

Cayman's Economic Substance Law

March 2019

The Cayman Islands government has recently introduced legislation, the International Tax Co-operation (Economic Substance) Law, 2018, which came into effect on 1 January 2019 (the "**Law**"). In addition, the Economic Substance for Geographically Mobile Activities Guidance (the "**Guidance**") and the International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2019 (the "**Regulations**") were published on 22 February 2019, providing additional detail and clarification in respect of the Law.

The Law sets out requirements applicable to in-scope Cayman Islands entities ("**Relevant Entities**") which carry on particular activities ("**Relevant Activities**") and which are not tax resident outside of the Cayman Islands. Relevant Entities which carry on Relevant Activities must demonstrate that such entities have "economic substance" in the Cayman Islands.

The Law has been passed as part of a move by the Cayman Islands to meet its commitments as a member of the OECD's global Base Erosion and Profit Shifting (BEPS) Inclusive Framework and following consultation between the Cayman Islands government and the EU Code of Conduct Group (the "**Group**"), subsequent to assessment by the Group of the tax policies of a range of countries, including the Cayman Islands, and its inclusion in a list of jurisdictions (including the BVI, Bermuda, Guernsey, Jersey and the Isle of Man) required to address the Group's concerns in relation to "economic substance".

The Cayman Islands Tax Information Authority (the "**Authority**") will be responsible for monitoring compliance with the Law.

This memorandum summarises the key provisions of the Law, as supplemented by the Guidance and Regulations.

Relevant Entity

Under the Law, a Relevant Entity is -

- a company, other than a domestic company, that is (i) incorporated under the Companies Law (2018 Revision); or (ii) a limited liability company registered under the Limited Liability Companies Law (2018 Revision);
- a limited liability partnership that is registered in accordance with the Limited Liability Partnership Law, 2017;
- a company that is incorporated outside of the Cayman Islands and registered under the Companies Law (2018 Revision);

but does not include:

- an investment fund; or
- an entity that is tax resident outside of the Cayman Islands.

Exclusions

Investment Funds

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An investment fund is considered to be an entity whose principal business is the issuing of investment interests (meaning a share, unit trust, partnership interest or other right that carries an entitlement to participate in the profits or gains of the entity) to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes any entity through which an investment fund directly or indirectly invests or operates, but does not include a person licensed under the Banks and Trust Companies Law (2018 Revision) or the Insurance Law, 2010, or a person registered under the Building Societies Law (2014 Revision) or the Friendly Societies Law (1998 Revision).

The Authority has also clarified that it will regard mutual funds licensed or registered with the Cayman Islands Monetary Authority ("CIMA") pursuant to the Cayman Islands' Mutual Funds Law (2019 Revision) as investment funds for the purposes of the Law.

Tax Residency

An entity which would otherwise fall within the scope of a Relevant Entity as set out above, will not be considered a Relevant Entity where such entity is tax resident outside of the Cayman Islands.

An entity may be regarded as tax resident outside the Cayman Islands if the entity is subject to tax in another jurisdiction by reason of its domicile, residence or any other criteria of a similar nature.

Relevant Activity

Relevant Entities (that are not subject to the exclusions) will be required to comply with the economic substance requirements under the Law, where such entity carries on one or more Relevant Activities.

Relevant Activities are considered to be activities in the following categories:

- banking business – meaning the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise;
- distribution and service centre business – meaning the business of either or both of the following:
 - purchasing from an entity in the same group –
 - component parts or materials for goods; or
 - goods ready for sale, and
 - reselling such component parts, materials or goods outside the Cayman Islands;
- providing services to an entity in the same group in connection with the business outside the Cayman Islands,

but does not include any activity included in any other Relevant Activity except holding company business (as further set out below);

- financing and leasing business – meaning the business of providing credit facilities for any kind of consideration to another person but does not include financial leasing of land or an interest in land, banking business, fund management business or insurance business (each as set out herein);

- fund management business – meaning the business of managing securities belonging to another person in circumstances involving the exercise of discretion carried on by a Relevant Entity licensed under the Securities Investment Business Law (2019 Revision) for an investment fund;
- headquarters business – meaning the business of providing any of the following services to an entity in the same group –
 - the provision of senior management;
 - the assumption or control of material risk for activities carried out by any of those entities in the same group; or
 - the provision of substantive advice in connection with the assumption of control of risk referred to in the paragraph above,

but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business (each as set out herein);

- holding company business – meaning the business of a pure equity holding company;
- insurance business – meaning the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims;
- intellectual property business – meaning the business of holding, exploiting or receiving income from intellectual property assets; or
- shipping business – meaning any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Cayman Islands or between the Cayman Islands –
 - the business of transporting, by sea, passengers or animals, goods or mail for a charge;
 - the renting or chartering of ships for the purpose described in the paragraph above;
 - the sale of travel tickets and ancillary services connected with the operation of a ship;
 - the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea; or
 - the management of the crew of a ship.

Investment fund business, defined as the business of operating as an investment fund, is specifically excluded from the definition of a Relevant Activity.

Economic Substance Test

Under the Law, a Relevant Entity conducting one or more Relevant Activities will be required to satisfy an economic substance test in relation to such Relevant Activities (the "**Test**").

