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Industry Information

## Guernsey Consolidates Economic Substance and Extends it to Partnerships

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Guernsey has brought partnerships into scope of economic substance requirements for accounting periods commencing on or after 1 January 2022, although partnerships formed on or after 1 July 2021 will be in scope immediately on formation where they conduct activities that trigger the economic substance requirements.

The legislation is contained in The Income Tax (Substance Requirements) (Implementation) Regulations, 2021 (the “New Substance Regulations”) which came into force on 30 June 2021. The New Substance Regulations consolidate and replace Guernsey’s previous substance legislation, and so cover the application of economic substance requirements to companies as well, although they do not make any significant changes to the economic substance requirements that existed for companies prior to the New Substance Regulations coming into force. This briefing focuses on the extension of economic substance requirements to partnerships.

This extension of economic substance requirements to partnerships has been implemented in Guernsey, as well as the other Crown Dependencies and the Overseas Territories, pursuant to commitments to adopt economic substance requirements made to the EU Code of Conduct Group on Business Taxation. These changes will be most relevant to the funds industry in Guernsey, as a number of carried interest, co-investment, and special purpose structures involving partnerships established or managed in Guernsey could come in scope of economic substance requirements. The changes are also relevant to other structures that use partnerships established or managed in Guernsey.

### Which partnerships will be brought in scope of economic substance requirements?

The following partnerships are in-scope of economic substance requirements if they carry on activities that trigger the application of the requirements:

- general partnership formed under Guernsey law;
- limited partnership (“LP”) formed under Guernsey law, unless it has its “place of effective management” (“POEM”) in a “qualifying jurisdiction”;
- limited liability partnership (“LLP”) formed under Guernsey law, unless it has its POEM in a qualifying jurisdiction; and
- foreign partnerships, including LPs and LLPs or similar, formed under non-Guernsey law and which have their POEM in Guernsey and which carry on business activity in Guernsey.

“POEM” is an internationally recognised tax concept, and is “the place where the management and commercial decisions necessary for the conduct of the business as a whole of that person are substantially made, having regard to all relevant facts and circumstances”. This will typically be where the most senior person or group of persons who manage the partnership make their decisions, and where the actions to be taken by the partnership as a whole are determined. For LPs, the POEM will generally be place where the general partner takes decisions and conducts its business in relation to the LP.

A “qualifying jurisdiction” is a jurisdiction other than Guernsey where:



- either the partnership is subject to economic substance requirements in that jurisdiction which are substantially the same as Guernsey's economic substance requirements; or
- the highest rate of tax on the income of any person in that jurisdiction is at least 10%.

The New Substance Regulations therefore ensure that there is no double-application of economic substance requirements in two jurisdictions and also prevent Guernsey law LPs and LLPs from being subject to economic substance requirements in Guernsey if they have their POEM in a higher tax jurisdiction (provided that the income tax rate in that jurisdiction is at least 10%). It is worth noting that this latter requirement applies to the income tax rate applicable to any person, and not the partnership itself, as typically the partnership would not be subject to tax as it is usually fiscally transparent.

#### What activities trigger the application of economic substance requirements?

The above partnerships will be in scope of economic substance requirements for a particular accounting period if they derive gross income from any of the following:

- a "relevant activity", being banking, insurance, financing and leasing, fund management, headquartering, shipping or a distribution and service centre;
- holding intellectual property (an "IP body"); or
- holding one or more controlling interests in other bodies and having no other commercial activity (a "pure equity holding body").

For the latter category it should be noted that a pure equity holding body must be a legal person for the purposes of Guernsey's beneficial ownership legislation, and as such only includes LLPs and incorporated LPs. LPs that are not incorporated and general partnerships cannot be pure equity holding bodies.

The above categories of activities are the same activities that apply to companies for economic substance purposes, and as with companies some of the categories are mutually exclusive and some can co-exist. So for example, a holding body that has income from lending will be carrying on the relevant activity of financing and leasing and will not be a pure equity holding body (as it carries on other commercial activity), however an IP body can also be financing and leasing.

#### Which partnerships will not be in scope of economic substance requirements?

As with companies, partnerships that are funds regulated by the GFSC are out of scope even where the fund partnership carries on an activity that triggers substance requirements. However, although "self-managed funds" (broadly a fund with no separate manager) are in scope of substance even where they are GFSC-regulated, it is not possible for a GFSC-regulated LP to be a "self-managed" fund as the general partner will be the fund manager.

SPV partnerships held by the fund vehicles, and carried interest and co-investment partnerships, are unlikely to be within the regulated fund exemption, but they would need to be carrying on activities that trigger substance to be in scope. We would not expect a carried interest vehicle to be in scope by virtue of holding the carried interest, but SPV and co-investment partnerships can be in scope if they lend money into a holding structure or are a pure equity holding body.

In addition to GFSC-regulated funds, the following partnerships are out of scope:

- partnerships where all the partners/members are Guernsey resident individuals; and
- partnerships conducting activities only in Guernsey and which are not part of a multinational group.



