Analysis

Jersey's economic substance rules

Speed read

Jersey has introduced economic substance legislation effective for accounting periods starting on or after 1 January 2019. The rules apply to Jersey tax resident companies performing one of nine 'relevant activities'. In-scope companies are required to demonstrate economic substance in Jersey by passing a certain test. Companies failing to meet that test could be subject to financial penalties and an exchange of information with other relevant tax authorities, and in the most serious cases, they could be struck-off Jersey's company register. Advisers should familiarise themselves with the rules as the Jersey income tax returns for the first reporting period of economic substance information are now available for completion.

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Throughout 2017, the EU Code of Conduct Group (Business Taxation) conducted a screening process whereby the tax regimes and administrations of more than 90 jurisdictions were subject to detailed analysis. In December 2017, Jersey was determined to be a cooperative tax jurisdiction. However, as part of an ongoing dialogue with the EU, the Government of Jersey made a number of commitments in relation to Jersey tax resident companies demonstrating economic substance in the jurisdiction.

Jersey, amongst other offshore financial centres such as Guernsey, Isle of Man, Cayman Islands, Bermuda and the British Virgin Islands, implemented economic substance legislation effective for financial periods starting on or after 1 January 2019.

Jersey incorporated/tax resident companies are required to file annual income tax returns for each calendar tax year ('the year of assessment'). Jersey permanent establishments also file returns but are not the subject of this discussion. These returns are filed with Jersey's tax authority, the Comptroller of Revenue ('the Comptroller'). The Jersey income tax returns for the first reporting period (the 2019 year of assessment) disclosing economic substance information are now available for completion.

The legislation gives the Comptroller the power to issue guidance notes/regulations over how the economic substance test may be met. Guidance notes have been produced in conjunction with the other Crown Dependencies.

References to articles below are to those in the Taxation (Companies – Economic Substance) (Jersey) Law 2019 unless otherwise stated.

Relevant activity

The legislation applies to Jersey tax resident companies undertaking one of the following 'relevant activities':

- Banking business: Jersey regulated deposit taking banks (excluding banks paying reduced business continuity fees to the Jersey Financial Services Commission).
- Insurance business: broadly, Jersey regulated insurance businesses.
- Fund management business: broadly, regulated investment managers and managers but can also include general partners of limited partnerships. Note that regulated Collective Investment Funds are excluded.
- Finance and leasing business: companies providing credit facilities, including to other group members, for any kind of consideration. Consideration includes interest. Note that leases granting an exclusive right to occupy land are excluded.
- Headquarters business: companies providing senior management or assuming or controlling material risks for activities in relation to foreign connected persons.
- Shipping business: a broad spectrum of those providing services in relation to shipping. Excludes businesses that operate solely between Jersey/Guernsey or within Jersey territorial waters.
- Holding company business: the business of being a holding company (and not conducting any other commercial activity).
- Intellectual property (IP) holding business: those holding and receiving income from IP assets.
- Distribution and service centre business: those either purchasing goods from foreign connected persons for resale or providing services to foreign connected persons. This includes administrative services.

Economic substance test

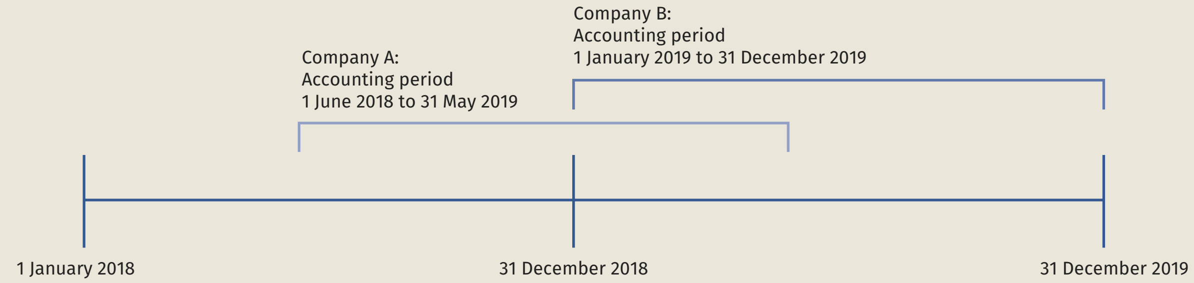
All Jersey tax resident companies conducting a relevant activity and in receipt of gross income from that activity in financial periods starting on or after 1 January 2019 must demonstrate that (article 5):

- the company is directed and managed in Jersey in relation to that activity ('the directed and managed test');
- having regard to the level of relevant activity carried on in Jersey:
  - there are an adequate number of employees in relation to that activity who are physically present in Jersey (whether or not employed by the resident company or by another entity and whether on temporary or long-term contracts);
  - there is adequate expenditure incurred in Jersey; and
  - there are adequate physical assets in Jersey; (these requirements together are known as 'the adequate substance tests')
- the company conducts Jersey core-income generating activity; and
- in the case of Jersey core-income generating activity carried out for the relevant company by another entity, it is able to monitor and control the carrying out of that activity by the other entity.

