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Isle of Man tax alert
Draft legislation on company economic substance published

On 8 November 2018, the Isle of Man (IOM) government published draft legislation (**The Income Tax (Substance Requirements) Order 2018**) that would introduce increased substance requirements on certain IOM resident companies.

Two other documents have been published to facilitate interpretation of the draft regulations: a "**key aspects document**" issued jointly by the governments of Guernsey, the Isle of Man and Jersey, and a **flow chart**. More comprehensive guidance notes also will be issued in due course.

The legislation, which will be submitted for consideration at the December sitting of Tynwald, will apply with effect from 1 January 2019 and will impact IOM resident companies with accounting periods commencing on or after 1 January 2019 that undertake "relevant activities" (see below).

The draft legislation has been designed to meet the high-level commitment made by the IOM government in November 2017 to address the EU Code of Conduct Group's (COCG) concerns that some companies that are IOM tax resident do not have sufficient substance to access the Isle of Man's corporate tax regime.

The Crown Dependencies of Guernsey, Jersey and the Isle of Man have been working together to develop proposals that aim to meet the commitment. Guernsey released **draft regulations** on 8 November 2018 and Jersey released **draft legislation** on 23 October 2018 that would introduce increased substance requirements on certain Guernsey and Jersey resident companies, respectively (see the **Guernsey tax alert** dated 13 November 2018

and the **Jersey tax alert** dated 25 October 2018 on the draft legislation).

The legislation is broadly in line with expectations. We have summarized below some of the key points relating to:

- The scope of the economic substance tests and their application to companies undertaking relevant activities (the "in-scope" companies);
- The requirements imposed on in-scope companies to demonstrate that they are directed and managed in the IOM, have IOM core income generating activities (CIGA), and meet the necessary "adequate" tests; and
- Next steps in terms of ensuring compliance with the economic substance tests for impacted companies and administrative matters, including potential sanctions and penalties.

Relevant activities

The draft legislation confirms that the nine relevant sectors are:

1) Banking;
2) Financing and leasing;
3) Intellectual property holding;
4) Fund management;
5) Shipping;
6) Headquarter activities;
7) Insurance;
8) Pure equity holding company activities; and
9) Distribution and service center business.

A certain amount of detail is provided in the definition of each category of relevant activity. The definition of a holding company confirms that "*a pure equity holding company is a company which as its primary function acquires and holds shares or an equitable interest in other companies, performs no commercial activity and which:*

- *holds the majority of the voting rights in another;*
- *is a member of another company and has the right to appoint or remove a majority of the board of directors of that other company; or*
- *is a member of another company and controls alone, under an agreement with other members, a majority of the voting rights in that other company."*

The definition of "finance and leasing business" states that this involves "… p*roviding a credit facility of any kind for consideration*." Accordingly, credit facilities that are not provided for consideration (such as interest-free loans) may in and of themselves not be expected to give rise to a relevant activity.

Substance requirements

If the draft legislation is enacted, companies that carry out relevant activities will be required to demonstrate that they:

- Are directed and managed in the IOM;
- Carry on CIGA in the IOM; and
- Have adequate staff, expenditure and physical premises in the IOM proportionate to the level of the relevant activity carried on in the IOM.

The draft legislation provides for specific substance requirements for pure equity holding companies, in recognition that these will likely be less than for the other categories. A pure equity holding company would have to comply with all applicable company law requirements and ensure that it has an adequate level of persons and presence in the IOM for holding and managing its investments.

This definition differs from the draft legislation in Jersey, which does not prescribe specific reduced requirements for holding companies, although it is not unreasonable to conclude that what may be considered to be sufficient in terms of both a company's direction and management, and adequacy of its staff, expenditure and physical assets is likely to be different for an entity that only holds equity investments compared to an entity that carries out one of the other relevant activities.

Outsourcing

The draft legislation makes it clear that outsourcing CIGA to another IOM entity should be sufficient to allow a company to meet the substance requirements, provided the company outsourcing the work is able to demonstrate adequate supervision of the outsourced activity.

There is no specific prohibition on outsourcing certain activities to non-IOM entities, as long as the core income-generating activities are carried out in the IOM. Parts of the key aspects document provide further guidance on this point.

Penalties and sanctions for noncompliance

The draft legislation provides further detail on the penalties that would be applied for failure to comply with the economic substance measures.

For the first year of noncompliance, the financial penalty would be up to a maximum of GBP 10,000 (GBP 50,000 for high risk IP companies). For subsequent years of noncompliance after an initial penalty notice has been issued, sanctions could include a financial penalty of up to a maximum of GBP 100,000 and the ability for the Assessor of Income Tax to serve notice on the Registrar that could result in the company being struck from the IOM Companies Register.

Spontaneous exchanges of information would take place for each year of noncompliance with the competent authorities of the EU member state where the immediate parent company, ultimate parent company and/or beneficial owner is resident.

In addition to the above, the legislation provides for financial penalties of up to GBP 5,000 for instances where a person fails to deliver information as requested, and/or provides inaccurate information.

As expected, the draft legislation confirms that where a company meets the definition of a "high risk IP company," the economic substance tests would be presumed not to be met, unless sufficient information is provided to satisfy the Assessor that the tests are met. Even in such cases, spontaneous overseas exchange of information in relation to the high risk IP company would apply.

Next steps

Potentially affected companies should address the application of the regulations and, where appropriate, plan and take any necessary steps from both a practical and a procedural perspective to ensure compliance with the regulations when they enter into effect on 1 January 2019 (or as soon as is feasible thereafter.)

Companies/groups should consider the following actions:

- Classifying their structures on a company-by-company basis to flag companies that undertake a relevant activity and, therefore, fall within the scope of the new requirements;
- Considering current and future compliance for entities that undertake relevant activities with respect to:
  - The "directed and managed" requirements;
  - The adequate staff, expenditure and physical assets tests; and
  - Demonstrating the existence of IOM CIGA;
- Considering the means by which compliance with the economic substance tests will be documented and evidenced;
- Reviewing outsourcing arrangements to ensure that these do not contravene the economic substance tests, in particular, the requirement to evidence CIGA carried on within the IOM; and
- Considering the increased tax return disclosure requirements arising from the regulations that are likely to be effective as from the 2019 year of assessment, for which the tax return would need to be filed by 1 January 2021.

Contacts

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