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INSIGHT: Are Tax Havens Susceptible (Or Immune) To Covid?

By Andrew Sams

Economic substance tests have become increasingly prevalent in recent years, having been introduced in multiple jurisdictions, including Jersey, Guernsey, the British Virgin Islands, the Cayman Islands, and Bermuda, with more expected to follow in the coming years. The root of the problem stems from the ability to move business operations (and income) that are inherently geographically mobile, particularly in an age where the flow of information and communications is fast, cheap, and effective. Placing businesses in these low to no-tax jurisdictions can play key tax deferral, tax rate arbitrage, and even avoidance functions.

These jurisdictions are often included in the list of those favoured by ultra-high net worth (UHNW) families to feature in their global asset holding structures alongside fund managers seeking tax efficient jurisdictions in which to site their private equity structures.

This is of particular importance at the moment as the deadlines for Economic Substance Test vary in each jurisdiction, making them very easy to miss given the wider environment. And the costs of missing a deadline, or not having sufficient substance, can be incredibly punitive.

What are the economic substance tests and why have they been introduced?

economic substance tests were introduced following wide-spread shifts in global attitudes towards tax avoidance or mitigation with the aim of reducing the ability of companies from having only 'paper operations' that enabled them to benefit from low/no tax regimes.

Various economic substance tests already established have arisen from the OECD/G20 Base Erosion and Profit Shifting (commonly referred to as 'BEPS') project, namely BEPS Action 5. These sit alongside the other OECD/G20 Actions that may also apply to holding structures such as: providing rules for controlled foreign companies; hybrid mismatches; prevention of tax treaty abuse; restriction of interest deductions, and the introduction of corporate general anti-abuse rules.

Each jurisdiction has legislated its own nuanced version but there are shared concepts, such that the economic substance tests apply to certain *'relevant entities'* carrying out certain *'relevant activities'*, with affected entities being required to meet a minimum level of substance in their local jurisdiction in areas such as:

- Management and control,
- Adequate employees,
- Sufficient expenditure and physical presence, and
- Core Income Generating Activities (CIGA)

In short, local jurisdictions are not just 'rubber stamping' tax residence but requiring a far higher bar of genuine economic substance.

What if the economic substance tests are not met?

The implications for not complying with economic substance tests can be severe: penalties range from increasing fines (up to hundreds of thousands of British pounds per fine), to removal/strike-off of the entity from the official local jurisdiction register, and even imprisonment.

How has Covid-19 affected the economic substance tests?

The global travel restrictions in place have had many impacts including:

- Difficulty in substantiating and maintaining management and control in the local jurisdiction for companies with globally based directors. Many people may not be able to physically get to the local jurisdiction in order to take part in meetings or make key strategic decisions (also an important factor in establishing corporate tax residence).

- Difficulty in undertaking sufficient CIGA in the local jurisdiction. This can be due to local jurisdiction lockdown and therefore lack of ability for employees to undertake their duties that result in CIGA, and/or for those companies who's CIGA are driven by globally situated employees, who have had difficulty in commuting to the local jurisdiction to perform their duties.

- Restricted cashflows. Sufficient local jurisdiction expenditure may present financing issues, or the need to repatriate cash to the local jurisdiction for such expenditure may bring undesirable tax consequences such as withholding tax on upstream dividend or interest payments, depending on the relevant jurisdictions in question.

How can UHNW families adapt to these unique circumstances?

Most jurisdictions are taking a pragmatic standpoint on the impact of travel restrictions, particularly as regards to management and control. Jersey and Guernsey have both made public statements to that effect.

However, it brings into question how long this pragmatic standpoint will be maintained, particularly if travel restrictions continue for many more months. In addition, these jurisdictions have also stated that such standpoint only applies where a company's operating practices have had to adjust to compensate for Covid-19, implicitly bringing a need to evidence such effect. As such, where possible it may be prudent to consider postponing strategic decisions, so that they can take place once directors are able to be physically present in the local jurisdiction.

If postponement of meetings is not possible, and physical presence is affected by travel restrictions, such that they take place ''virtually,'' companies should keep contemporaneous records of why such meetings were held remotely, explicitly citing the travel restrictions or company policies which prevented directors from attending in person.

Another option is to reconsider the purpose of holding structures in such jurisdictions and reviewing whether a family should maintain tax residence of their entities in such jurisdictions. Broadly, if the entities are not tax resident in such jurisdictions, then the local jurisdiction's economic substance tests are no longer in point.

The typical process here is to first undertake a detailed risk review of existing entities to determine what the risk may be that they do not quite have sufficient substance to meet the economic substance tests. This should be promptly followed by a cost-benefit analysis as to what the financial cost would be of enhancing existing substance compared to migrating the entity(ies) to another jurisdiction(s) that may not have as obviously favourable tax regime(s) in place.

Of particular note, are non-U.K. entities holding U.K. real estate interests. Many of the tax benefits of holding such interests outside of the U.K. have evaporated over the years. Most recently, the April 2019 U.K. tax changes concerning commercial real estate and indirect disposals of UK real estate have prompted a large number of Cayman Island, BVI, Jersey etc. holding companies to migrate their tax residence to the U.K. In such cases the tax position is not disadvantaged in doing so (in certain instances, it is actually simplified or improved) and the risks associated with not complying with economic substance tests are removed.

Conclusion

The impact of Covid-19 is far reaching and given that the introduction of economic substance tests is relatively new but has various upcoming deadlines with potentially highly punitive consequences for non-compliance, this could present a perfect storm for the ill-advised.

UHNW Families should undertake a detailed risk review of their asset holdings structures to ensure their position is clarified and appropriate mitigation actions can be progressed. There are multiple considerations such as enhanced documentation and prudence while mandatory Covid-19 related travel restrictions are in place, as well as more substantive longer-term strategic contemplation of tax residence migration of asset holding structures. In this environment, a total balance sheet approach to financial management, undertaken by advisers with a global outlook and ability and experience to execute in a cross-border environment is mission critical.

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Author Information

Andrew Sams is director of wealth planning in the London office of TwinFocus where he works closely with the firm's family office clients to incorporate the investment, tax and commercial implications of an ever evolving financial and fiscal landscape. Prior to TwinFocus, Andrew spent 10 years at Deloitte U.K. as a tax adviser focused primarily on providing holistic solutions to ultra-high-net-worth families and entrepreneurs.