Economic substance laws were introduced in major offshore jurisdictions including the Bahamas, Bermuda, British Virgin Islands (BVI), Cayman Islands, Channel Islands (Guernsey and Jersey), Isle of Man, Marshall Islands, and became effective on 1 January 2019. The introduction of the new laws was in response to the various efforts made by the Organization for Economic Cooperation and Development to enhance global tax transparency, as well as the review by the Code of Conduct Group of the European Union (EU) into certain low or no corporate income tax jurisdictions.

The underlying concept behind these laws, that economic substance should align with where profits are booked, and thus the tax outcome should follow, is not new. The laws also aim to level the playing field among the no or low tax jurisdictions and therefore the laws are substantially similar.

The BVI’s Economic Substance (Companies and Limited Partnerships) Act, 2018 (the act) is of particular interest to Hong Kong corporate groups because it is common to find BVI companies within them. Therefore, the act has wide implications for Hong Kong businesses.

The framework

A “relevant entity” (including BVI incorporated companies, foreign entities registered in the BVI and limited partnerships having legal personality) that engages in one or more of the nine “relevant activities” are required to comply with the act by maintaining an appropriate level of economic substance in the jurisdiction commensurate with the entity’s business.

The relevant activities are 1) banking, 2) distribution and service centres, 3) finance and leasing, 4) fund management, 5) headquarter business, 6) holding companies, 7) insurance, 8) intellectual property holding, and 9) shipping. The coverage of these relevant activities are intentionally wide.

The economic substance requires that the relevant entity should be able to demonstrate that it is managed and directed by the board locally. This means a sufficient quorum of the board of directors should meet periodically in the BVI to manage the entity. The core income generating activities that correspond to the entity’s business should also be conducted locally by qualified employees stationed within a physical premise. Lastly, an appropriate level of expenditure would naturally be spent in the BVI as a result of the above local business substance.

To provide the necessary implementation guidance, the Rules on Economic Substance in the Virgin Islands (the rules) were finalized on 9 October 2019.

There are potentially three ways to respond to the act if a relevant entity falls within its scope:

1. **Build economic substance locally.** BVI entities could choose to build and maintain local substance if this is commercially practicable and justifiable. The key challenge in this regard is the limited resources available in the BVI. The cost and effort required to acquire and then manage local resources (including the logistics of personnel travelling to the BVI) should not be underestimated;

2. **Revise the corporate group’s operational and legal structure.** Make the entities fall outside the scope of the act. There are some important exceptions and exclusions that are discussed below; and

3. **Transfer business operations and assets out and liquidated or wind down the BVI entities.** If the BVI entities are intermediate or direct holding companies, special attention should be paid to whether the local laws where the subsidiaries are located would deem such change as an indirect transfer of ownership which may trigger tax implications. Based on the rules, the act would still need to be complied with until the liquidation is officially completed. Re-domiciling the BVI entities would also withdraw the entities from the BVI regime. However, the Hong Kong Companies Ordinance (CO) currently does not provide for a re-domiciling regime. This is currently being proposed by a number of professional bodies in Hong Kong.

Compliance with the act is assessed based on a 12-month period which can be different from the accounting period of the entities, and may be shortened on election. Reporting should be done within six months after the relevant financial period. For entities incorporated before 1 January 2019, the first reporting period
runs from 30 June 2019 (when a transition period expired) to 29 June 2020 (or an earlier date upon election). Therefore, the immediate reporting deadline will be 29 December 2020 if no such election is made. For entities incorporated on or after 1 January 2019, the first reporting period runs from the date of incorporation to 12 months thereafter, unless elected otherwise.

Reporting should be done through the entities’ registered agents. The information collated including the entities’ tax residence status, turnover, number of employees, amount of expenditure, address, etc., together with supporting documentary evidence where relevant, will be reported to the authorities through the existing Beneficial Ownership Secured Search system.

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

Exceptions and exclusions

There are some exceptions and exclusions that may result in the BVI entities operating fully outside the prescribed operations of the act.

No relevant activities

Although the coverage of “relevant activities” is wide, there are still some activities that are not covered. For example, investment funds and entities holding immovable properties (outside the BVI) are not “relevant activities.”

Also, if no actual business activities are conducted, or if no income is generated, the entities would not be considered as engaging in “relevant activities.”

