

BRITISH VIRGIN ISLANDS - ECONOMIC SUBSTANCE REGIME IMPLEMENTED

Overview:

Following the introduction of the Economic Substance (Companies and Limited Partnerships) Act, 2018 (the **Act**) in the British Virgin Islands (the **BVI**) on 1st January 2019 all BVI companies and all limited partnerships with legal personality need to assess their compliance with the Act and report their findings within six months after the end of their financial reporting period. The BVI International Tax Authority (the **ITA**) is advising companies and their directors to seek BVI legal assistance should the assessment under the Act not be straightforward and clear.

Depending on the assessment, some BVI entities must establish economic substance in the BVI in order to comply with the requirements of the Act.

This BVI legislation was enacted in response to requirements established by the EU Code of Conduct Group in June 2018. Similar legislation has been enacted in other offshore jurisdictions such as Bermuda, Cayman Islands, Jersey, Guernsey and the Isle of Man.

The Rules on Economic Substance in the British Virgin Islands (the **Rules**) were published by the ITA on 10th October 2019 and updated on 10th February 2020. The Rules provide important guidance on how the Act is interpreted by the ITA. The Rules became effective on 31st October 2019.

What entities are caught by the Act?

Under the Act, “legal entities” carrying on “relevant activities” are caught. Legal entities are, broadly speaking all BVI companies and Limited Partnerships (except for Limited Partnerships without legal personality), excluding legal entities which are tax resident in a jurisdiction outside the BVI except for certain non-cooperative jurisdictions listed by the European Union. If an entity conducts a relevant activity and claims to be tax resident in a jurisdiction outside of the BVI (which is not listed as a non-cooperative jurisdiction by the European Union) then it will need to supply evidence of such tax residence. An entity that is deemed to be tax transparent under applicable tax legislation abroad will need to demonstrate tax residence outside of the BVI with reference to each person participating in that entity.

Which activities are caught by the Act?

Only relevant activities (as defined in the Act) are caught, being:

- Banking Business
- Insurance Business
- Fund Management Business
- Finance and Leasing Business
- Headquarters Business
- Shipping Business
- Holding Business
- Intellectual Property Business
- Distribution and Service Centre Business

Legal entities conducting any of these relevant activities will have to comply with the economic substance requirements as set out in the Act.

The business of being an **investment fund** is not a relevant activity. It is outside the scope of the economic substance requirements under the Act in the same way as all other forms of business activity which are not specifically mentioned in the Act. However, investment funds may in certain circumstances fall under the category of holding business and therefore conduct relevant activities since they are not specifically exempted under the Act.

What does Banking Business mean?

The Act follows the definition of “banking business” in section 2(1) of the Banks and Trust Companies Act, 1990 (as amended), following which banking business is 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,

- a) in making or giving loans, advances, overdrafts, guarantees or similar facilities; or
- b) the making of investments,

for the account and at the risk of the person accepting such deposits.

What does Insurance Business mean?

The Act follows the definition of “insurance business” in section 3(1) of the Insurance Act, 2008 (as amended), following which insurance business is 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.

What does Fund Management Business mean?

Fund Management Business means the conduct of an activity that requires the legal entity to hold an investment business licence pursuant to section 4 and category 3 of Schedule 3 of the Securities and Investment Business Act, 2010 (as amended) (**SIBA**). Fund Management which is not regulated under SIBA and non-discretionary investment management will not be relevant activities pursuant to the Act.

What does Finance and Leasing Business mean?

Finance and leasing business means the business of providing credit facilities of any kind for consideration. The consideration may include consideration by way of interest. The provision of credit facilities as an incidental part of a different sort of business will not be caught. Only where the provision of credit facilities can be seen to be a business activity in its own right will the legal entity be treated as conducting finance and leasing business.

Legal entities which hold debt or debt instruments for the purpose of investment will not be regarded as being in the business of providing credit facilities.

What does Headquarters Business mean?

Headquarters business means the business of providing any of the following services to an entity in the same group:

- 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)

but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business.

What does Distribution and Service Centre Business mean?

Distribution and service centre business means the business of either or both of the following:

- a) purchasing from foreign affiliates
 - (1) component parts or materials for goods; or
 - (2) goods ready for sale; and
 - (3) reselling such component parts, materials or goods;
- b) providing services to foreign affiliates in connection with the business,

but does not include any activity included in any other relevant activity except holding business.

What does Shipping Business mean?

Shipping business means any of the following activities involving the operation of a ship anywhere in the world other than solely within British Virgin Islands waters (as defined in section 2(2)(a) of the Merchant Shipping Act, 2001):

- 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.

