



HONG KONG TAX ALERT

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New Economic Substance Laws are a potential game changer for international businesses

Summary

Effective from 1 January 2019, certain offshore jurisdictions such as the Cayman Islands, the British Virgin Islands and Bermuda have introduced new Economic Substance Laws which will require an increased level of substance to be maintained in these jurisdictions for all entities that fall within the new regime. This will be a potential game changer for groups operating in Asia, especially with respect to their approach in using, managing and operating offshore companies going forward.

Many organisations will need to review their operational and holding structure and evaluate how to respond to the new requirements. Given that an update to the guidance and detailed implementation rules have not yet been released, there remains a level of uncertainty and ambiguity over the application of the new economic substance rules.

We have recently seen moves on the part of governments in certain offshore jurisdictions such as the Cayman Islands, the British Virgin Islands, Bermuda and the Channel Islands to introduce economic substance laws. These will require an increased level of substance to be maintained in the jurisdictions for all entities that fall within the new regime.

These laws are being introduced in part to ensure that the jurisdictions meet their commitments to the European Union as well as its obligations as an Inclusive Framework member under the OECD's global Base Erosion and Profit Shifting (BEPS) initiatives – in particular, Harmful Tax Practices (Action 5).

This is potentially a game changer for groups operating in Asia, especially with respect to their approach in using, managing and operating offshore companies going forward. This is because the new laws essentially require all entities that fall within the regime to maintain a level of operational substance that is commensurate with the income generating activities of that entity.

In the case of the Cayman Islands, British Virgin Islands and Bermudan laws which are in force from 1 January 2019, the laws will apply to entities that are conducting "relevant activities". Such activities are broadly defined to include a wide range of businesses, including banking, insurance, fund management, finance and leasing, distribution and service centre business, headquarters business, intellectual property business, shipping, and holding company business.

At a more practical level, there is likely to be a reduced level of substance requirements for a pure investment holding company – a passive equity investment holding company – but this will be subject to further guidance. In contrast, a high-risk intellectual property holding structure will likely face more onerous substance requirements.

Most forms of entity will be covered by the requirements. In the Cayman Islands for example, the rules will apply to most Cayman Islands exempted companies, limited partnerships and Cayman LLCs, along with registered foreign companies.

Carve-outs

There are some important carve-outs under the relevant laws for certain companies. This would include for certain of the jurisdictions such as the Cayman Islands and the British Virgin Islands where the entity is a tax resident elsewhere.

In addition, in the Cayman Islands for example, investment funds and their investment holdings are specifically excluded.

Separately, in the case of Bermuda, regulated entities such as banks and insurance companies will be exempted from the rules where they satisfy regulatory substance requirements.

Practical guidance issued by the Cayman Islands

The objective of these laws is to ensure that substantive operations at the local entity level are commensurate with the profit generating activities being carried out by the entity. However, there remains a level of uncertainty and ambiguity over the application of the new substance rules in practice, and the level of substance that will be needed to satisfy compliance with the rules.

On 22 February 2019, the Cayman Islands issued its guidelines on the Cayman Islands law. We understand that an update to the guidance will be issued in the near future, and it is hoped that it will provide greater clarity for the international business community. For example, further clarity is needed around:

- The level of substance requirements with regards to the income derived from the relevant activity carried out in the Cayman Islands
- The necessary amount of operating expenditure that must be incurred in the Cayman Islands
- What is considered a sufficient physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands
- The number of full-time employees or other personnel with appropriate qualifications needed in the Cayman Islands; and
- Whether outsourcing of “core income generating activities” within the jurisdiction is permitted and can count towards satisfying the substance requirements, provided the entity can monitor and control the carrying out of that activity by any delegate.

Transition period and reporting obligations

Generally speaking, and subject to local variation, existing companies as at 31 December 2018 will have a six month transition period (i.e., until 1 July 2019) to comply with the new rules. For companies established on or after 1 January 2019, substance requirements need to be satisfied starting from the time they provide the relevant activities.

There will also be in some cases annual reporting obligations to the local tax authorities in respect of compliance with the new rules. In addition, penalties for failing to satisfy the requirements may be imposed and other sanctions such as entities potentially being struck off local registers may arise.

KPMG observations

The economic substance laws being introduced by these offshore jurisdictions are potentially game changing for the international business community. Many organisations use these jurisdictions within their group holding and operating structures. The laws will require such organisations to review their entities to evaluate whether or not they will need to comply or be carved out and exempted from the new substance requirements. Further, if they need to comply, a determination of the level of additional substance required will need to be evaluated.

This presents another 'challenge' for these offshore jurisdictions, following broader scrutiny by the European Union and the OECD through their tax transparency related and other initiatives. Amongst these, Country-by-Country Reports are now starting to be reviewed by Tax Authorities, and groups with significant assets or income in entities in jurisdictions with little or no substance and tax paid currently will likely be a particular focus area.

