

Economic substance in the Cayman Islands

UPDATE

The International Tax Co-operation (Economic Substance) Law, 2018 came into force on 1 January 2019 and imposes economic substance requirements on companies and LLCs in the Cayman Islands

Background

In December 2017, the Cayman Islands committed to address the concerns of the EU Code of Conduct Group regarding the existence of a favourable tax regime facilitating offshore structures generating profits without real economic activity. The International Tax Co-operation (Economic Substance) Law, 2018 (as amended, the **Substance Law**), which introduces economic substance requirements, is the Cayman Islands' response to those concerns and also reflects Cayman's commitment as a member of the OECD's Inclusive Framework on Base Erosion and Profit Shifting (**BEPS**) and, in particular, BEPS Action 5¹.

Whilst the Substance Law came into force on 1 January 2019 and initial Guidance on Economic Substance for Geographically Mobile Activities² (the **Guidance**) was issued by the Cayman Islands Tax Information Authority (the **TIA**) in late February 2019, the new economic substance regime will be implemented in accordance with regulations which are yet to be issued. We anticipate that those regulations will provide additional detail and depth to the framework introduced by the Substance Law.

In-scope entities

The new economic substance regime applies to **relevant entities**, the definition of which includes:

- Cayman Islands companies and limited liability companies (**LLCs**);
- foreign companies registered in the Cayman Islands; and
- Cayman Islands limited liability partnerships (**LLPs**),

but does not include:

- an investment fund (see below); or
- an entity that is tax resident outside the Cayman Islands³.

In addition, the definition of relevant entity excludes domestic companies⁴. Cayman Islands exempted limited partnerships and trust vehicles do not fall within the economic substance regime.

¹ The Inclusive Framework on BEPS decided to resume the application of BEPS Action 5 to no or only nominal tax jurisdictions in October 2018. BEPS Action 5 focuses on the requirement for substantial activities in preferential regimes, including intellectual property regimes, which attract geographically mobile business income.

² A copy of the Guidance can be found on the "Economic Substance" webpage of the Tax Information Authority at: http://www.tia.gov.ky/pdf/Economic_Substance.pdf.

³ The TIA may regard an entity 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 similar criteria, but will require the production of satisfactory evidence to substantiate that claim. Satisfactory evidence may include a Tax Identification Number, tax residence certificate and assessment or payment of a tax liability. The entity will also be required to provide details regarding ownership and tax residence of its parent company/ies and ultimate beneficial owners.

Investment funds – excluded entities

As noted above, investment funds do not fall within scope of the economic substance regime.

For the purposes of the Substance Law, an **investment fund** is an entity whose principal business is the issuing of investment interests 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. This definition:

- currently includes downstream investment vehicles; and
- excludes persons licensed under certain regulatory laws, including the Banks and Trust Companies Law (2018 Revision) and the Insurance Law, 2010 (as amended).

The Guidance clarifies that the TIA will regard mutual funds registered with or licensed by the Cayman Islands Monetary Authority (**CIMA**) pursuant to the Mutual Funds Law (2019 Revision) (as amended, the **Mutual Funds Law**) as "investment funds" for the purposes of the Substance Law.

Relevant activities

The term **relevant activity**, captures regulated activities such as banking business, fund management business and insurance business, together with distribution and service centre business, financing and leasing business, headquarters business, holding company business, intellectual property business and shipping business.

The definition of relevant activity excludes **investment fund business**, meaning the business of operating as an investment fund. In addition, the definition of "fund management business" currently means that persons registered as "excluded persons" under the Securities Investment Business Law (2019 Revision) fall out of scope of the economic substance regime. However, we understand from industry discussion that this position is very likely to change in the future and will release a further update when more information becomes available.

It is anticipated that the regulations to be issued under the Substance Law will further define the scope of the relevant activities.

What is the economic substance test?

Under the Substance Law, a relevant entity which carries on a relevant activity is required to satisfy the economic substance test in relation to that relevant activity. If a relevant entity carries on more than one relevant activity, it must comply with the economic substance test in relation to each relevant activity.

