BRITISH VIRGIN ISLANDS ECONOMIC SUBSTANCE REQUIREMENTS

Authors
Joshua Mangeot
Kiril Pehlivanov

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INTRODUCTION

Every B.V.I. company and limited partnership has some obligations in respect of the economic substance regime and must take the following steps:

- It must have adequate systems and controls to ensure compliance with this regime.
- During each compliance period, it must determine whether it carries on or receives gross income from any of the nine relevant activities. If so, it must determine whether it qualifies for exemption due to its tax status.
- It must file an economic substance at required intervals, generally on an annual basis, even if the entity is not subject to any economic substance requirements.

This article summarizes the B.V.I. economic substance regime and provides practical guidance for compliance and reporting.

BACKGROUND

The 15-point Base Erosion and Profit Shifting ("B.E.P.S.") Action Plan of 2015 developed by the Organization for Economic Cooperation and Development (the "O.E.C.D.")' marked a watershed moment for international tax advisers.

B.E.P.S. Action 5 requires that no or only nominal tax jurisdictions ("N.T.J.'s")) adopt substantial activities requirements proposed by the O.E.C.D.'s Forum on Harmful Tax Practices ("F.H.T.P."). In addition, the European Union ("E.U.") Code of Conduct Group ("C.O.C.G.") evaluates whether countries require economic substance as a precondition for the allowance of tax advantages linked to certain geographically mobile activities. On June 22, 2018, the C.O.C.G. published a scoping paper identifying nine relevant activities and economic substance criteria, which it expected N.T.J.'s to adopt by 2019. Failure to comply with E.U. requirements carries the threat of being placed on Annex I of the E.U.'s list of noncooperative jurisdictions for tax purposes (the "E.U. Blacklist").

Twelve N.T.J.'s were identified – Anguilla, Bahamas, Bahrain, Barbados, Bermuda, the B.V.I., the Cayman Islands, Guernsey, Isle of Man, Jersey, the Turks and Caicos Islands and the United Arab Emirates.[1]

Joshua Mangeot is a partner in the B.V.I. office of Harneys. His practice covers a broad range of corporate, finance, transactional regulatory, and tax matters. Josh is regarded as a leading specialist on the implementation of the economic substance rules of B.V.I. law.

Kiril Pehlivanov is a member of the investment funds and regulatory team in the B.V.I. Office of Harneys.

[1] The United Arab Emirates has subsequently adopted a corporate income tax system effective from June 1, 2023.

The B.V.I.'s economic substance requirements were implemented via the Economic Substance (Companies and Limited Partnerships) Act 2018 (the "Economic Substance Act"), which came into force on January 1, 2019, with a six-month transitional period for companies and limited partnerships with separate legal personality and that were registered in the B.V.I. before that date. Of such entities, the vast majority were companies incorporated under the B.V.I. Business Companies Act (the "B.C. Act"). As a result, by default, the key commencement date was June 30, 2019, for most B.V.I. companies registered prior to 2019.

In October 2019, the O.E.C.D. released guidance on its framework for the spontaneous exchange of economic substance information by N.T.J.'s. As a result, economic substance reporting requirements were introduced via various amendments to the Beneficial Ownership Secure Search System Act 2017 (the "B.O.S.S. Act") between 2019 and 2021. N.T.J.'s exchange certain information under the O.E.C.D. standard, thereby enabling recipient tax administrations to conduct risk assessments and apply anti-B.E.P.S. provisions under their domestic laws.

Limited partnerships without separate legal personality ("Relevant Partnerships") were added to the regime effective July 1, 2021, with a six-month transitional period for those formed prior to such date.[2]

Owing to the tight timeframes for implementation and the high-level nature of the C.O.C.G.'s scoping paper, many key concepts and requirements are not defined in detail in the Economic Substance Act, itself. The scoping paper uses many defined terms and concepts that are not in common use in the B.V.I. or common law and which are untested before a B.V.I. court. Further guidance appeared in economic substance rules and explanatory notes (the "Economic Substance Rules") published by the B.V.I. International Tax Authority ("I.T.A."), which is the regulator for the regime. The Economic Substance Rules were most recently updated as version 3 on 24 February 2023.[3]

The I.T.A. is now investigating and taking enforcement action where appropriate against certain entities in respect of the first compliance periods that commenced in 2019. The I.T.A. has broad powers under the Economic Substance Act and, in June 2022, its powers were increased via amendments to the International Tax Authority Act (the "I.T.A. Act") and related regulations. Under that Act, all companies and limited partnerships registered in the B.V.I. are required to have adequate systems and controls in place to ensure compliance with the Economic Substance Regime.

