

CAYMAN ISLANDS IMPLEMENTATION OF THE OECD ECONOMIC SUBSTANCE RULES

January 2019

The Cayman Islands introduced the *International Tax Cooperation (Economic Substance) Law, 2018* ("**ES Law**") to implement the economic substance standards of Action 5 of the OECD Base Erosion and Profit Shifting ("**BEPS**") initiative.¹ These economic substance standards are being implemented by 100-plus countries under the auspices of the OECD's Inclusive Framework on BEPS and apply, in the context of certain specified categories of 'geographically mobile' business activity, both to preferential regimes of those countries that target such activity for tax benefits and, by virtue of a November 2018 decision of the OECD, to countries that have uniform nominal or zero rates of corporate taxation.

The objective of the OECD economic substance standards is to realign the taxation of profits with the substantial activity generating them, that is, ensure that a taxpayer only be permitted to benefit from preferential, low or zero corporate tax treatment to the extent that the core income-generating activity producing the relevant business income is undertaken in the jurisdiction providing the tax benefit.

The ES Law came into force on 1 January 2019 and applies to 'relevant entities' engaged in one of nine specified 'relevant activities', as further described below. An in-scope entity formed on or after 1 January 2019 is required to satisfy the economic substance test under the ES Law from the date on which it commences the relevant activity time and an in-scope entity in existence prior to 1 January 2019, from 1 July 2019. Guidance in respect of the ES Law requirements is under development by the Cayman Islands Tax Information Authority (the "**Authority**"), in consultation with industry, and is expected to be issued in February 2019. Therefore, the information below is preliminary in certain respects and subject to refinement once the Guidance has been issued.

Scope of the economic substance rules

The ES Law requires a 'relevant entity' that carries on a 'relevant activity' to satisfy the 'economic substance test' set out in section 4 of the ES Law and make certain compliance-related filings to the Authority. These key terms are defined below. An entity must be both a 'relevant entity' and carrying on a 'relevant activity' to be within scope of the ES Law.

A. What is a 'relevant entity'?

Subject to certain exclusions, a 'relevant entity' is –

- i) a company incorporated under the *Companies Law (2018 Revision)* or a limited liability company registered under the *Limited Liability Companies Law (2018 Revision)*;
- ii) a limited liability partnership that is registered in accordance with the *Limited Liability Partnership Law, 2017*; or
- iii) a company that is incorporated outside of the Islands and registered under the *Companies Law (2018 Revision)* (i.e. a foreign company registered under Part IX of that Law).

Exclusions

¹ The BEPS initiative focuses on business taxation and BEPS Action 5 is: *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*.

There are three categories of exclusion:

- i) a company under i) above that is a domestic company, provided it is not part of a multinational group with group revenue of US\$850m or more;
- ii) any entity in i) to iii) above that is centrally managed and controlled in a jurisdiction outside the Islands and is tax resident outside the Islands; and
- iii) an investment fund.²

A 'domestic company' means a company that is one of the following – ³

- i) a company carrying on business in the Islands and which complies with section 4(1) of the *Local Companies Control Law (2015 Revision)* or section 3(a) of the *Trade and Business Licensing Law (2018 Revision)*;
- ii) a company under the *Companies Law (2018 Revision)* that is a company limited by guarantee or an association not for profit; or
- iii) a subsidiary of any of i) and ii) above.

B. What is a 'relevant activity'?

A 'relevant activity' is –

- i) banking business;
- ii) distribution and service centre business;
- iii) financing and leasing business;
- iv) fund management business;
- v) headquarters business;
- vi) holding company business;
- vii) insurance business;
- viii) intellectual property business; or
- ix) shipping business;

but does not include investment fund business. These activity categories (including investment fund business) are defined individually in the ES Law.⁴

C. What is the 'economic substance test'?

A relevant entity carrying on a relevant activity satisfies the economic substance test if it –

- conducts Cayman Islands 'core income generating activities' ("**CIGA**") in relation to the relevant activity being undertaken;
- is directed and managed in an appropriate manner in the Islands; and
- having regard to the level of income derived from the relevant activity carried out in the Islands (i.e. Cayman Islands CIGA) -
 - o has an adequate amount of operating expenditure incurred in the Islands;
 - o has an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Islands; and

² 'Investment fund' is defined to include any type of fund, not just a 'mutual fund' as defined under the Mutual Funds Law, and includes any entity through which an investment fund directly or indirectly invests or operates. In addition to not being a relevant entity, the business of an investment fund is excluded from the definition of 'relevant activity'.

