

BVI economic substance requirements

The British Virgin Islands (**BVI**) International Tax Authority (**ITA**) rules and explanatory notes on economic substance (the **Rules**) were published on 9 October 2019. Joshua Mangeot, Senior Associate at Harneys, summarises what BVI companies and limited partnerships should be doing now in view of the BVI economic substance requirements and the key deadlines involved.

The BVI Economic Substance (Companies and Limited Partnerships) Act 2018 (the **Act**) came into force on 1 January. The Act addressed concerns expressed by the EU's Business Taxation Code of Conduct Group and the OECD's Forum on Harmful Tax Practices (**FHTP**) regarding economic substance.

Similar legislation was enacted by other leading international financial centres, including the Bahamas, Bermuda, the Cayman Islands, Jersey, Guernsey and the Isle of Man. Economic substance is a new feature of the "offshore" market of which readers should be aware. In practice, some clients may not be familiar with the new laws, which is largely due to the very short implementation timetable imposed by the EU.

Despite that timetable, the BVI's implementation of the new requirements has been successful. In July 2019, the FHTP confirmed that the BVI's domestic laws (together with those of ten other jurisdictions, including the Cayman Islands) reflect the FHTP's expected standard and are "not harmful."

Who is affected?

The Act potentially applies to any **legal entity**, which includes all BVI companies, as well as limited partnerships formed with legal personality and any foreign company or limited partnership with legal personality registered in the BVI.

Most BVI vehicles are of course incorporated as companies.

What should I be doing now?

Directors and operators of BVI companies (and their advisors) and other corporate service providers (**CSPs**) should note the following:

- The first compliance period has started for all BVI legal entities.

The first "financial periods" during which compliance must be demonstrated have commenced for all affected BVI companies and other legal entities.

New entities incorporated in 2019 were immediately subject to the Act. For "grandfathered" entities existing prior to 1 January 2019, the first financial period commenced by 30 June 2019 at the latest.

- BVI entities are required by law to classify their activities.

From 1 October 2019, ongoing legal obligations for BVI legal entities (and therefore, in the case of companies, their directors) were introduced via amendments to the BVI's Beneficial Ownership (Secure Search System) Act 2017 (the **BOSS Act**). Broadly, these include an obligation to identify whether the entity carries on any "relevant activities" under the Act.

The ITA has stated publicly that it expects that the basis of this classification should be formalised in sufficient detail to assist it in determining compliance. As part of its investigation and enforcement powers, the ITA will generally expect BVI registered agents (**RAs**) to have the relevant details and documentation on file. For example, this may take the form of detailed board resolutions or minutes and/or formal written advice (although clients may prefer to avoid disclosing the latter to avoid waiving any legal advice privilege).

- Only some BVI entities require economic substance.

Many entities will not be subject to economic substance requirements – either because they qualify

as “non-resident” due to their foreign tax status or because they do not carry on any relevant activity.

In the case of entirely passive “pure equity holding entities” without any employees or premises apart from their BVI RA and registered office in the BVI, these should generally be compliant already under reduced requirements applicable to them under the Act.

However, entities carrying on any other relevant activity will need to ensure that they have considered and understood their new obligations, as reorganisational changes may be required. We expect BVI entities and their professional directors or CSPs may wish to obtain formal BVI legal advice (if they have not done so already), given the complexity of the new law and the fact that the first compliance financial periods have already commenced.

- The Rules have been published.

Further guidance on the Act and the new reporting requirements under the BOSS Act appears in the ITA’s Rules. These were published by the BVI ITA as a draft code on 23 April 2019 and finalised as Rules on 9 October 2019 to reflect comments from the EU and industry.

The Rules include rules with statutory effect and non-binding explanatory notes on the ITA’s approach as the competent authority under the new regime.

- The main reporting deadlines are in 2020.

Reporting will be conducted on a backward-looking basis to demonstrate how the relevant entity has complied during the financial period commencing in 2019. Although the main reporting deadlines fall due within six months of the end of the financial period (so in 2020), all BVI companies and other legal entities should therefore ensure that they have classified their status under the Act. The main exception is that beneficial ownership reporting obligations will now apply to previously “exempt persons” under the BOSS Act, if they carry on any relevant activity.