As part of their monitoring of compliance and enforcement by the N.T.J.'s, the C.O.C.G. and F.H.T.P. regularly review the I.T.A. and the I.T.A. generally has up to six years from the end of the relevant period to determine noncompliance. Directors or general partners of relevant B.V.I. entities and their advisors should therefore continue to monitor B.V.I. entities to ensure compliance.

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2 As most Entities are companies incorporated under the BC Act, we focus on companies in this article. Limited partnerships should consider the specific guidance in Part 16 of the Rules.

3 At the time of writing, version 3 of the Rules is available here. Subsequent references to a "Rule" or "Explanatory Note" are to the corresponding Rule or Explanatory Note in that version.

HOW IS THIS RELEVANT TO EACH B.V.I. ENTITY?

Whether domestic or foreign, every company and limited partnership registered in the B.V.I. (an "Entity") has some obligations under the regime – even if merely to file nil returns via its registered agent.

Economic Substance Act Requirements

The key obligation under the Economic Substance Act is for an Entity that carries on any relevant activity during any financial period to comply with economic substance requirements in relation to each such activity.

Under Rule 1, an Entity will be deemed to carry on relevant activity during any financial period in which it receives gross income from that activity. Our interpretation of Explanatory Notes 2.2 and 6.4 is that an activity must generate gross income, or be expected to generate gross income at some point to be a relevant activity of the Entity. Subject to Rule 1, the absence of any gross income during any specific financial period generally is not determinative.[4]

Relevant Activities and Investment Funds Exemption

The Economic Substance Act defines nine relevant activities, and detailed guidance on each definition appears in Part 5 of the Rules. The relevant activities are the following:

- Banking business
- Insurance business
- Fund management business
- Finance and leasing business
- Headquarters business
- Distribution and service center business
- Shipping business
- Holding business
- Intellectual property ("I.P.") business

Investment fund business (as defined) is expressly excluded from being a relevant activity.[5] However, as mentioned above, fund management business is included.[6]

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[4] Gross income is defined by Rule 20 and purposively we do not think 'income' has its narrow accounting sense (*i.e.*, it should include capital gains or other gains on sale).

[5] This means the business of operating an investment fund, which means an entity whose principal business is the issuance of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management, or disposal of investments and which includes any entity through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held. It does not include a person licensed under the Banks and Trust Companies Act, 1990 or the Insurance Act, 2008, or a person registered under the Cooperatives Societies Act 1979 or the Friendly Societies Act 1928.

[6] Fund management business is activity requiring a license under category 3 of Schedule 3 of the Securities and Investment Business Act 2010.

In practice, we are finding that persons not familiar with the Economic Substance Regime are most frequently caught out by the breadth of the finance and leasing business definition. There are no carveouts for intragroup debt.

The definitions of (i) the distribution and service center business and (ii) the headquarters business are specifically aimed at intragroup sales of goods and provision of services.

The intellectual property business regime is particularly fearsome so any Entity holding any form of intellectual property rights should ensure it has considered this topic.

The concept of relevant activity is also misleading in that the passive receipt of income may be sufficient to bring an Entity into scope by virtue of Rule 1.

Financial Periods

Compliance with the economic substance and related reporting requirements is assessed for each financial period. A financial period cannot cover more than 12 months.