If no gross income from any relevant activity is received during a financial period, then the economic substance test does not apply that (article 5(8)).

However, there are broad anti-avoidance rules in the guidance notes (see bit.ly/2WybzCW) produced by the Crown Dependencies' tax authorities to prevent companies manipulating or artificially suppressing their income to avoid being subject to the economic substance rules.

Example of first period of account



Jersey has a calendar tax year (the year of assessment). Financial periods ending during 2019 are taxed as the 2019 year of assessment.
Economic substance affects financial periods starting on or after 1 January 2019.
Company A – not in scope for the 2019 year of assessment as no financial period starts in 2019.
Company B – in scope as it has a financial period starting on or after 1 January 2019.
Both companies will need to file 2019 year of assessment income tax returns by 31 December 2020.
Only company B will need to disclose economic substance data.

The directed and managed test

In order to meet this test:

- the company's board of directors must meet in Jersey at an adequate frequency having regard to the amount of decision-making required at that level;
- at such board meetings, a quorum of directors are physically present in Jersey;
- the minutes of such board meetings are to record the making of strategic decisions of the company at the meeting;
- the directors of the company are to have the necessary knowledge and expertise to discharge the duties of the board; and
- the minutes of all board meetings and the records of the company are to be kept in Jersey (article 5(8).

Impact of the coronavirus

Coronavirus has affected the ability of some company directors to attend board meetings in Jersey. The Comptroller has issued a practice note explaining that, where a company's operating practices have to be adjusted as a result of the coronavirus outbreak, the Comptroller will not necessarily determine that a company has failed the economic substance test. This treatment will only apply to adjustments to the normal operating practices, and to the extent required to mitigate the threats from this outbreak.

> There are no safe harbours specifying a minimum level of substance

The adequate substance tests

A company is required to have an adequate number of (qualified) employees proportionate to the level of activity carried out in Jersey, combined with adequate expenditure proportionate to the level of activity carried on in the Island and an adequate physical presence in Jersey (article 5(2)b).

The legislation does not prohibit a company from outsourcing company activities, including to corporate service providers. However, the outsourcers should be based in Jersey and they should monitor the level of substance in Jersey for reporting purposes. Outsourcing, in this general context, includes contracting or delegating to third parties or group companies.

There are no safe harbours specifying a minimum level of substance. In-scope companies have responded in a number of different ways, including:

- performing GAP analysis to identify any areas that need attention;
- bringing staff over to Jersey to increase substance levels; and
- having documentation on-file supporting the level of substance in Jersey.

Core income-generating activities

Jersey core income-generating activities (CIGAs) relates to relevant activities carried out from within Jersey.

CIGA are the essential and valuable activities that generate the income of the company. It is not necessary for a company to perform all of the CIGA listed in the legislation for its relevant sector, but it must perform the CIGA that generate its income (see *Economic substance guidance notes* at bit.ly/2WBNA6a).

In order to meet the economic substance requirements, the CIGA that generates the income must be performed in Jersey. Where the CIGA involves making relevant decisions, a majority of decision makers must be present in Jersey when the decision is made, otherwise the decision will not be considered to have been made in Jersey (see Economic substance guidance notes).

Activities undertaken outside Jersey must not be CIGA. General support functions such as IT support or HR functions are a necessary activity for the majority of companies, but they do not generally generate income for the company and hence may not be included as CIGA.

Companies performing a relevant activity will need to demonstrate that they undertake their CIGA in Jersey in order to pass the economic substance test.

Enquiry window

Based on the information contained in submitted income tax returns, the comptroller generally has six years after the end of financial periods (starting on or after 1 January 2019) to make a determination that a company has failed the economic substance test (see article 6(1)). The comptroller has the power to examine business documents to assist in making a determination. Penalties of £3,000 can be levied for inaccurate information, or where there is a failure to provide information at all (see article 10).