“Nil returns” will be required for entities which do not carry on any relevant activity – that is, they will still need to make a filing via the RA to confirm this.

What are the relevant activities?

The Act requires any legal entity which carries on any relevant activity during any financial period to comply with the “economic substance requirements” in relation to each such activity.

- legal entities (other than pure equity holding entities) whose only sources of income from relevant activities

Compliance with the Act is measured over financial periods (generally of 12 months each). The Act and Part 10 of the Rules permit entities to shorten one of their periods – for example, so that their financial period under the Act matches their existing financial year for tax or accounting purposes.

The nine relevant activities are defined in the Act and are:

- holding business, as a pure equity holding entity;
- finance and leasing business;
- shipping business;
- headquarters business;
- distribution and service centre business;
- banking business;
- insurance business;
- fund management business; and
- intellectual property (*IP*) business.

Important guidance on these definitions is set out in Part 5 of the Rules. There is no express carve-out for investment funds but we understand that the ITA generally expects that regulated funds will not be carrying on a relevant activity. Operating as a fund vehicle is distinct from fund management business, which is one of the three relevant activities which are already regulated and require a license in the BVI (the others being banking and insurance business).

The EU is expected to provide further technical guidance regarding funds and collective investment vehicles generally later in 2019.

What is a “non-resident” entity?

An entity which qualifies as non-resident (for tax purposes) during a financial period will not be required to demonstrate economic substance. However, it will need to make a claim to that effect and be able to evidence such status.

This is discussed in detail at Part 4 (*Tax residence outside the BVI*) of the Rules. In particular, it should be noted that the usual concept of “residence” is greatly expanded under the Rules and includes:

- “transparent entities”, in respect of which the entire profits or gains are treated under foreign law as attributable to and taxable on some or all of the participators or partners in the relevant entity (and tax residence must therefore be demonstrated by reference to each such participator or partner); and

are subject to tax in a jurisdiction outside the BVI (which will be regarded as resident in that other jurisdiction).

However, an entity regarded as resident in a jurisdiction outside the BVI that appears on Annex I to the EU “blacklist” of non-cooperative jurisdictions for tax purposes cannot claim non-resident status.¹ The blacklist is updated by the EU periodically, so any changes should be monitored where an entity is non-resident.

What are the economic substance requirements?

There is a simplified requirement for any pure equity holding entity that only conducts holding business. If the entity holds the relevant equity participations passively and does not have any employees or premises outside the BVI, it should be treated as compliant provided it complies with its statutory obligations under BVI company or limited partnership laws (as applicable) and has an RA and registered office in the BVI.

If an entity carries on any of the other relevant activities, it must direct and manage the relevant activity, and conduct core income-generating activity (**CIGA**), in the BVI. Considering the nature and scale of the relevant activity, it must also have in the BVI an adequate level of suitably-qualified employees and expenditure and appropriate physical premises for its CIGA. Outsourcing of income-generating activities is allowed subject to some anti-avoidance restrictions. If IP business is involved, any special equipment required for the business must also be located in the BVI.

The Rules state that what is commercially “adequate” or “suitable” varies and is therefore largely a factual question depending on the specific entity and business involved.

IP businesses should ensure they have taken appropriate advice as the fines and penalties for non-compliance are potentially significant in the case of a “high risk IP legal entity” and the analysis can be quite complex.

What are the reporting requirements?

The new reporting requirements will depend on the entity and its classification under the Act and are too complex to set out here. Detailed guidance on these is set out in Part 12 of the Rules and further amendments to the BOSS Act

are expected, as the system will be updated to permit reporting via the database maintained by each RA.

The first step is therefore to classify your entity (if you have not already done so) and the compliance and reporting obligations then all flow from that classification.

Harneys has developed an online classification solution that provides a cost effective way for BVI companies and limited partnerships with legal personality to demonstrate formally that they have considered their position under the Act. For more information, visit [economicsubstance.vg](https://www.harneys.com/economicsubstance.vg).

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¹ <https://www.consilium.europa.eu/en/policies/eu-list-of-non-cooperative-jurisdictions/>