Part 10 of the Rules prescribes default financial periods determined by the Entity's date of registration in the B.V.I. In broad terms, the default financial periods are as follows:

Registration Date	Start of First Financial Period	End of First Financial Period
Company / limited partnership with separate legal personality registered **before** January 1, 2019	June 30, 2019 by default	June 29, 2020
Company / limited partnership with separate legal personality registered **from** January 1, 2019 onwards	Date of incorporation	12 months from date of incorporation
Relevant Partnership that is registered **before** July 1, 2021	January 1, 2022 by default	December 31, 2022
Relevant Partnership that is registered **on or after** July 1, 2021	Date of formation	12 months **from** date of formation

There are various mechanisms to alter these default financial periods, by filing an election or application with the I.T.A. The financial period need not coincide with the Entity's financial year for accounting or tax purposes. Of crucial importance is the need to refer to individual, non-consolidated company financial statements because intra-group balances can influence the Entity's classification and reporting information.

In many cases, it will be simplest to align the financial period with the Entity's financial year – particularly in view of the new annual return requirement applicable to companies under the B.C. Act from 2024 onwards.

Nonresident Entities for Tax Purposes

Broadly speaking, a legal entity that is nonresident for tax purposes in the B.V.I. is not treated as an Entity. To be considered a nonresident, the entity must be resident for tax purposes in a jurisdiction that is not on the E.U. Blacklist. Part 4 of the Rules expands the traditional concept of residence to include certain transparent Entities and Entities all of whose income from relevant activities is subject to tax, other than withholding tax.

Special provisions dealing with entities claiming residence in another N.T.J. are provided under Rules 5 and 5A.

An Entity must claim nonresident status in its report for the financial period and either (i) provide evidence complying with Rule 3 (or 5A, if applicable) or (ii) submit a provisional nonresidence application under Rules 6-10, and if its application is accepted, provide evidence of residence in a country that is not on the E.U. Blacklist within the timeframe allowed by the I.T.A.

"In practice, the nonresident tests can be complex to apply."

In practice, the nonresident tests can be complex to apply. The determination depends in large part on questions of law in other jurisdictions and whether the other jurisdiction is on the E.U. Blacklist. Entities may need to seek advice from their B.V.I. and tax advisors to help when preparing reports and supporting evidence.

Broadly, a nonresident claim will result in spontaneous exchanges of all information regarding the Entity on the B.O.S.S. registered agent database with the overseas competent authority in each relevant overseas jurisdiction as described in Part 14 of the Rules. If a beneficial owner or legal owner as defined for purposes of the B.O.S.S. Act of the Entity is resident in an E.U. Member State, information will also be exchanged spontaneously with the competent authority in the Member State in which the beneficial owner or legal owner resides.

Reporting Obligations

Broadly, every Entity must identify if it carries on any of nine relevant activities during the financial period, and if so, the specific relevant activities carried on. Unless it is an "exempt person" for the purposes of the B.O.S.S. Act that does not carry on any relevant activity, the Entity must ascertain and report certain prescribed economic substance information to the I.T.A. via its registered agent. The precise information depends on the activities and ownership of the Entity and whether it claims to be nonresident.[7]

The reporting deadline is six months following the end of the relevant financial period. The I.T.A. has the power to impose penalties for late filing.

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[7] From October 1, 2019, exempt persons that were previously exempt from beneficial ownership reporting obligations under the B.O.S.S. Act are no longer exempt if they carry on any relevant activity. Broadly, the exempt person definition includes (i) certain licensees and regulated persons under B.V.I. financial services legislation, (ii) entities whose securities are listed on a recognized exchange, and (iii) subsidiaries of entities within (i) or (ii).

WHAT ARE THE ECONOMIC SUBSTANCE REQUIREMENTS FOR EACH RELEVANT ACTIVITY?

The Pure Equity Holding Entity Definition

Holding business is defined as the business of being a pure equity holding entity (a "P.E.H.E.") that only holds equity participations in other entities and only earns dividends and capital gains. This is a narrowly defined term of art and should not automatically be equated with being a holding company in the commercial sense.

Except as provided below, if an Entity has non-equity assets or sources of gross income other than dividends or gains on equity assets, it will generally not be a P.E.H.E. Consequently, it will need to consider whether it carries on any of the other eight relevant activities.

Viewed purposively, we do not think that having a bank account to receive dividends and pay expenses or physical premises used in the holding business should take an Entity outside the narrow P.E.H.E. definition.

