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Hong Kong issuers economic substance guide

This update is for listed groups and their advisors considering the British Virgin Islands' and Cayman Islands' economic substance (***ES***) regimes. It is aimed primarily at issuers listed in Hong Kong but many of the points raised are of more general application.

This update is framed in broad terms. We have published specific guides for directors and operators of BVI and Cayman Islands companies as there are differences between the domestic legislation. Our BVI guide is available here and our Cayman Islands guide is available via here. For our BVI reporting guide, please click here.

Summary of key points

- Every BVI company (***BVICo***) and Cayman Islands company (***CayCo***) must continue to monitor its individual status under the ES legislation as it will be required to report on this periodically. Every CayCo must file an ES notification annually with its annual return by 31 March each year and, if it carries on any "relevant activity", submit a substantive ES return within 12 months of the end of its financial year. Every BVICo must submit an ES report via its BVI registered agent within six months of the end of its "financial period" for the purposes of the BVI ES legislation. The BVI reporting portal is now live and the format for reporting has been published.

- The majority of BVICos were incorporated before 2019 and have a default "financial period" of 30 June 2019 to 29 June 2020 under the legislation, so their first reports demonstrating compliance or non-compliance must be submitted in Q3 or Q4 2020 and before 30 December 2020 at the latest. Under the Cayman Islands regime there is no default for a financial period or financial year end, so we recommend that unless CayCos have formally done so, they adopt a financial year end (this can be achieved by way of simple board resolution).

- Many BVICos and CayCos in listed structures may qualify for a reduced ES requirement as "pure equity holding" companies or may not be carrying on any relevant activity, but determining this will require careful consideration with BVI or Cayman Islands counsel. In particular, certain types of intragroup debt financing, corporate governance services or other service arrangements may trigger ES requirements and are easily overlooked in practice. Equally, merely passively holding assets or receiving gross income may be sufficient to trigger ES requirements – so even "dormant" or inactive subsidiaries should be considered.

- For companies that are conducting a relevant activity, the potential exemption for companies to be treated as tax resident outside the BVI or Cayman Islands may be complex to apply in practice in the case of jurisdictions which impose income tax on a basis other than residence (such as Hong Kong) and satisfactory evidence will need to be provided to support a "non-resident" claim – companies hoping to rely on such exemption should consider the requirements carefully with appropriately qualified counsel.

- Many groups with a listed parent prepare consolidated financial statements – however, the ES assessment often requires careful consideration of the individual, non-consolidated position of each BVICo and CayCo in the group, as any intragroup activities capable of generating gross income (as opposed to profit) for the relevant activity of the company may be applicable to the analysis.

- Finally, a listed BVICo or any subsidiary of a listed BVICo which carries on any "relevant activity" should consider its new obligations under the Beneficial Ownership Secure Search System Act 2017 (the ***BOSS Act***) as it will no longer qualify for exemption from the BOSS Act requirements as an "exempt person". This change came into effect from 1 October 2019 but is easily missed, as this is a fairly technical area of law.

What does this update cover?

This update follows the publication of version 3.0 of the Cayman Islands' Tax Information Authority (***TIA***) ES Guidance on 13 July 2020, which replaces version 2.0 of 30 April 2019 and includes important new sector-specific guidance – in particular regarding headquarters business, distribution and service centre business, finance and leasing business and holding company business, which are the four areas on which we most frequently receive queries from public issuers.

The BVI International Tax Authority (***ITA***) guidance remains in version 2 of its ES Rules and explanatory notes on 10 February 2020. The ITA has also published the reporting schema for the BVI "BOSS(ES)" reporting portal, which went live on 12 June 2020.

This guide is aimed at listed groups and does not deal with investment funds (which are broadly exempt) or with companies carrying on "intellectual property business" (which are potentially subject to very burdensome ES requirements). We strongly recommend that any BVICo or CayCo that may be carrying on IP business seeks legal advice.

What is economic substance?

Broadly, a BVICo or CayCo carrying on one or more of nine "relevant activities" must demonstrate adequate economic substance for such activity in the BVI or Cayman Islands (as applicable), unless exempted.

The relevant legislation came into effect from 1 January 2019, following requirements effectively imposed by the European Union and the Organisation for Economic Co-operation and Development on all the UK Crown Dependencies and Overseas Territories and most other major international financial centres with low- or zero-tax regimes. The timetable set by the EU for implementation was extremely short compared with similar international initiatives, with only a seven-month "grandfathering" period permitted for companies registered before 2019.

How does this affect the Hong Kong market?

Of the 2,449 companies listed on the Hong Kong Stock Exchange as at 31 December 2019, 1,397 (or 57%) were BVICos or CayCos. The majority of those are CayCos but it is common to find intermediary BVICo holding companies in listed groups, as BVICos are widespread in Hong Kong and the People's Republic of China.

