Economic Substance Law in the British Virgin Islands

Summary
The BVI Economic Substance Law came into effect on 1 January 2019 and the detailed rules and interpretations of the BVI Economic Substance Law have recently been finalised. Although the rules have provided some implementational details that Hong Kong businesses should welcome, there are still uncertainties that may need to be clarified in the future.

It is imperative that BVI entities review their circumstances to see whether they fall into the scope of the Economic Substance Law, and ensure compliance therewith as soon as possible.

Introduction
The British Virgin Islands (“the BVI”), together with other major offshore jurisdictions, introduced economic substance laws. The BVI Economic Substance (Companies and Limited Partnerships) Act, 2018 (“the Act”) became effective from 1 January 2019. Companies incorporated on or after 1 January 2019 have to comply with the Act immediately, while a transition period to 30 June 2019 was provided for entities established before 1 January 2019. This is in response to the European Union (“EU”) and the Organisation for Economic Cooperation and Developments’ (“OECD”) various efforts to enhance tax transparency.

In simple terms, a relevant BVI entity (including locally incorporated companies, foreign entities registered in the BVI and limited partnerships having legal personality (see Table 1 in Figure 1)) that engages in one or more of the Relevant Activities (see Table 2 in Figure 1) would be required to comply with the Act by maintaining an appropriate level of economic substance (see Table 3 in Figure 1) in the BVI, unless exceptions apply. Please refer to our previous Hong Kong Tax Alert Issue 4 for details.

The Act was drafted broadly, setting out the framework of the economic substance requirements of the BVI. To provide the necessary implementational guidance, the BVI authorities released a set of draft codes in April 2019 containing detailed explanations and some examples to help interpret the Act. The draft codes, which

Table 1 – Relevant Entities
- Locally incorporated companies
- Foreign companies registered in the relevant jurisdictions
- Limited partnerships with legal personality

Table 2 – Relevant Activities
- Holding company
- Banking business
- Distribution and service center
- Finance and leasing
- Fund management
- Headquarter business
- Insurance business
- Intellectual property (IP) holding
- Shipping business

Table 3 – Required substance
- Physical premises
- Adequate employees
- Managed and directed (Board)
- Core income generating activities (CIGA) conducted locally
- Operating expenditure

Relevant Jurisdictions
Barbados, Bermuda, BVI, Cayman Islands, Guernsey, Isle of Man, Jersey, Marshall Islands, etc.

Figure 1 Conceptual Illustration of Offshore Economic Substance Laws
had generated widespread discussions amongst practitioners and the business sector, were finalised on 9 October 2019 as “Rules on Economic Substance in the Virgin Islands” (“the Rules”). The Rules were not significantly different from those previously released, and the general understanding is that EU and OECD have reviewed the Rules. It is worth noting that other offshore jurisdictions including the Cayman Islands and the Channel Islands have revised or released similar rules in recent months, although some of these rules are still in the process of updating.

BVI entities are commonly used by Hong Kong businesses for various purposes and therefore the Act has wide implications in Hong Kong. There are potentially three ways to respond to the Act if a BVI entity falls into the scope of the Act, namely:

1. Build economic substance locally. BVI entities could choose to build and maintain substance in the BVI if this is commercially and practically achievable. The major challenges we have seen are the availability of resources in the BVI, and the external and internal costs required to achieve this goal. This is especially relevant for BVI entities conducting intellectual property holding businesses, where the Rules state that functions like development, enhancement, maintenance, protection and exploitation of intangibles (“DEMPE”) would need to be conducted from the BVI;

2. Revise the corporate group’s operational and legal structure in order to fall within the specific carve outs (see below for more discussions); and

3. Wind down the BVI entities, if feasible, to fall outside of the scope of the Act. Although the BVI liquidation process in itself is straightforward, the impact of the change of direct and indirect shareholder(s) of the underlying subsidiaries from local tax and commercial law perspectives should be considered. Based on the Rules, the Act would still need to be complied with until the liquidation is officially completed.

Carve outs and reduced substance requirements

The Act is intended to have a wide coverage for the Relevant Entities but there are a few important carve outs and exceptions:

- BVI entities that are not conducting Relevant Activities are out of scope. Although the Relevant Activities are widely defined with the intention of encompassing most entities, there are still some business activities that are out of scope, e.g. the holding of immovable property. Investment fund is not a Relevant Activity, however, it is not entirely clear whether, similar to the Cayman Islands’ approach, any entity through which an investment fund directly or indirectly invests or operates is part of an investment fund. That said, fund management business is not excluded, and is one of the Relevant Activities requiring local economic substance.