Penalties

If the comptroller determines that the company has failed the economic substance tests, then for the first period of failure, there is a maximum penalty of £10,000 (see article 9).

Jersey's economic substance legislation requires that the Comptroller tells a company that fails the economic substance test how the company can meet the test going forward (see article 9(3)(f)).

If there is a subsequent additional failing, the penalty can rise to £100,000 (see article 9(4)) and the Comptroller can make a report to the Minister for Treasury and Resources (see article 9(5)). The minister may subsequently decide whether to go to the Royal Court for an order to make the company comply (see Companies (Jersey) Law 1991 art 143B). Ultimately, for persistent failures, these orders could result in the company being struck off from Jersey's company register.

Exchange of information

Where a company fails the economic substance test, the comptroller can also exchange information with the competent authority in the jurisdiction of residence of:

- a holding body;
- the ultimate holding body of the Jersey company;
- an ultimate beneficial owner; and
- if the company itself is incorporated outside Jersey, the competent authority of the country or territory in which the resident company is incorporated (see article 8(1)(b)).

In order for information to be exchanged, the provision of information must be permitted under:

- a bilateral agreement made between Jersey and that country or territory; or
- the OECD and Council of Europe (2011) multilateral convention on mutual administrative assistance in tax matters (as amended by the 2010 protocol) (see article 8(3)).

High risk IP companies

Companies holding IP should consider if they are high risk IP companies. A high risk IP company is either:

- a company that does not carry out research and development (R&D), branding or distribution as part of its Jersey core-income generating activities; or
- is a company which:
  - did not create the IP in an IP asset which it holds for the purposes of its business;
  - acquired the IP asset either from (i) a connected person or (ii) in consideration for funding R&D by another person situated in a country or territory other than Jersey; and
  - licenses the IP asset to one or more connected persons or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by foreign connected persons (see article 1).

High risk IP companies are deemed to fail the economic substance test for every financial period unless documentation is submitted with the annual income tax return which satisfies the comptroller that the test has been passed (see article 6(3)).

These materials must explain how the development, enhancement, maintenance, protection and exploitation (DEMPE) functions have been under the company's control, and that this has involved people who are highly skilled and perform their core activities in Jersey.

The high evidential threshold requires:

- detailed business plans which clearly lay out the commercial rationale for holding the IP asset(s) in Jersey;
- 'concrete' evidence that the decision making is taking place in Jersey; and
- information on employees in Jersey, including their experience, the contractual terms of employment, their qualifications and their length of service.

At this stage, the comptroller has not released any further guidance about how this information should be presented.

Irrespective of whether the comptroller determines that the economic substance test has been failed for a financial period, for high risk IP companies information (as above) will be exchanged with relevant competent authorities.

Companies holding IP should review whether they are high risk IP companies and if so, they should begin to collate the required information.

Some groups are responding to the significant number of changes around the world affecting the taxation of IP, including the Jersey economic substance requirements, and are re-evaluating current IP holding structures.

Reporting of information

Jersey's 2019 year of assessment income tax returns are now available for filing (the deadline to file is 31 December 2020). If they have not done so already, companies performing a relevant activity should start to collate information, which will need to be filed with their returns. Information to be included in the returns include:

- business/income types in order to identify the type of relevant activity;
- amount and type of gross income by relevant activity (this will generally be the turnover figure from the financial statements);
- net book value of the tangible assets held in the course of carrying out the relevant activities;
- amount of operating expenditure by relevant activity (this will generally be the company's operating expenditure from the financial statements, excluding capital);
- details of premises (business address);
- number of (qualified) employees, specifying the number of full-time equivalents;
- confirmation of the CIGA conducted for each relevant activity; and
- confirmation of whether any CIGA have been outsourced and if so relevant details.

Financial statements also need to be submitted with all Jersey income tax returns for the 2019 year of assessment onwards. At present, there is no requirement for these financial statements to be audited (unless required by relevant company law). Historically, not all Jersey tax resident companies have prepared financial statements and such companies should be speaking to their account preparers to ensure that these financial statements are prepared in advance of the tax filing deadline. ■

For related reading visit www.taxjournal.com

- ▶ The new economic substance rules for corporate groups: practical implications (Hilary Barclay & Emily Osborne, 19.6.19)
- ▶ The Jersey substance proposals, in substance (Julian Feiner, 11.10.18)