Substance in the Channel Islands:

Key considerations and requirements for fund managers

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

AZTEC GROUP

Substance in the Channel Islands

January 2022 marks the third anniversary of the introduction of the Economic Substance Legislation by the Crown Dependencies and Overseas Territories. In that time, there have been plenty of twists and turns, with the legislation continuing to evolve and COVID-19 posing a number of challenges from a compliance standpoint.

In this short guide, we reflect on the changes to the Legislation since its inception on 1 January 2019, specifically in the Channel Islands, and provide practical guidance on the steps and measures you can take to ensure your structures are compliant.

> **Legislation is continuing to evolve and COVID-19 is posing a number of challenges.**

Jump to:

First things first: Are you in scope?

> **The definition of "resident" applies to companies incorporated in the Islands and foreign companies claiming tax residency in Jersey and Guernsey.**

From 1 January 2019, all resident Jersey and Guernsey companies were required to be assessed as to whether they were in or out of scope of the Economic Substance requirements, as outlined in the legislation enacted by both Governments (the "**Legislation**").

The definition of "resident" applies to companies incorporated in the Islands and foreign companies claiming tax residency in Jersey and Guernsey. Therefore, a foreign company which meets the management and control test for tax residency in the Islands, would still need to consider the applicability of the Legislation. Conversely, any Jersey or Guernsey incorporated companies would not need to comply with the Legislation if their tax residency was elsewhere, such as the UK.

The Legislation in both Islands was amended to bring self-managed funds into scope for financial periods commencing on or after 1 October 2020 in Guernsey and 1 January 2021 in Jersey. Although the Fund Management Business definition was not amended in the context of self-managed funds, the main difference was that such entities would be in scope regardless of the gross income received.

In 2021, both Islands also brought in new legislation applicable to resident partnerships as part of previous commitments to the EU, being the Income Tax (Substance Requirements) (Implementation) Regulations, 2021 in Guernsey and Jersey Taxation (Partnerships – Economic Substance) (Jersey) Law 2021 in Jersey (the "**Partnership Legislation**"). This new legislation is broadly similar to the legislation for companies. However, it introduces the concept of place of effective management for partnerships.

Both pieces of Legislation were immediately applicable from 1 July 2021 for new resident partnerships established on or from this date, and for financial periods commencing on or after 1 January 2022 for existing resident partnerships. For further information around the place of effective management test, please refer to the Partnership Guidance issued in December 2021 found **here.**

The implications for your structures:

How you can achieve compliance

The view of the fund administration industry in the Channel Islands was largely that the Legislation codified the robust corporate governance principles already in place. However, the main consideration when the Legislation first came into effect, and still to this date, is around how managers should proceed with regard to the composition and functioning of the board, as explored over the next couple of pages.

1 Meeting the directed and managed test

Companies which meet the 'management and control' test for tax residency still need to ensure that they also meet the directed and managed test in order to have adequate substance in the Islands. As a reminder, the directed and managed test consists of the following points, and must be demonstrated in each accounting period:

a. the Board of Directors must meet in the Island at an adequate frequency given the level of decision making required;

b. during the meetings in the Island, there must be a quorum of the Board of Directors physically present;

c. strategic decisions of the company must be set at meetings of the Board of Directors and the minutes must reflect those decisions. If a company has one director, then they should evidence that written resolutions were passed by that director when he is physically present in the Island;

d. the Board of Directors, as a whole, must have the necessary knowledge and expertise to discharge their duties as a board; and

e. all minutes and company records must be kept in the Island.

In cases where there are corporate directors, these will be looked through to the individuals (officers of the corporate director) actually performing the duties of the director.

2 Due regard to quorum on Island

Articles of Association (especially bespoke articles) must be carefully reviewed when incorporating new structures. This is to ensure that it is feasible that quorum will be in the relevant jurisdiction for meetings to be held at an adequate frequency, given the level of decision making required to demonstrate adequate substance for the relevant activity in question. Even if a company is not intending to conduct a relevant activity, this may change throughout the entity's life cycle. Therefore, the quorum requirement should be carefully considered for all entities, not just those in scope.