The economic substance test has three limbs, and a relevant entity complies with the economic substance requirements if the relevant entity:

- conducts Cayman Islands core income-generating activity (**CIGA**) in relation to that relevant activity;
- is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity (see below);
- having regard to the level of relevant income derived from the relevant activity carried out in the Cayman Islands:
 - incurs an adequate amount of operating expenditure in the Cayman Islands;
 - has an adequate physical presence (including maintaining business premises or equipment) in the Cayman Islands; and
 - has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

⁴ A **domestic company** is a company which is not part of an MNE Group (as defined in the Tax Information Authority (International Tax Compliance) (Country-By-Country Reporting) Regulations, 2017) and which is:

- (a) carrying on business in the Cayman Islands and complies with section 4(1) of the Local Companies (Control) Law (2019 Revision) (as amended) or section 3(a) of the Trade and Business Licensing Law (2019 Revision);
- (b) a company referred to in section 9 or section 80 of the Companies Law (2018 Revision) (as amended).

The Substance Law lists certain core activities which are considered to be CIGA for the purposes of each relevant activity.

Appropriate direction and management

The Substance Law clarifies that a relevant entity will comply with the requirement to be directed and managed in an appropriate manner if, in relation to a relevant activity:

- the relevant entity's board of directors⁵, as a whole, has the appropriate knowledge and expertise to discharge its duties as a board of directors;
- meetings of the board of directors are held in the Cayman Islands at adequate frequencies given the level of decision making required;
- during meetings of the board of directors held in the Cayman Islands, a quorum of directors is present in the Cayman Islands;
- the minutes of board meetings held in the Cayman Islands record the making of strategic decisions at the meeting; and
- the minutes of all meetings of the board of directors and appropriate records of the relevant entity are kept in the Cayman Islands.

The Guidance states the following in relation to this limb of the economic substance test:

- what constitutes an appropriate number of meetings in the Cayman Island will depend upon the relevant activities of each company. However, it is generally expected that the majority of meetings will be held in the Cayman Islands;
- there is expected to be at least one board meeting per year, even for companies with a minimum level of activity; and
- where there are corporate directors, the requirements will apply to the individual officers or employees of the corporate director actually performing the duties.

Meaning of "adequate" and "appropriate"

The Guidance states that:

- **adequate** shall mean "as much or as good as necessary for the relevant requirement or purpose"; and
- **appropriate** shall mean "suitable or fitting for a particular purpose, person, occasion".

Accordingly, what is adequate or appropriate for a relevant entity will depend upon the facts, circumstances and business activities applicable to each particular relevant entity. Each relevant entity will need to maintain and retain books and records demonstrating the adequacy and appropriateness of the resources utilized and expenditure incurred in order to reflect its compliance with the substance requirements.

Pure equity holding companies – reduced requirements

Pure equity holding companies are subject to a reduced economic substance test, requiring confirmation that:

- the relevant entity has complied with all applicable filing requirements under the Companies Law (2018 Revision) (as amended, the **Companies Law**); and
- has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity interests in other entities.

A **pure equity holding company** is a company that only holds equity participations in other entities and only earns dividends and capital gains.

⁵ For the purposes of the Substance Law, **director**, in relation to an entity, means any director, member or other person in whom the management of the entity is vested.

The Guidance states that a pure equity holding company may engage its registered office service provider in the Cayman Islands to satisfy this reduced economic substance test where the relevant entity is passively holding equity interests in other entities.

IP businesses

As the risk of artificial profit shifting is considered to be greater, the Substance Law contains a rebuttable presumption that a relevant entity which conducts high risk IP business will not meet the economic substance test for a financial year.

Relevant entities in liquidation

The economic substance test applies to relevant entities for so long as they are in existence. If a relevant entity is in liquidation, it must satisfy the economic substance test in respect of any period in which it carries on a relevant activity. However, the economic substance test will not apply once the entity ceases to carry on a relevant activity and reporting (see below) will not be required for any period in which relevant activities were not carried out.

Outsourcing

The Substance Law recognises that relevant entities may use service providers located in the Cayman Islands to carry out activities on their behalf, stating that a relevant entity satisfies the economic substance test in relation to a relevant activity if its Cayman Islands CIGA in relation to that relevant activity are conducted by another person and the relevant entity is able to monitor and control the carrying out of those activities by that other person. However, a relevant entity must not use outsourcing to circumvent the economic substance test.

Outsourcing in this context includes outsourcing, contracting or delegating to third parties or to entities within the same group.

