

Cayman Islands Economic Substance Requirements

May 2019

In common with numerous other international financial centres, including the Bahamas, the British Virgin Islands, Guernsey, Jersey and the Isle of Man, at the beginning of this year the Cayman Islands passed legislation to introduce new substance requirements for certain Cayman Islands entities. These requirements are the latest in a series of steps taken by the jurisdiction to meet its 2017 commitment as an Inclusive Framework member under the Organisation for Economic Co-operation and Development's (OECD) global Base Erosion and Profit Shifting (BEPS) initiative, and corresponding European Union (EU) requirements encompassing no or nominal tax jurisdictions.

In simple terms, the legislation requires in-scope Cayman Islands entities that are carrying on particular activities to be able to demonstrate economic substance in the Cayman Islands.

The New Legislation

On 1 January 2019, two new laws in the Cayman Islands came into force: The International Tax Co-operation (Economic Substance) Law, 2018, and The International Tax Co-operation (Economic Substance) (Prescribed Date) Regulations, 2018 (together the "Law"). On 22 February the Law was amended by the publication of The International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2019 (the "Regulations" and together with the Law the "ES Law"), and the first version of the Guidance on Economic Substance for Geographically Mobile Activities (the "Guidance") was issued. A copy of the ES Law and Guidance can be found at www.tia.gov.ky/pdf/Economic_Substance.pdf. The ES Law was enacted after

an extensive process of consultation with the EU Code of Conduct Group, the OECD and Cayman stakeholders.

Relevant Entities

The new economic substance regime applies to "relevant entities". A "relevant entity" is:

- a company, other than a domestic company, that is: (i) incorporated under the Cayman Islands Companies Law; or (ii) a limited liability company registered under the Cayman Islands Limited Liability Companies Law;
- a Cayman Islands limited liability partnership; and
- a foreign company registered in the Cayman Islands.

The following Cayman Island entities are not "relevant entities":

- entities without separate legal personality (such as certain forms of partnership or trusts);
- investment funds; and
- an entity that is tax resident outside the Cayman Islands.

Relevant Activities

A relevant entity is only in scope of the economic substance requirements if it conducts any "relevant activity". The ES Law defines relevant activities as occurring in nine business sectors:

- Banking business
- Distribution and service center business
- Financing and leasing business

- Fund management business
- Headquarters business
- Holding company business
- Insurance business
- Intellectual property business
- Shipping business

Each of the above relevant activities is defined in the ES Law and supplemented in the Guidance.

Economic Substance

The Test

Relevant entities that carry on relevant activities must satisfy the economic substance test.

In general to satisfy the economic substance test in relation to a relevant activity, a relevant entity must:

- conduct core income generating activities (CIGAs) in the Cayman Islands (the ES Law defines CIGAs as activities that are of central importance to a relevant entity in terms of generating income and that are being carried out in the Cayman Islands);
- be “directed and managed” in an appropriate manner in the Cayman Islands in relation to that relevant activity; and
- having regard to the level of relevant 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 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.

Directed and Managed – What Does It Mean?

The ES 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 directors, as a whole, has the appropriate knowledge and expertise to discharge its duties as a board;

- meetings of the board are held in the Cayman Islands at adequate frequencies given the level of decision making required, and that a quorum of the board of directors is present on the Island at such meetings;
- minutes of such board meetings record the strategic decisions made at these meetings; and
- all board minutes and appropriate records are retained in the Cayman Islands.

The published Guidance on satisfying the economic substance test includes material on the meaning of “adequate” and “appropriate”. Rather than providing a prescriptive formula, the Guidance states that what is adequate or appropriate for each relevant entity will be dependent on the particular facts of the relevant entity and its business activity. A relevant entity will therefore be required to maintain and retain appropriate records to demonstrate the adequacy and appropriateness of the resources utilized in the Cayman Islands and expenditures incurred.

The Test and Holding Company Business

Holding companies which only hold equity participations in other entities and only earn dividends and capital gains are subject to a reduced substance test. Under this they must confirm that:

- the relevant entity has complied with all applicable filing requirements under Cayman Islands Companies Law; and
- has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity interests in other entities.

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.

The Test and Intellectual Property Business

Relevant entities carrying on high-risk intellectual property business are subject to a higher burden of proof in demonstrating they maintain adequate economic substance in the Cayman Islands.

The Test and Liquidation

The economic substance test applies to a relevant entity for as long as it exists. 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. The economic substance test will not apply once the entity ceases to carry on a relevant activity and filing will not be required for any period in which relevant activities were not carried out.

Compliance, Filing and Penalties

The ES Law provides a timetable for compliance and filing as well as outlining the penalties for non-compliance.

Compliance and Filing

- Relevant entities in existence prior to 1 January 2019 must satisfy the economic substance test in relation to a relevant activity by 1 July 2019.
- Relevant entities formed on or after 1 January 2019 must satisfy the economic substance test in relation to a relevant activity from the date on which the relevant entity commences the relevant activity.

Starting in 2020, relevant entities will be required to file a notice with the Cayman Islands Tax Information Authority (TIA) stating whether or not they are carrying out relevant activities. We understand that the TIA will develop and launch a portal to facilitate electronic notification and reporting in accordance with the ES Law.

Twelve months after the last day of the end of each financial year commencing on or after 1 January 2019, a relevant entity carrying out any relevant activity will be required to file a return setting out details of income, expenses, assets, management, employees, physical presence and other matters. These filings will be examined by the TIA to ensure that the relevant entity has adequate economic substance in the Cayman Islands.

In addition, the Cayman Islands Companies Law has been amended to require companies that keep their accounting records outside the Cayman Islands to provide their registered office with additional information regarding the records at least annually. The exact nature of this requirement is yet to be confirmed, but failure to comply will lead to daily penalties. This requirement will not apply to

companies that file accounting information with the Cayman Islands Monetary Authority (CIMA) pursuant to a regulatory law.

Penalties

The penalty for failure to satisfy the economic substance test in a financial year is US\$12,200. The penalty for failure to satisfy the economic substance test in the subsequent financial year is US\$122,000, and possibly being struck off from the Register.

What Next?

It is envisaged that the ES Law and Guidance will evolve over the coming months. The ES Law makes provision that further regulations can be issued from time to time to prescribe and amend certain matters of the ES Law. 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 likely to change in the future. It is also expected that certain practical aspects of the economic substance requirements will be further clarified by additional Guidance in due course.

Responsibility for compliance with the ES Law rests with the directors of companies and the general partners of limited liability partnerships. All companies and limited liability partnerships that fall within the scope of the ES Law should start to evaluate whether or not they are tax resident in the Cayman Islands (or elsewhere) and whether they are engaged in any relevant activity to determine what measures, if any, they might need to take in order to achieve compliance. Legal advice should be sought if required for further direction on the legal aspects of the ES Law and Guidance. We can refer you to legal counsel as you may require. We can also work with your legal counsel to implement solutions if your entity is impacted by the ES Law.

A further update will be provided when more information is received on the ES Law and Guidance, as well as the practicalities of us reporting as the registered office of your entity. If you have questions in relation to the new substance requirements, or require assistance, please contact your usual Trident Trust representative or [Louise MacDougall](#) in our Cayman office.

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