong Kong. The previous limitation on the corporate legal form for investment funds has gone away, as the open-ended fund structure provides flexibility to vary share capital and the creation and cancellation of shares in order to meet investors' requests for subscriptions for and withdrawals of their capital from the fund (subject to the terms and conditions under its instrument of incorporation).

- On the other hand, under the Inland Revenue Ordinance, (both onshore and offshore) publicly offered funds authorised as a collective investment scheme under the Securities and Futures Ordinance ("SFO") are generally eligible for profits tax exemption (subject to meeting applicable requirements).

Hong Kong fund managers are recommended to conduct a closer review of their existing structure and set-up, including any offshore incorporated fund management entity that may be impacted by the ES requirements, and also potentially re-consider the tax residency of the offshore funds and investment structures under their current product offerings and operating models.

Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

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[3] https://www.vteu.co/2018/12/11/international-tax-cooperation-spurs-key-development-of-the-hong-kong-asset-management-industry/