In summary, all groups using offshore jurisdictions need to review the impact of the relevant law. It cannot be ignored. This will therefore require corporates and other investors to:

- Review their organisational structures to determine why a particular entity is being used and whether it still makes sense in light of recent developments
- Consider the level of substance and whether substance needs to be created specifically for the company or whether the substance can be outsourced (having regard to the internal efforts required to manage the outsourced substance); and
- Consider the costs and benefits of maintaining the entity in the offshore jurisdiction versus migrating the residence or otherwise transferring the trade and assets of the entity to somewhere like Hong Kong or another 'mid-shore' jurisdiction

The outcome of this exercise for active trading companies and IP holding entities may be a significantly different tax profile. However, for more traditional holding companies which generally derive dividends and/or capital gains, a decision to rebase tax residency and/or operations to Hong Kong may well not alter the tax profile of the entity. That said, appropriate diligence should be undertaken prior to implementing such a course of action so as to understand any potential commercial, legal, tax and other implications of this on prior periods.

We will provide further updates as further guidance is issued.

Contact us:



Lewis Y. Lu
National Head of Tax
Tel: +86 21 2212 3421
lewis.lu@kpmg.com



Curtis Ng
Head of Tax, Hong Kong
Tel: +852 2143 8709
curtis.ng@kpmg.com

Corporate Tax Advisory



Matthew Fenwick
Partner
Tel: +852 2143 8761
matthew.fenwick@kpmg.com



Stanley Ho
Partner
Tel: +852 2826 7296
stanley.ho@kpmg.com



Charles Kinsley
Partner
Tel: +852 2826 8070
charles.kinsley@kpmg.com



Alice Leung
Partner
Tel: +852 2143 8711
alice.leung@kpmg.com



Ivor Morris
Partner
Tel: +852 2847 5092
ivor.morris@kpmg.com



John Timpany
Partner
Tel: + 852 2143 8790
john.timpany@kpmg.com



Eva Chow
Director
Tel: +852 2685 7454
eva.chow@kpmg.com



Elizabeth de la Cruz
Director
Tel: +852 2826 8071
elizabeth.delacruz@kpmg.com



Natalie To
Director
Tel: +852 2143 8509
natalie.to@kpmg.com



Eugene Yeung
Director
Tel: + 852 2143 8575
eugene.yeung@kpmg.com

Deal Advisory, M&A Tax



Darren Bowdern
Head of Financial Services
Tax, Hong Kong
Tel: +852 2826 7166
darren.bowdern@kpmg.com



Sandy Fung
Partner
Tel: +852 2143 8821
sandy.fung@kpmg.com



Benjamin Pong
Partner
Tel: +852 2143 8525
benjamin.pong@kpmg.com



Malcolm Prebble
Partner
Tel: +852 2685 7472
malcolm.j.prebble@kpmg.com



Anthony Pak
Director
Tel: +852 2847 5088
anthony.pak@kpmg.com

China Tax



Daniel Hui
Partner
Tel: +852 2685 7815
daniel.hui@kpmg.com



Adam Zhong
Partner
Tel: +852 2685 7559
adam.zhong@kpmg.com



Travis Lee
Director
Tel: +852 2143 8524
travis.lee@kpmg.com



Wade Wagatsuma
Head of US Corporate Tax,
Hong Kong
Tel: +852 2685 7806
wade.wagatsuma@kpmg.com



Vivian Tu
Director
Tel: +852 2913 2578
vivian.l.tu@kpmg.com



Becky Wong
Director
Tel: +852 2978 8271
becky.wong@kpmg.com

US Tax

Global Transfer Pricing Services



Karmen Yeung
Head of Global Transfer
Pricing Services, Hong Kong
Tel: +852 2143 8753
karmen.yeung@kpmg.com



Patrick Cheung
Partner
Tel: + 852 3927 4602
patrick.p.cheung@kpmg.com



Irene Lee
Director
Tel: +852 2685 7372
irene.lee@kpmg.com



Lachlan Wolfers
National Head of Indirect
Tax & Tax Technology;
Asia Pacific Regional
Leader, Indirect Tax
Tel: +852 2685 7791
lachlan.wolfers@kpmg.com



Alexander Zegers
Director, Tax Technology
Tel: +852 2143 8796
zegers.alexander@kpmg.com

People Services



Murray Sarelius
National Head of People
Services
Tel: +852 3927 5671
murray.sarelius@kpmg.com



David Siew
Partner
Tel: +852 2143 8785
david.siew@kpmg.com



Gabriel Ho
Director
Tel: +852 3927 5570
gabriel.ho@kpmg.com



Kate Lai
Director
Tel: +852 2978 8942
kate.lai@kpmg.com

kpmg.com/cn

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