The ES legislation created new continuing obligations for every BVICo and CayCo – broadly, to determine whether the relevant company is subject to or exempt from ES requirements, to comply with any applicable ES requirements and to report on such compliance or exemption.

Failure to comply or report may result in significant fines and other penalties, including spontaneous information exchange with overseas authorities and, in limited circumstances, striking-off or liquidation. The quantum of such penalties is likely to increase if non-compliance persists over multiple periods or otherwise results from deliberate or egregious failure to comply.

Where do I begin?

The first step is to classify each company's status (and to determine the effect of any proposed changes, if relevant).

Often, where an IPO or a new listing is involved, a new BVICo or CayCo issuer will be incorporated so ES aspects should be considered with BVI or Cayman Islands counsel advising on the deal.

For listed groups, it is the direct activities and non-consolidated assets and sources of gross income (as opposed to profits or net income) during the relevant "financial period" of each individual BVICo and CayCo that must be considered. If the group generally only produces formal consolidated accounts for a financial year, this may require preparation of individual accounts (and, for BVICos, it may be advisable to apply to the ITA to alter the default "financial periods" to match the company's financial year). The passive receipt of gross income from an activity is generally sufficient for the company to be regarded as still carrying on that activity for ES purposes. Equally, a company may still be carrying on a relevant activity but have no gross income from that activity during the relevant period, in which case it is generally expected that it will file a report for that period akin to a "nil return".

Where ES classifications have not already been completed in the case of existing companies, this exercise should be undertaken as soon as possible and Harneys' BVI and Cayman Islands ES specialists will be happy to assist.

For BVICos, Harneys' team of BVI ES specialists have developed an innovative automated online classification solution providing formal legal advice on a reliance basis for a low fixed fee. The solution and further information can be found here.

What will my company need to do?

Everything flows from the initial classification. There may not then be much to do in practice other than report on the position.

However, the ES laws can be fairly complex and it may be appropriate to take legal advice. In some cases, the company may already be compliant or exempt from ES requirements. In others, however, action may be needed to achieve compliance or to qualify for exemption (and, as mentioned, there will be potential fines and penalties to be considered, if there has been a period of non-compliance).

With the exception of "pure equity holding" companies (or ***PEHCs***, which qualify for a reduced ES requirement) and companies which qualify for exemption from ES requirements due to their foreign tax status (if any), if a company carries on "relevant activity" it will be subject to the general ES requirements.

Fortunately, many BVICos and CayCos issuers we encounter in practice either are not carrying on any relevant activity or qualify for a reduced ES requirement as PEHCs.

If the general ES requirements are applicable, compliance can typically be achieved fairly simply but requires careful consideration with BVI or Cayman Islands counsel early in the proposed transaction.

Given the current Covid-19 pandemic and travel restrictions, temporary arrangements may need to be put in place and groups should document any issues or challenges presented by the pandemic as, although the compliance and reporting deadlines have not been permitted to be extended by the EU or OECD, it is to be hoped that the effect of the pandemic will be taken into account where appropriate.

What do issuers need to consider in particular?

Many issuers are incorporated solely to raise debt or equity capital on the relevant market and to hold shares in one or more subsidiaries. Where the issuer finances its subsidiaries by way of equity or capital contributions, such an issuer may well qualify for a reduced ES requirement as a PEHC. However, the PEHC definition is narrow and requires that the company only holds equity participations in other entities and only earns dividends and capital gains. Holding debt or other assets other than equity participations may take the issuer outside this narrow category.

The Cayman Islands v.3.0 Guidance states that the activities of a PEHC may still include ownership of a bank account, governance decisions, entering into contractual arrangements with professional or other service providers and the payment of fees or expenses.

However, if a company undertakes other activities or earns other income that is not part of, or incidental to, its business as a PEHC, it will not be a PEHC but will instead need to meet the higher substance requirements, if applicable, for any relevant activity it carries on.

For example, an issuer should consider whether it carries on any headquarters (***HQ***) or distribution and service centre (D&SC) business. In relation to HQ business, provided that corporate governance "best practice" is followed and strategic and managerial decisions are taken by each subsidiary's board of directors in respect of its own business strategy and risks (and no intragroup service contracts or arrangements are in place), it is unlikely that the definition will be met. Similarly, where intragroup service arrangements may be involved, the services limb of the D&SC business test should be considered, although the Cayman Islands v.3.0 Guidance makes clear that intragroup activities which are "incidental" (meaning occasional, minor activity with no profit-making purpose) to some other business should not trigger ES requirements, unless that other business is a relevant activity.

