



China Tax Alert

Issue 6, February 2019

New Economic Substance Requirements for key offshore centres

Regulations discussed in this issue:

- Council Conclusions on the criteria for and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes, published by Council of the European Union in Official Journal of the European Union (2016/C 461/02) on 10 December 2016
- Council Conclusions on the EU list of non-cooperative jurisdictions for tax purposes, published by Council of the European Union in Official Journal of the European Union (2017/C 438/04) on 19 December 2017
- Harmful Tax Practices - 2018 Progress Report of Preferential Regimes: Inclusive Framework on BEPS: Action 5, released on the OECD website on 29 January 2019

Background

Last month a number of offshore jurisdictions, including the British Virgin Islands, Cayman Islands, Bermuda, Guernsey, Jersey and Isle of Man, enacted legislation requiring local entities carrying on specified activities in these countries to have adequate economic substance.

These changes are a response to recently established European Union (EU) economic substance requirements, and a parallel new global OECD standard on substantial activities requirements for no or only nominal tax jurisdictions. Reviewing this new global standard will be a key part of the OECD's Forum on Harmful Tax Practices ("FHTP") work plan for 2019. Chinese enterprises and individuals investing overseas, as well as foreign businesses with operations in China, should assess, on an ongoing basis, the use of such jurisdictions in their structures and any possible need for adaptation.

Overview of new economic substance requirements

In recent years the EU has taken action, through its Code of Conduct Group to identify non-cooperative jurisdictions based upon a criteria of tax transparency, fair taxation and compliance with the OECD's Base Erosion and Profits Shifting (BEPS) requirements. A number of offshore jurisdictions made commitments to reform their economic substance requirements by the end of 2018 to bring them into line with EU's 'fair taxation' principle that "a jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction", and avoid their inclusion in the EU's list of non-cooperative jurisdictions ("EU Blacklist").

While each jurisdiction has independently drafted and enacted their own economic substance legislation, the requirements are broadly equivalent across each of the offshore jurisdictions. The substance requirements took effect from 1 January 2019, with a six-month grace period given to existing entities to meet the requirements.

The rules require both local and foreign registered companies and limited partnerships which carry on 'relevant activities' in an offshore jurisdiction and are not tax resident in another jurisdiction, to comply with the economic substance requirements for such activity in the offshore jurisdiction.

Relevant activities for the purposes of this legislation covers the following nine businesses:

- banking business
- Distribution and service centre business
- Finance and leasing business
- Fund management business
- Headquarters business
- Holding company business
- Insurance business
- Intellectual property holding business
- Shipping business

The economic substance that needs to be established and maintained in respect of the relevant activity are:

- The entity be managed and directed in the offshore jurisdiction;
- Core income generating activities are undertaken in the offshore jurisdiction with respect to the relevant activity;
- The entity maintains adequate physical presence in the offshore jurisdiction;
- There are adequate full time employees in the offshore jurisdiction with suitable qualifications; and
- There is adequate operating expenditure incurred in the offshore jurisdiction in relation to the relevant activity.

There are certain exceptions to these general economic substance requirements for holding companies (which will only be required to meet a reduced test for economic substance) and intellectual property companies (which will face more onerous requirements).

Entities will have reporting obligations in relation to their compliance with economic substance requirements to local tax authorities. Penalties can be imposed both for a failure to provide required information and for operating a legal entity in breach of the economic substance requirements, including fines, imprisonment and/or strike-off.

KPMG Observations

Enterprises and individuals that have offshore entities within their existing investment and/or operating structures should take action to understand the substance requirements applicable for the offshore jurisdiction(s) in which they operate, and to determine what steps may need to be taken to comply with these measures. At the same time, more changes may be in the pipeline as some jurisdictions have flagged that additional guidance notices and regulations will be issued in relation to the implementation of these rules.

A key question for companies as they look to implement economic substance in offshore jurisdictions will be extent of local resources deployed in the offshore jurisdiction. While guidance in the area is still developing, it may be that under the FHTP standard there might be more latitude for entities to 'outsource' their substance-related activities to a third party (e.g. corporate secretarial) whereas indications from the EU were that they might take a stricter line, on there being 'dedicated' local personnel to provide company substance. If the tougher approach wins out, this could have significant commercial implications for the use of entities in offshore jurisdictions.

The EU will also be reviewing the legislation enacted by the various offshore jurisdictions to determine whether their new substance measures meet the EU's 'fair taxation' principles. If the EU concludes that the legislation does not meet these principles, offshore jurisdictions risk being included in the EU Blacklist. Given the potential adverse consequences for countries being on such list – including higher withholding taxes, denial of tax deductions, controlled foreign company attribution – amendments to the legislation (and guidance notes) therefore cannot be ruled out in such circumstances.

Enterprises and individuals, in China and elsewhere, should therefore continue to closely monitor developments in this area over the next few months.





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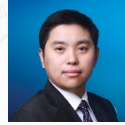
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