A Relevant Entity will be subject to the Test from the date on which the Relevant Entity commences the Relevant Activity unless the Relevant Entity was in existence prior to 1 January 2019, in which case the deadline for compliance with the Law is 1 July 2019. Any Relevant Entity incorporated after 1 January 2019 will be expected to be in compliance with the Test from incorporation.

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In order to satisfy the Test, a Relevant Entity must:

- conduct Cayman Islands core income generating activities ("**CIGA**") in relation to the Relevant Activity – this relates to activities which are of central importance to a Relevant Entity in terms of income generation and which are carried out in the Cayman Islands;
- be directed and managed in an appropriate manner in the Cayman Islands in relation to a Relevant Activity; and
- having regard to the level of income derived from the Relevant Activity carried out in the Cayman Islands:
 - have an adequate amount of operating expenditure incurred in the Cayman Islands;
 - have adequate physical assets or an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
 - have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

For the purpose of the Test, the terms "adequate" or "appropriate" as applicable to each Relevant Entity will be dependent on the particular facts of the Relevant Entity and its Relevant Activity.

1. Cayman Islands Core Income Generating Activities

A Relevant Entity must ensure that it conducts its Cayman Islands CIGA in respect of the Relevant Activities in accordance with the Guidance.

Relevant Entities are permitted to seek expert professional advice and engage the services of specialists in other jurisdictions provided that any activities performed by such advisors or specialists in other jurisdictions is not Cayman Islands CIGA and that the relevant income (i.e. the income being subject to no corporate income tax in the Cayman Islands) are commensurate with the Cayman islands CIGA being undertaken in the Cayman Islands.

2. "Directed and Managed"

The reference within the Test to a Relevant Entity being "directed and managed in an appropriate manner in the Cayman Islands in relation to a Relevant Activity," relates primarily to the requirement for decision-making at a board level to be conducted in the Cayman Islands. It is expected that the majority of board meetings will be held in the Cayman Islands and that, even for Relevant Entities with a minimal level of Relevant Activity, there will be at least one meeting of its board of directors per annum

3. Outsourcing

Outsourcing of Cayman Islands CIGA within the Cayman Islands is permitted and contributes to the satisfaction of the Test in relation to a Relevant Activity, provided the Relevant Entity is able to adequately monitor and control the carrying out of the Cayman Islands CIGA by that other person, as well as, demonstrate such monitoring and control. Outsourcing includes outsourcing, contracting or delegating to third parties or entities in the same group, and the resources of the outsourced service provider will be taken into consideration when determining whether the people and premises element of the Test is met.

It is important to note that the Relevant Entity will remain responsible for ensuring accurate information is reported in its reporting notice and this will need to include precise details of the resources employed by its service providers.

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Variations to Test Requirements

At present, holding companies will be subject to a reduced Test where such entities only hold equity participations in other entities, whereas Relevant Entities which carry on the business of holding, exploiting or receiving income from intellectual property assets will be subject to a more onerous Test.

Notification and Reporting

Notification

Beginning in 2020, a Relevant Entity will be required to notify the Authority annually of –

- whether or not it is carrying on a Relevant Activity;
- if carrying on a Relevant Activity, whether or not all or any part of its gross income in relation to the activity is subject to tax in a jurisdiction outside of the Cayman Islands, and if so, will be required to provide evidence of this;
- the date of the end of its financial year.

Reporting

A Relevant Entity performing a Relevant Activity must prepare and submit to the Authority a report, such that the Authority may make a determination as to whether the Test has been fulfilled by such entity. The report must be made within 12 months after the last day of the end of each financial year of that entity, commencing on or after 1 January 2019.

The report shall be in a form approved by the Authority and shall include the information relating to the type of Relevant Activities conducted; amount and type of relevant income, expenses and assets; location of place of business, plant, property or equipment; and number of full-time employees or other personnel with appropriate qualifications responsible for carrying on Relevant Activity. The Authority has proposed it will take a "principles-based" approach to determining whether or not a Relevant Entity has satisfied the Test.

A Relevant Entity which is required to satisfy the Test must retain records in respect of this for a period of 6 years after the end of a financial year.

The Authority, may on notice require a Relevant Entity to provide certain information or access for inspection various information by the Authority to determine compliance with the Law.

General

The Authority shall specify the time, form and manner of such notification and reporting, and it is expected that the Authority will launch an online portal through which such notification and reporting shall be made.

It is important to note that the timing for compliance of the notification requirements are separate from timing of compliance with the Test.

Penalties

As mentioned above, all Relevant Entities will be required to file an annual notice with the Authority as to whether or not Relevant Activities have been carried out in its preceding financial year.

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Where Relevant Activities have been carried out, the Relevant Entity will be required to show particulars as to income, physical presence, employees, management, assets, expenditure and other matters. The filings will then be examined by the Authority to ensure that the Relevant Entity meets the requirements of the Test in respect of such entity for adequate economic substance in the Cayman Islands.

Relevant Entities conducting Relevant Activities which do not meet the Test will be given direction by the Authority on how shortcomings may be resolved, and the requirements of the Test met, and may face a fine of up to C\$10,000 (US\$12,200 equivalent). Ongoing failure by a Relevant Entity to meet the requirements of the Test in the following year may result in additional fines of up to \$100,000 (US\$122,000 equivalent) and further failures could lead to a Relevant Entity being struck off the register after two consecutive years of failure.