- BVI entities that do not receive income from the respective businesses (e.g. providing non-interest bearing loans) during the reporting period (typically a 12-month period) is not regarded as conducting Relevant Activities. This could also apply to intellectual property holding entities that do not charge a royalty or licence fee (e.g. the primary reason for holding such intellectual property through a BVI entity was due to various legal and commercial considerations). In fact, the Rules specifically mention that a BVI entity “can discontinue the activity, or modify it so it no longer falls within the scope of a relevant activity”. However, wider considerations including the counterparties’ transfer pricing and local tax implications should be taken into account.
• BVI entities that are tax residents in another jurisdiction (which is not a black-listed jurisdiction) are out of scope, provided their income from relevant activities are subject to tax in a jurisdiction outside the BVI. The underlying rationale is that such entities should be properly taxed in such another jurisdiction. The Rules go on to explain that the tax residence of a transparent entity is demonstrated by reference to the tax residence of the participators or partners, and it is sufficient that an entity is accepted to be a taxable entity in a jurisdiction not imposing tax based on residence. By contrast, there are no such provisions in the Cayman Island rules.

The above is of particular relevance to Hong Kong, which only taxes Hong Kong sourced profits. The general understanding is that the BVI authorities would practically recognise a BVI entity having registered as a non-Hong Kong company under Part 16 of the Companies Ordinance (and consequentially registered under the Business Registration Ordinance) as a Hong Kong tax resident for the purposes of the Act. This is on the basis that the BVI entity would be subject to tax as it derives chargeable profits according to the Hong Kong Inland Revenue Ordinance. This appears to be a practical way out for Hong Kong businesses using BVI companies that only earn offshore income, dividends and/or capital gains which are not taxable in Hong Kong. However, before registering such BVI entities in Hong Kong, historical and go-forward Hong Kong Profits Tax implications (if any) should be considered.

• Holding companies are subject to a less stringent economic substance requirements where only an appropriate level of employees (or outsourced resources) and business premises are required. The reduced requirements apply to “Pure Equity Holding Companies” which are defined as entities that only hold equity investment, and only receive dividend and capital gains. A strict application of this intentionally narrow definition is required. Importantly, Pure Equity Holding Companies are not required to be managed and directed in the BVI which helpfully suggests that maintaining sufficient qualified director(s), sufficient quorum of each board meetings physically present in the BVI, etc. are not necessary.

Interestingly, the Rules clarified that for a Pure Equity Holding Company that actively manages its equity participations, it should maintain adequate and suitably qualified employees and appropriate premises locally. While outsourcing is always permissible, the practical aspects of this operating model should be considered especially with regards to a BVI entity established to trade equity investments on a regular basis.

Reporting and penalties

Relevant Entities will be required to report certain information on their activities annually to registered agents. This includes information on the entity’s tax residence status, turnover, number of employees, amount of expenditure, address, etc. The information collated by the registered agents, together with supporting documentary evidence where relevant, will be reported to the BVI authorities through the existing Beneficial Ownership Secured Search (BOSS) system within six months after the reporting period. For BVI entities incorporated before 1 January 2019, the first reporting period runs from 30 June 2019 to 29 June 2020, or an earlier/shorter period of time on election. Therefore the immediate reporting deadline will be 29 December 2020 if no such election is made.

There are potentially severe penalties which can be imposed for non-compliance, including monetary penalties, exchange of information with the tax authorities where the beneficial owners are located, and striking off the entities in extreme situations.

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1 European Union’s list of non-cooperative jurisdictions for tax purposes.
KPMG observations

The introduction of the Rules assists in the interpretation of the Act. While the Rules provide some helpful clarifications, uncertainties remain. Objectively, the BVI authorities are not able to clarify all situations and therefore a certain level of ambiguity of the Act is inevitably expected. The BVI entities should continue to monitor the development of the Act and the Rules, especially in light of the on-going discussions with the EU and OECD in this matter and the evolving BEPS initiatives. The level of the BVI authorities’ enforcement is also worth observing that may impact how Hong Kong businesses will respond to the Act.

The BVI entities should accordingly go through the following 3-step review process:

• Do the BVI entities fall within the definition of a Relevant Entity;
• Are they carrying on a Relevant Activity; and
• Are they able to meet the Economic Substance requirements, or fall out of the scope of the Act.

Such a review should not only focus on the BVI entities (or those in the relevant offshore jurisdictions), a holistic review of the group’s entire legal structure and operational capability should be undertaken to optimise an appropriate structure enabling future growth. In addition, the re-organisation should be forward looking, considering the rapidly changing global tax landscape. Based on our experience, this kind of re-organisation typically involves multiple functions within an organisation (e.g. finance, legal and compliance, company secretarial and tax, etc.), and therefore aligning a common goal and defining ownership, accountability among stakeholders are key to success.