When do the economic substance requirements apply?

Pursuant to the International Tax Co-operation (Economic Substance) (Prescribed Dates) Regulations, 2018:

- the economic substance requirements apply to legal entities formed or incorporated on or after 1 January 2019 with immediate effect; and
- legal entities existing prior to 1 January 2019 must comply with the economic substance requirements by 1 July 2019.

Reporting/filing obligations

All relevant entities

Each relevant entity will be required to notify the TIA annually of:

- whether or not it is carrying on a relevant activity;
- if the relevant entity is carrying on a relevant activity, whether all or any part of the entity's gross income in relation to that relevant activity is subject to tax outside the Cayman Islands and, if so provide appropriate evidence; and
- its financial year end.

The filing obligation will commence in 2020 in respect of the financial year commencing in 2019 and the TIA will develop and launch a portal to facilitate electronic notification and reporting in accordance with the Substance Law.

Relevant entities will also be obliged to provide the TIA with such other information as the TIA may require in order to make an assessment or determination regarding economic substance.

Relevant entities subject to the economic substance test

Relevant entities which carry on a relevant activity and are required to satisfy the economic substance test will be required to prepare an annual report providing details of the entity's activities, income, location and employees, in order to allow the TIA to assess whether that company meets the economic substance requirements with respect to the relevant activity carried on by that entity.

The economic substance report must be prepared and submitted to TIA annually, within 12 months of the entity's financial year end, initially with respect to the financial year commencing on or after 1 January 2019.

Companies which keep their books of account overseas

In addition, the Companies Law has been amended to require companies which keep their books of account outside the Cayman Islands to provide its registered office with additional information regarding its books of account at least annually. The exact nature of this requirement is yet to be confirmed, but failure to comply will lead to the incurrence of initial and daily penalties.

This requirement will not apply to companies which file accounting information with CIMA pursuant to a regulatory law, including mutual funds registered or otherwise regulated under the Mutual Funds Law.

Penalties

Failure to meet the economic substance test in respect of a financial year may lead to a fine of up to CI\$10,000 (approximately US\$12,195). Continued failure to meet the test in the following year could lead to an additional penalty of up to CI\$100,000 (approximately US\$121,951), and possibly being struck from the Register.

It is an offence to fail to provide information requested by the TIA without reasonable excuse, or to knowingly or wilfully alter, destroy, hide or remove any such information, punishable by a fine of up to CI\$10,000 (approximately US\$12,195) and/or up to two years' imprisonment. It is also an offence to knowingly or wilfully supply false or misleading information to the TIA, punishable by a fine of up to CI\$10,000 (approximately US\$12,195) and/or up to five years' imprisonment.

The Substance Law also contains vicarious liability provisions relating to offences committed by bodies corporate with the consent or connivance of, or due to any neglect on the part of, any director, member, manager, secretary or other officer. In such circumstances, the relevant director, member, manager, secretary or officer commits the same offence as the body corporate and is liable to be proceeded against and punished accordingly.

Information sharing

Where a relevant entity fails the economic substance test, the TIA will systematically provide the economic substance information filed with it to:

- the competent authority in the jurisdiction in which the parent company, ultimate parent company and ultimate beneficial owner of the relevant entity resides; and
- in the case of a relevant entity incorporated or formed outside the Cayman Islands, the competent authority in the jurisdiction of incorporation/formation.

Economic substance information is also to be shared in relation to relevant entities which conduct high risk IP business.

Contacts

To find out more, please get in touch with your usual Mourant contact or, alternatively, get in touch with one of the specific contacts named below.



Hayden Isbister
Managing Partner, Mourant Ozannes
Cayman Islands
+1 345 814 9125
hayden.isbister@mourant.com



Paul Christopher
Managing Partner, Mourant Ozannes
Hong Kong
+852 3995 5700
paul.christopher@mourant.com



Robert Duggan
Managing Partner, Mourant Ozannes
London
+44 20 7796 7622
robert.duggan@mourant.com

This update is only intended to give a summary and general overview of the subject matter. It is not intended to be comprehensive and does not constitute, and should not be taken to be, legal advice. If you would like legal advice or further information on any issue raised by this update, please get in touch with one of your usual contacts. © 2019 MOURANT OZANNES ALL RIGHTS RESERVED