Economic Substance Requirements for a Holding Business

An Entity meets the economic substance requirements for holding business if two conditions are met. First, it must comply with its statutory obligations under the B.C. Act or the Limited Partnership Act, as applicable. Second, it must have adequate employees and premises in the B.V.I. for holding or managing its equity participations. The Economic Substance Rules acknowledge that holding of equity participations may be entirely passive in nature. In reality, no employees or premises may be required during a financial period. In such cases, the industry expectation is that having a B.V.I. registered office may be adequate.

I.P. Business

Broadly, an Entity will be considered to carry on I.P. business if it holds I.P. rights in intangible assets from which identifiable income or gains accrue (that are separately identifiable from any income generated from any tangible asset in which the right subsists).

In addition to the general economic substance requirements outlined below, Entities involved in I.P. businesses are subject to particularly burdensome economic substance requirements as I.P. was identified by the C.O.C.G. and F.H.T.P. as giving rise to increased B.E.P.S. risks. To illustrate, a requirement exists for any specialist equipment used in the I.P. business to be located in the B.V.I.

Certain presumptions of noncompliance with economic substance requirements may also apply as set out in Part 9 of the Rules. In practice, compliance for most I.P. businesses is extremely difficult and any Entity holding I.P. rights should ensure it has considered economic substance requirements carefully.

Other Relevant Activities

Entities carrying on any of the other seven relevant activities comply where all of the following requirements are met:

- The relevant activity is directed and managed in the B.V.I.
- Having regard to the nature and scale of the relevant activity:
    - An adequate number of suitably qualified employees are physically present in the B.V.I., even if employed by another entity.
    - Adequate expenditures for the relevant activity are incurred in the B.V.I.
    - The Entity has physical offices or premises in the B.V.I. as appropriate for its core-income generating activities ("C.I.G.A.").
- The entity conducts C.I.G.A. in the B.V.I.
- In the case of income-generating activity carried out for the Entity by another entity, no C.I.G.A. is carried on outside the B.V.I. and the arrangements comply with certain other anti-avoidance provisions relevant to outsourcing.

The holding business regime is quite straightforward and the most common relevant activity encountered in practice. For Entities carrying on any of the other relevant activities, there is no one-size-fits-all solution. Professional advice is usually required to review the structure carefully and make necessary changes as the potential consequences of non-compliance are significant.

PATH FORWARD

Every Entity is required by law to ensure that it has adequate systems and controls in place to meet its obligations under the Economic Substance Regime.

In particular, every director or general partner of a B.V.I. Entity may find it prudent to ensure the following:

- He or she knows the Entity's financial period and has considered if the financial period should be altered to match the financial or fiscal year.
- On a continuing basis, he or she identifies whether the Entity may be carrying on or receiving gross income from a relevant activity.
- If the Entity carries on a relevant activity or receives gross income from any relevant activity, he or she determines the following:
    - Whether the Entity qualifies for exemption from the economic substance requirements because it is a tax nonresident.
    - If the Entity qualifies in principle as a tax nonresident, the steps and deadlines for filing a provisional claim and then marshaling evidence in support of that claim, including sufficient evidence of residence in a jurisdiction that is not on the E.U. Blacklist.

- A fallback plan exists to allow in compliance with the economic substance requirements applicable to the Entity's relevant business. As discussed above, those requirements range from a simplified regime for holding businesses to very onerous requirements for I.P. businesses.

- He or she fully understands the reporting requirements that apply to the Entity, which depend on the foregoing points.

Part 12 of the Economic Substance Rules sets out the prescribed economic substance information which every Entity needs to consider.[8] The required information for financial periods commencing on or after January 1, 2022, has increased significantly, particularly for Entities carrying on relevant activity and not claiming to be nonresident. Entities affected by these changes will be well advised to allow longer than usual to prepare reports on a timely basis, leaving enough time for a thorough review by local counsel.

In view of the I.T.A. Act requirements, it may be prudent to record that the directors or general partners have considered these points in minutes or resolutions and, if the Entity carries on relevant activity, to document the steps taken to ensure compliance.

[8] Entities considering the reporting requirements for financial periods commencing prior to January 1, 2022 should refer to version 2 of the Rules.

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