What does Holding Business mean?

Holding business means the business of being a legal entity that only holds equity participations in other entities and only earns dividends and capital gains. If a legal entity holds any assets other than equity participations, e.g. an interest-bearing bond, then it will not be carrying on holding business as defined in the Act.

What does Intellectual Property Business mean?

Intellectual property business means the business of holding intellectual property assets and intellectual property asset means 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).

Income in respect of an intellectual property asset includes:

- a) royalties;
- b) capital gains and other income from the sale of an intellectual property asset;
- c) income from a franchise agreement; and
- d) income from licensing the intangible asset.

The relevant activity consists merely of holding an intellectual property asset from which identifiable income accrues (if no identifiable income accrues there is no intellectual property asset at all). The definition does not therefore apply to a business which owns intellectual property merely as an adjunct to its business. Most businesses will own some form of intellectual property - trademark protection, copyright in their advertising material, technical know-how relating to their processes, but this property, like premises or plant and machinery, does not earn specific amounts of revenue - it simply contributes to (or protects) the general profitability of the business.

How does a Legal Entity comply with the Economic Substance Requirements under the Act?

The spectrum of economic substance requirements applicable to a legal entity depends on the type of relevant business the legal entity is conducting.

The requirements for legal entities conducting holding business are less onerous than for other relevant activities. A holding company will need to comply with existing statutory obligations and to have adequate employees and premises for holding equitable interests and where it manages those equitable interests it will need to have

adequate employees and premises for carrying out that management. For a legal entity carrying on a passive holding business only, the substance requirements will be lighter than for a legal entity that actively manages its equity participations. It is anticipated that a legal entity conducting passive holding business will most likely meet the substance requirement by having a BVI registered agent and registered office.

Legal entities carrying on relevant activities other than holding business must manage and direct the relevant activity and conduct core income-generating activity in the BVI. They must also have an adequate level of employees and expenditure in the BVI and appropriate office space for the core income generating activity in the BVI. Outsourcing is permitted in certain circumstances.

Entities carrying on intellectual property business will be subject to more onerous requirements than entities carrying on other relevant activities.

How does a Legal Entity comply with the Reporting Requirements under the Act?

In order to allow the ITA to monitor compliance with the Act, all BVI companies and limited partnerships with legal personality have to make a report under the Act on their compliance with the Act during the previous reporting period. This report is required regardless of whether or not a relevant activity pursuant to the Act was conducted. Importantly, the ITA have made it clear that random spot checks will be conducted in order to supervise and assure compliance with the Act.

For entities not conducting a relevant activity during a financial reporting period, a short confirmation of this fact will most likely be sufficient. Entities conducting relevant activities (and which (i) do not claim to be tax resident outside the BVI or (ii) tax resident in a non-cooperative jurisdiction) will need to disclose the following information:

- a) the total turnover generated by the relevant activity;
- b) the total amount of expenditure incurred on the relevant activity;
- c) the amount of expenditure incurred on the relevant activity within the BVI;
- d) the total number of employees engaged in the relevant activity;
- e) the number of employees engaged in the relevant activity within the BVI;
- f) the address of any premises within the BVI which is used in connection with the relevant activity and the address of each such premise; and
- g) the names of the persons responsible for the direction and management of the relevant activity, together with the relationship to the company and whether they are resident in the BVI.

For entities carrying on intellectual property business additional requirements apply. For entities carrying on holding business, only paragraphs d), e) and f) apply.

The reporting will be done via the already existing Beneficial Ownership Secure Search System (BOSS). The BOSS system was introduced to hold information on beneficial ownership of BVI entities.

What is the Timeline?

Compliance with economic substance requirements pursuant to the Act is generally assessed over a period of one year.

For legal entities formed in 2019 or later the reporting period started or will start on the day of formation and will end one year after its formation.

For legal entities formed before 1 January 2019 the first reporting period started on 30 June 2020 and will end 29 June 2020.

Compliance reports must be submitted within six months after the end of each reporting period. This means that for entities formed before 2019 compliance reports will need to be submitted no later than by 30 December 2020. Entities formed in 2019 or later will have to submit first reports no later than 18 months after the date of formation, i.e. first deadlines will be end of June 2020.

Importantly, non-compliance may lead to substantial penalties, imprisonment and/or strike off.

How can Hatstone help you?

All BVI entities will have to properly assess their business activities in light of the Act and report their findings. Hatstone is ready to assist you.

A number of entities will need to consider immediate modifications to their operational business model. We have bespoke solutions which we are happy to discuss with you.

If you have any questions, please contact us.

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