This is practically useful, for example, if an intellectual property holding company received no royalties or license fees for the relevant financial period it would fall out of scope of the act. Corporate groups using a BVI special purpose vehicle to hold legal title of the intellectual property for other legal and commercial reasons, and not to generate income from the exploitation of the intellectual property, could potentially maintain status quo. However, for an entity that had been charging royalties in the past and decided to stop charging royalties, the group’s wider transfer pricing and local tax implications should also be considered before such changes are undertaken.

Pure equity holding company

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 a “pure equity holding company” (PEHC) that is narrowly defined as an entity that only holds equity investment and receives dividends and capital gains only. A PEHC is not required to be managed and directed in the BVI. This would suggest that maintaining sufficient qualified director(s), maintaining sufficient quorum of each board meetings physically present in the BVI, and making key decisions in the BVI are not necessary.

Having said that, this narrow definition also likely means a very strict application of the law. For example, a holding company that provides financing to its subsidiary by way of an interest bearing loan is likely not a PEHC, and could potentially be subject to the economic substance requirements applicable to a financing and leasing company if it is regarded as carrying on a financing business.

Interestingly, the rules clarified that for a PEHC that actively manages its equity participations, adequate and suitably qualified employees and appropriate premises should be maintained locally. This could mean that a PEHC that trades listed shares (as these are by definition equity investments) frequently may need to employ at least one investment manager who would manage the buying and selling of the shares from a local office. While outsourcing is always permissible, the practical aspects of this operating model should be considered. For completeness, it is important to note that by virtue of its share trading activities, this BVI entity may have already constituted a taxable presence or permanent establishment somewhere outside the BVI notwithstanding the enactment of the act, and thus the relevant (historical) tax implications should also need to be dealt with in tandem.

Non-resident in the BVI

BVI entities that are tax residents in another jurisdiction which is not “black-listed” (i.e. not a jurisdiction included in the
EU’s list of non-cooperative jurisdictions for tax purposes) 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.

That said, the rules go on to explain that: “It is accepted that some jurisdictions charge tax by reference to a criterion other than residence. What matters is whether the tax authority in the jurisdiction in question has accepted that the entity (or its participants in the case of a transparent entity) is chargeable to tax (to the extent that the jurisdiction charges tax on income) in that jurisdiction by reference to the relevant local criteria.”

The underlined explanation is of importance and relevance to Hong Kong, which only taxes Hong Kong sourced profits. As mentioned above, Hong Kong does not have a re-domiciling regime and so to be regarded as a tax resident in Hong Kong, the procedure would involve registering the BVI entity as carrying on business in Hong Kong (i.e. a place of business in Hong Kong), and exercising management and control from Hong Kong.

To achieve this, the BVI entity would have to be registered as a non-Hong Kong company under Part 16 of the CO (and consequentially registered under the Hong Kong Business Registration Ordinance). The rationale behind is, perhaps, that once the BVI entity is registered in Hong Kong, it would be subject to profits tax under the Hong Kong Inland Revenue Ordinance. The BVI entity would have to produce evidence such as a tax identification number, copies of profits tax return, notice of assessment, Business Registration Certificate, certificate of tax residence, etc.

The fact that the BVI entity may have some non-taxable income (i.e. dividend income or offshore interest income) should not disqualify that entity from being regarded as a Hong Kong tax resident. While this interpretation would fall within the “relevant local criteria” basis of taxation for Hong Kong, this position has not been tested and may be subject to the views of the BVI authorities.

Assuming this position can be sustained, registering the BVI entities as tax residents in Hong Kong may be a practical way out to Hong Kong corporate groups with BVI entities (that are not holding companies) as part of their corporate structure. However, before registering such BVI entities in Hong Kong, historical and go-forward Hong Kong profits tax implications (if any) should be considered. Particularly, late registration under both the Companies and Business Registration Ordinances, and late or under reporting of prior year profits tax would trigger potentially significant penalties.

**Going forward**

The act is part of the game plan in enhancing global tax transparency, which also fundamentally changes the legal and tax considerations in using offshore entities. Although the BVI entities have issued the rules to provide implementation clarifications to the act, a lot of uncertainties remain. Corporate groups should not only implement measures to ensure compliance with the act, but a holistic review of the group’s entire legal and operational structure should be conducted to develop a longer-term solution. It is also necessary to bear in mind potential changes in view of the changing global tax landscape, and the potential stricter interpretation and enforcement of the act in the medium term. Finally, as one may notice from the above, the act and the potential solution and compliance have wide and multidisciplinary implications from the aspects of legal, tax, finance, operations and compliance, etc. A detailed project plan, with support from different internal and external experts, is key to the successful implementation of the solution.

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**A PLUS**

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