3 Written resolutions should not replace formal meetings

It is encouraged that alternate directors are not used frequently for in-scope entities, nor should written resolutions be used as commonplace in the absence of formal meetings. This is particularly important given tax returns include reporting around number of meetings in the year for in-scope entities (which written resolutions cannot be counted towards), as well as the directed and managed requirements that the Board must meet at an adequate frequency (although there is still no guidance around what constitutes adequacy, it is dependent on the activity of the entity). Furthermore, to evidence adequate substance, there is an expectation that the minutes of meetings should capture strategic discussions made by the Board, especially around Core Income Generating Activities (CIGA) decisions, which is where the use of Written Resolutions would fall short.

4 Physical presence is a must for CIGA decisions (even in the current climate!)

When a CIGA decision is required to be made by the Board, then a majority of those making the decision must be physically present in the jurisdiction (this is in addition to quorum). This, therefore, goes further than the directed and managed test. The CIGA decision making requirements in practice can be most challenging for split boards; for example, where there are two resident directors and two non-resident directors. In the absence of travelling to the relevant jurisdiction to attend a CIGA meeting, only one non-resident director can participate in a CIGA meeting (this is on the assumption that quorum is any two directors, which can be satisfied each time by the resident directors).

5 Achieving substance in the face of COVID-19

The coronavirus pandemic has continued to cause disruption during 2021. In March 2020, Guernsey and Jersey issued pragmatic guidance for applying economic substance requirements in the face of COVID-19, particularly around physical attendance at board meetings. However, in January 2021 this guidance was clarified to outline that the exemption only applied to the directed and managed test and not CIGA decisions, therefore CIGA meetings still required a majority present on Island.

In practice we have found there has been too much reliance placed on the earlier COVID-19 guidance. There is now an expectation that Boards have had sufficient time to reconsider their composition, with a view to ensuring that meetings can be held from the relevant jurisdictions.

There was also an expectation that if a company was relying on the directed and managed exemption, that appropriate disclosure was included in the company's 2020 tax return to this effect.

Relevant activities:

Are you getting it right?

The other common misstep in the Financing and Leasing space is where holding companies have an interest in an underlying group company through debt and equity.

We have seen that classification of companies under the Legislation has resulted in relevant activities being undertaken that perhaps differ from an entity's intended purpose. In the fund administration space, the relevant activities that are most applicable to our clients are:

- Fund Management Business,
- Financing and Leasing Business, and
- Holding Company Business.

Most notably, entities which are set up to be holding companies have often fallen into the Financing and Leasing space if they issue interest bearing inter-group loans. The other common misstep in the Financing and Leasing space is where holding companies have an interest in an underlying group company through debt and equity. The debt element of the investment should be split out from the equity element and the accrued interest on the debt investment recognised as the company's gross income for the purposes of its Financing and Leasing Business. In practice, this may result in additional disclosures in the notes to the financial statements to recognise the accrued interest, as most financial reporting frameworks will allow for the overall investment to be recorded at Fair Value through Profit or Loss on the face of the Statement of Financial Position and the overall unrealised movement in the Statement of Comprehensive Income.

In practice, the CIGA requirements for Financing and Leasing businesses are limited to matters in respect of the loan activity, whereas for Holding Company Business all matters that the directors are required to consider in respect of the Company are considered CIGA decisions.

Future changes to tax return reporting

An annual tax filing will be required to be made for resident partnerships, aligned with the company return deadlines in both Islands.

The Government of Jersey has just issued a consultation (closing 31 March 2022), on the proposed reporting obligations, to be known as a 'Combined Notification'. The Notification will replace the existing income tax obligations of Jersey partnerships and their partners and will be split into three sections:

1	**Risk-based partnership identification notice** (including disclosure of nature of activity and levels of turnover and profit).
2	**Economic substance requirements** (broadly similar to the ES section on the corporate tax return, including available exemptions).
3	**Partnership tax statement** (required if the partnership income would give rise to Jersey income tax liabilities for any of the partners).