However, if senior management are employed by the issuer (which is sometimes the case) and they regularly spend time with group subsidiaries advising on their strategy and risk, the Cayman Islands v.3.0 Guidance indicates that the TIA may regard this as HQ business even if the benefit to the issuer is indirect (that is, through interest, dividends and capital gains from its debt and equity investments) rather than a service fee. If the company carries on certain other relevant activities (for example, finance and leasing (***F&L***) business) which are carved out of the HQ and D&SC business definitions, then that will not be regarded as HQ or D&SC business (as applicable) unless the HQ- or D&SC-related activities form a distinct business line in their own right.

F&L business may be relevant if the issuer on-lends the proceeds of the capital raise or otherwise provides credit to any person. There is no exception for intragroup debt and care should be taken that intragroup debt receivables are not overlooked, where the group produces consolidated accounts. However, the loans or other credit facilities must be provided for consideration (such as interest or a lending fee) in order to fall within the definition, meaning that most customary intra-group loans provided on a non-interest bearing basis should not fall foul of the ES regime. Again, the "incidental" provision of credit should not be caught. Holding debt instruments or securities for investment purposes (such as gilts, quoted bonds or similar securities) also falls outside the scope of F&L business. Equally, the mere provision of security by an issuer in favour of a party lending funds to a subsidiary should not be regarded as F&LB business.

However, if one of the main functions of the issuer is regularly to raise capital and on-lend the proceeds for interest or other consideration, for example, this is more likely to be regarded as F&L business.

If the commercial structure really requires that a BVICo or CayCo undertakes HQ, D&SC or F&L business, it may be more efficient to incorporate a separate vehicle to undertake the relevant activities (as opposed to the listed issuer).

As regards the BVI, since 1 October 2019, "exempt persons" which were previously exempt from beneficial ownership reporting obligations under the BOSS Act are no longer exempt if they carry on any relevant activity. The "exempt person" definition includes entities whose securities are listed on recognised stock exchange and their subsidiaries, so this is highly relevant to listed groups. Entities affected by this change should contact Harneys to understand the new BOSS Act reporting obligations which are applicable to them as the fines and penalties for non-compliance can be significant.

Is my company exempt due to its tax status?

The official BVI Rules and Cayman Islands' Guidance expand the traditional concept of tax "residence" to treat as tax resident outside the BVI or Cayman Islands (or ***Non-Resident***) certain other entities – very broadly, "transparent" or "disregarded entities" or entities which are subject to tax on all of their income from relevant activities. Applying the relevant tests in practice may well require appropriate tax advice to be sought in the relevant jurisdiction(s) where the liability to tax arises.

A company only needs to claim exemption as Non-Resident if it carries on relevant activity during the relevant "financial period". For a company that is not carrying on relevant activity, there is no need to consider or report on the tax status of the company for ES purposes.

The TIA v.3.0 Guidance confirms that the TIA will regard a company as Non-Resident as regards the relevant activity in question if it is "subject to income tax on all of its income from a relevant activity by virtue of its tax residence, domicile or any other criteria of a similar nature" in another jurisdiction. A similar test applies under the BVI ES Rules.

The application of this test for jurisdictions which impose income tax on a basis other than residence (such as Hong Kong) is potentially complex. A Non-Resident claim requires that satisfactory evidence be provided to the TIA or ITA (as applicable) and will trigger the spontaneous exchange of information with other competent authorities to verify the validity of the claim as required by the EU and OECD. This includes not only the competent authority of the relevant jurisdiction(s) in which the company claims Non-Resident tax status but also those of the jurisdiction(s) in which any immediate parent, ultimate parent and ultimate beneficial owner of the company resides.

We therefore recommend that issuers considering claiming Non-Resident status seek appropriate legal and tax advice.

What are the reporting deadlines?

A CayCo must file an economic substance notification annually with the Registrar of Companies in accompaniment of its normal annual return and the deadline for this is 31 March. For a CayCo which is conducting a relevant activity, it must submit an ES report within 12 months of the end of its financial year for the Cayman Islands (via the TIA's DITC portal, which is expected to be available in Q4 2020).

A BVICo must submit an ES report via its BVI registered agent (***RA***), to be uploaded to the ITA's BOSS(ES) portal within six months of the end of its "financial period". For BVICos incorporated prior to 2019 which have not altered their default "financial period" (of 30 June 2019 to 29 June 2020), this means that the first ES reports are due by the end of 2020. BVI RAs should already be contacting their clients to take reasonable steps to collect the prescribed ES information.

If you have any queries or concerns regarding the Cayman Islands or BVI ES requirements, please let your usual Harneys contact or one of our team of ES specialists know.

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