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New economic substance rules introduced by “tax havens” brought into force from 1 January 2019

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Introduction

In December 2017, the European Union ("EU") Code of Conduct Group assessed the tax policies of jurisdictions with no or only nominal tax ("NOONs") against the criterion of 'economic substance'. The criterion stated that a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction. A list of 'non-cooperative jurisdictions for tax purposes' was published, under which a number of NOONs were grey-listed (i.e. they had committed to meet this criterion within a year, in order to avoid being blacklisted).

In November 2018, the Organization for Economic Cooperation and Development (''OECD'') announced a new global standard on Base Erosion and Profit Shifting ("BEPS") Action 5 for inclusive framework jurisdictions to prevent business activities from being relocated to NOONs to avoid the substantial activities requirement that applies to preferential regimes for geographically mobile income.

In response to the above, and to circumvent reputational concerns, governments of the following NOONs enacted legislation introducing enhanced economic substance requirements for tax purposes, bringing the rules into force as from **1 January 2019**[1]:

- Bermuda
- British Virgin Islands (BVI)
- Cayman Islands
- Isle of Man
- Jersey
- Guernsey
- Mauritius
- Bahamas
- Seychelles

Overview of the new economic substance rules

The economic substance rules introduced by the abovementioned countries are broadly similar, as they are based on the guidance and requirements issued by the EU as well as by the OECD. Essentially, the legislations impose the following three requirements on a resident entity[2] that undertakes relevant activity[3] to demonstrate economic substance (the exact rules may vary depending on the respective jurisdiction):

1. **The 'Directed and Managed' Test:** The entity will need to be directed and managed in the jurisdiction with regards to the relevant activity (e.g. having board meetings with an adequate frequency, quorum of directors physically present at such meetings, the directors having the necessary knowledge and expertise to discharge their duties as directors, meeting minutes kept in the jurisdiction, etc.).

2. **The 'Core Income Generating Activities' ("CIGA") Test:** The entity will need to demonstrate that the relevant CIGAs have been undertaken in the jurisdiction, having regard to the level of relevant income derived from the relevant activity. The CIGAs could be outsourced to a corporate service provider in the jurisdiction, subject to oversight by the entity (e.g. monitor and control). In

[1] In some jurisdictions, the rules are applicable on accounting periods commencing on or after 1 January 2019 (e.g. Jersey and Cayman Islands).
[2] See next section.
[3] The local legislation of the respective jurisdictions specify the relevant sectors and/or relevant activities that are within the remit of the new economic substance rules. In most instances, these include banking, insurance, shipping, fund management, financing and leasing, headquarters, holding companies, intangible property, and distribution and service centres.

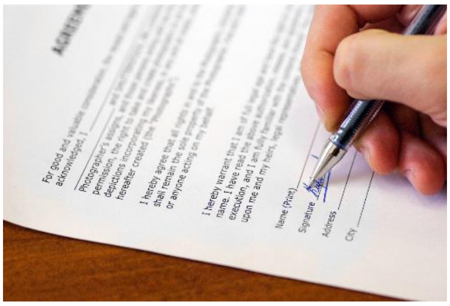
such cases, the relevant resources of the service providers will be taken into account when determining whether the CIGA test is satisfied. In practice, however, it is unlikely that corporate service providers would be comfortable assuming key CIGA functions due to liability concerns (see below).

The CIGAs vary depending on the relevant activity in question. Below we have set out examples of CIGAs for a few relevant activities (as per guidance from the BEPS Action 5 report):

Relevant activity	Examples of CIGAs
Headquarter business	Taking relevant management decisions; incurring expenses on behalf of group entities; coordinating group activities.
Distribution and service centres	Transporting and storing goods; managing stock and taking orders; providing consulting/administrative services.
Financing and leasing	Agreeing funding terms; setting terms and duration of any financing; monitoring and revising any agreements; managing risks.
Holding companies	Complying with applicable corporate law filing requirements; having people and premises to hold and manage equity participations.
Intangible property (IP)	R&D activities

3. **The ‘Adequate’ Test:** The entity will need to have an adequate number of qualified employees in the jurisdiction, incur adequate expenditure in the jurisdiction proportionate to the level of activity and have adequate physical presence in the jurisdiction (e.g. office space, facilities, etc.). The Adequate Test is not designed to be prescriptive, and what is deemed to be adequate will be dependent on the particular facts and circumstances of the entity and the relevant activity in question. Further guidance may be issued in due course as to the interpretation of “adequate” in the context of the economic substance requirements.

Application of the new economic substance rules



In general, the economic substance requirements apply to all legal entities that are resident for tax purposes according to the laws of the respective jurisdiction, unless they are tax resident elsewhere. For example:

- In **Jersey**, an entity that is established in Jersey is considered to be tax resident in Jersey, unless its business is centrally managed and controlled outside Jersey in a country or territory where the highest rate at which any company may be charged to tax on any part of its income is **10% or higher,** and the company is resident for tax purposes in that country or territory.
- **Cayman Islands** defines a resident entity as an entity incorporated in Cayman Islands, unless its business is centrally managed and controlled in a jurisdiction outside the Islands, and the entity is tax resident outside the Islands. A foreign entity incorporated outside the Islands could also be a Cayman Islands tax resident, if it is centrally managed and controlled in the Islands, unless it is tax resident outside the Islands.

In light of the above, an entity undertaking relevant activities would be subject to the economic substance requirements, unless it can demonstrate that it is tax resident outside of the respective jurisdiction (e.g. by obtaining a tax residence certificate).

Considering that companies in NOONs are typically not tax resident in another country (e.g. we note that it may practically be impossible for a non-UAE incorporated company to obtain a UAE tax residency certificate), we would expect a large number of NOON incorporated entities likely to be caught by the above substance requirements.

Penalties and sanctions for non-compliance

If the competent tax authorities of the respective jurisdictions determine that the economic substance tests described above have not been met for a financial period, financial penalties could arise. For example:

- **Jersey** provides for a penalty of up to £10,000 for the first year of non-compliance. Subsequent instances of non-compliance may attract a penalty of up to £100,000.
- In the **BVI**, a fine of up to USD 20,000 may apply for the first year of non-compliance, increasing to USD 200,000 in case of consecutive non-compliance.

In addition to these financial penalties, the competent tax authorities may also have the power to recommend that persistently non-compliant companies should be struck-off the respective jurisdiction’s companies register.

Key takeaways for MENA based multinationals

MENA based multinationals operating in or through the abovementioned NOONs are encouraged to review their corporate structures to ascertain whether their activities fall within the remit of the new economic substance rules, and then consider the impact that these may have on their operations.

To the extent that the new rules are applicable, entities should consider, if not already done so, what steps and measures should be taken to increase the level of substance to ensure compliance with the local requirements. Alternatively, possible restructuring options may be considered, e.g. liquidation, restructuring, re-domiciliation into another jurisdiction, etc.

Outlook for the UAE

The UAE is part of the EU’s grey list, after being removed from the blacklist, following its commitments made to remedy EU concerns and to implement BEPS related measures. The UAE is also a member of the inclusive framework on BEPS, which means that it has committed to implementing the minimum standards. What changes the UAE would bring in its domestic legislation to comply with the EU’s criterion of economic substance as well as the new global standard on BEPS Action 5 is yet to be seen. However, the introduction of similar rules is likely given the commitments made, and to remove some of the pressure stemming from the international tax arena.

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