In Guernsey, the Revenue Service issued a circular on 21 December 2021 which outlines the future reporting requirements for partnerships. This can be found **here.** All Guernsey resident partnerships will be required to file returns annually, enclosing accounts and information confirming compliance with the economic substance requirements (if applicable).

In both Islands, partnerships that were in existence at 30 June 2021 will be required to file a return for the year in which their first accounting period, commencing on or after 1 January 2022, ends. New partnerships (being those partnerships formed on or after 1 July 2021) will be required to file a return for the year in which their first accounting period, commencing on or after 1 July 2021, ends. Therefore, assuming new partnerships don't have a short first accounting period ending on 31 December 2021, the first reporting for partnerships in both Islands will not be until late 2023.

Substance audits and the consequences of failing the substance test

The Revenue authorities will soon have two years' worth of tax return data to review and act on. In 2021 following the submission of the first economic substance returns, we saw the Revenue authorities in both Islands respond quickly to companies that disclosed failure to meet substance requirements, through the issuance of penalty notices. There were also a number of investigative proceedings into companies that may have not passed the test. For the 2019 reporting period, the financial penalty for companies failing to meet economic substance requirements was up to £10,000 (such a fine will be levied for failure to meet the test in any given financial period). However, if in the 2020 financial period a company has failed to meet the requirements for a second consecutive period, they will be subject to a fine of up to £100,000. For partnerships, financial penalties will also be dependent on the number of consecutive periods of default.

Given the number of investigations that will be undertaken over the coming years, it is important that all resident entities, regardless of whether they are in scope or not, have sufficient documentation on file to support the Board's assessment as to the applicability of the relevant legislation to the entity, and, if in scope, the relevant activity undertaken, in order to rebut any challenges that might come from tax audits. It is important that these classifications are re-assessed on a regular basis, as we have seen entities switch between relevant activity from one financial year to the next. Regularly considering the entity's relevant activity is just as important as an in or out of scope classification, given that CIGA decisions are specific to each relevant activity.

Therefore, our recommendation is that as a minimum on an annual basis the Board formally consider and minute classifications with reference to the applicable Legislation. Notwithstanding the formal classification being minuted annually, the financial activity of the entity should be reviewed frequently to ensure the correct substance requirements are being fulfilled, especially in the context of financing and investment transactions, whereby interest profile of loans may change from non-interest bearing to interest bearing and new equity interests are acquired during the financial period.

Furthermore, tax returns should be formally approved at Board level and not delegated. The tax return process should also be co-ordinated alongside the Financial Statements approval process, given that the financial activity of the entity and its substance classification goes hand in hand.

Future of substance: Next steps

The expansion of the legislation to cover partnerships will be of particular relevance to the funds industry given the predominant use of limited partnerships in private equity and other fund structures. Groups should review their structures to identify if there are partnerships which could be captured by the Partnership Legislation. Helpfully, the Partnership Legislation includes a funds carve out to ensure there is not a double application of substance requirements to the General Partner/Manager and the corresponding fund. Holding Company Business is also only applicable to Limited Liability Partnerships.

Some may also be of the opinion that the extension of economic substance to tax transparent vehicles such as partnerships, is a sign of the future expectations of the OECD and the broad brush approach that may be applied to all tax transparent entities, such as trusts. However, the introduction of the OECD model rules on the global minimum rate of tax (Pillar 2) from 2023, does not require the removal of the 0% standard rate of corporate income tax in the Channel Islands.

Get in touch

If you would like to discuss any of the topics in this guide, as well as how the Aztec Group can support you, please talk to either your usual contact or get in touch with:

Chris McErlane
Head of Real Assets - Guernsey
Telephone: +44 (0) 1481 749746
Email: Chris.McErlane@aztecgroup.co.uk

Debbie Reeve
Associate Director
Telephone: +44 (0) 1534 836813
Email: Debbie.Reeve@aztecgroup.co.uk

The Bright Alternative

Explore: aztecgroup.co.uk | .eu | .us

Private Equity Fund Services
Real Asset Fund Services
Private Debt Fund Services
Corporate Services

AZTEC GROUP

Aztec Group is a regulated financial services group