### When will partnerships be brought in scope of economic substance requirements?

Partnerships that are formed on or prior to 30 June 2021 will be subject to a transitional period and will come into scope for accounting periods commencing on or after 1 January 2022. For example, if an LP is formed on 1 June 2021 and has its first accounting period end date on 30 June 2022, it will be in scope from the accounting period commencing 1 July 2022 (assuming that it conducts activities that trigger economic substance requirements). However, a partnership formed on or after 1 July 2021 will come in scope immediately on formation (again assuming that it conducts activities that trigger economic substance requirements).

### How will economic substance requirements apply to partnerships?

As a general matter the same economic substance requirements that apply to companies that are in scope also apply to partnerships that are in scope.

A partnership conducting relevant activities is subject to the following economic substance requirements:

- it must be “directed and managed” in Guernsey - this requirement relates to the location, frequency and content of the decisions of the partnership’s “governing board” (being the relevant management body of the partnership, such as the board of the general partner in the case of an LP), as well as the knowledge and expertise of the governing board and location of partnership records;
- it must carry on “core income generating activity” (“CIGA”) in Guernsey;
- it must have an adequate level of appropriately qualified employees in Guernsey proportionate to the level of relevant activity carried on in Guernsey – however this does not require the partnership to employ full or part-time employees directly and the on-Island staff of a Guernsey service provider can count towards this requirement;
- it must have an adequate physical presence in Guernsey proportionate to the level of relevant activity carried on in Guernsey – however this does not require the partnership to lease or own office space and the premises of a Guernsey service provider can count towards this requirement if the partnership has access or use of them; and
- it must have an adequate level of operating expenditure in Guernsey that is proportionate to the level of relevant activity carried on in Guernsey.

A partnership that is a pure equity holding body is subject to reduced substance requirements, being:

- it must comply with all obligations under applicable partnership law (being the partnership law of the jurisdiction of its registration/ establishment); and
- it must have an adequate level of persons in Guernsey and an adequate physical presence in Guernsey, in each proportionate to the level of activity carried on in Guernsey, for holding or managing the controlling interests that it holds - this does not require the partnership to lease or own office space and the premises of a Guernsey service provider can count towards this requirement if the partnership has access or use of them.

A partnership that is an IP body is subject to broadly similar substance requirements as that which carries on a relevant activity, except that:

- both the directed and managed and CIGA requirements also require the involvement of Guernsey resident persons; and
- further requirements apply to “high-risk” IP bodies, which are outside the scope of this briefing.

### What are the sanctions for non-compliance?

Failure to meet the test for a particular accounting period can lead to a penalty, automatic exchange of information and, in serious cases, strike-off, although the Guernsey Revenue Service’s ability to strike off a partnership is limited to Guernsey law LPs with legal personality and Guernsey LLPs. The Guernsey Revenue Service is unable to strike off a Guernsey general partnership, a Guernsey LP with no legal personality or a non-Guernsey partnership and instead has increased penalty powers in relation to these partnerships.



The financial penalty for non-compliance is up to £10,000 for the first period of default, up to £50,000 for the third consecutive period of default and up to £100,000 for the fourth consecutive period of default. There is no financial penalty for the second consecutive period of default. For partnerships that cannot be struck off (as noted above), the maximum penalty for subsequent periods of default after the fourth consecutive period is up to £150,000.

Guernsey law LPs with legal personality and LLPs may be struck-off if they fail to meet economic substance requirements, and if they fail to meet the requirements for four consecutive accounting periods they must be struck-off.

Non-compliance by partnerships may be reported to the GFSC, so that the GFSC could also take action against a regulated administrator or services provider if a partnership that it administers continues to fail to meet economic substance requirements.

Failure to meet economic substance requirements also triggers an automatic exchange of information in relation to the partnership by the Guernsey Revenue Service with certain jurisdiction(s).

#### What filing requirements will apply?

All Guernsey law partnerships as well as all foreign partnerships with a Guernsey POEM must:

- register with the Guernsey Revenue Service - this applies to all such partnerships and not just those that are subject to economic substance requirements; and
- file an annual tax return together with financial statements – as with a company, the partnership must confirm whether or not it is subject to economic substance requirements and demonstrate compliance where it is so subject. The filing deadline will be aligned with that for companies.

#### Walkers comment

The purpose of the New Substance Regulations is to extend the application of economic substance requirements to partnerships in a way that aligns their economic substance position to that of companies.

Partnerships are generally fiscally transparent and so are typically not treated as tax resident entities (although some jurisdictions have election regimes to allow taxation at the partnership level, such as the US “check-the-box” regime). The New Substance Regulations needed to deem a partnership to be “tax resident” somewhere in order to apply economic substance requirements where appropriate. Given the nature of partnerships, POEM is a more appropriate concept to achieve this than the “central management and control” concept that generally applies to the tax residence of companies, although there is a degree of overlap between the two concepts.

Further, by using the internationally recognised concept of POEM Guernsey can benefit from OECD guidance and commentary on this concept.

For LPs, the place where the general partner conducts its business will generally be the POEM of the LP. Unregulated corporate general partners of LPs will continue to not be carrying out the relevant activity of fund management, but the LP itself may be in scope due to its activities and where it is the general partner will be responsible for ensuring that the LP complies with economic substance requirements.

#### About Walkers’ economic substance practice

Walkers has a dedicated experienced regulatory group that can offer bespoke privileged legal advice and guidance in connection with all aspects of the Channel Islands’ regimes for economic substance.



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