³ A Special Economic Zone ("**SEZ**") company does not come within the definition of 'domestic company'.

⁴ In particular, it should be noted that: i) only distribution and service centre business that is being undertaken in a group construct is captured, and ii) holding company business is restricted to a company that only holds equity participations in other entities and only earns dividends and capital gains. Such holding company must be something that is not an investment fund, as investment fund business is not a relevant activity.

- o has an adequate number of full-time employees or other personnel with appropriate qualifications in the Islands.

Where a relevant entity conducts more than one relevant activity, the economic substance test must be satisfied in relation to each such activity.⁵

'Cayman Islands CIGA' means activities conducted in the Cayman Islands that are of central importance to the generation of income from the relevant activity and the ES Law sets out in loose terms the types of activity that are included in CIGA in respect of each of the nine categories of relevant activity. It is not necessary for all the types of CIGA specified in relation to a relevant activity to be performed in order to satisfy the economic substance test and it is permitted to outsource CIGA provided that it is still undertaken in the Islands and is able to be monitored and controlled by the relevant entity outsourcer.⁶

In relation to the 'directed and managed' limb of the test, the ES Law provides that a relevant entity complies with this limb if – ⁷

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

It is not required that the any of the directors be Cayman Islands persons.

The ES Law provides that what is 'adequate' or 'appropriate' is to be construed in accordance with the Guidance issued by the Authority. It is not expected that the Guidance will be prescriptive in this regard or adopt a 'one size fits all' approach but will rather allow a commercially reasonable determination based on the specific facts and circumstances of the relevant activity being undertaken. In particular, given the significant overlap between the economic substance requirements and the requirements for licensing under the regulatory laws, it is expected that a relevant entity conducting a relevant activity that requires it to be, separately, licensed by the Cayman Islands Monetary Authority (being banking business, fund management business and insurance business) will by virtue of such licensing be well-placed to easily satisfy the economic substance test.

In-scope entities that are Special Economic Zone ("SEZ") companies, by virtue of the in-built facilities provided to such companies and ease of access to work permits for staff, will be reasonably placed to satisfy the economic substance test, with the caveat that the administrative/clerical staff provided by the SEZ, as they would not be undertaking CIGA, would not be able to be taken into account for the purposes of the 'adequate' employees/personnel element of the economic substance test.⁸

Special rules

Holding company business is subject to a reduced economic substance test, which is satisfied if the relevant entity confirms that -

⁵ Satisfaction of the economic substance test will not cause an exempted company to be in breach of s.174 of the *Companies Law*.

⁶ Nothing in the ES Law restricts or prevents the outsourcing outside of the Cayman Islands of any activity that is not Cayman Islands CIGA

⁷ Note that the annual compliance return (see below) addresses the board requirements by way of a general declaration and does not seek details; however, the Authority has the power to obtain supporting information from a relevant entity on request.

⁸ However, the cost of services and facilities provided by the SEZ would be counted as operating expenditure.

- it has complied with all applicable filing requirements under the *Companies Law (2018 Revision)*; and
- it has adequate human resources and adequate premises in the Islands for holding and managing equity participations in other entities.

High risk intellectual property business as defined in the ES Law is subject to an enhanced economic substance test i.e. a relevant entity conducting such business will be presumed not to satisfy the economic substance test unless it provides detailed evidence that it maintained active control over the development, exploitation, enhancement, maintenance and protection of the intellectual property asset.⁹

Notification and reporting obligations for entities within scope

In-scope entities must make to the Authority:

- i) an annual notification filing, starting in 2020, notifying the Authority of: a) the relevant activity carried on, b) whether or not all or any part of the relevant entity's gross income derived from the relevant activity is subject to tax in a jurisdiction outside the Islands, and if so, provide appropriate supporting evidence as may be required by the Authority, and c) the date of the financial year end; and
- ii) an annual report, for the purpose of the Authority's determination of the relevant entity's satisfaction of the economic substance test, within 12 months of the each financial year end of the relevant entity commencing on or after 1 January 2019, containing the details specified in the ES Law, as relevant to the business activity conducted.

It is expected that the Authority will establish a dedicated electronic portal for these filings and publish a user guide for the portal.

Enforcement

If the Authority determines that a relevant entity that is required to satisfy the economic substance test in relation to a relevant activity has failed to satisfy such test for a financial year, the Authority is required to issue a notice to the relevant entity notifying it of such determination, giving the reasons, details regarding any penalty, directing any action to be taken to satisfy the test and advising of the relevant entity's right to appeal. Failure to satisfy the economic substance test attracts an administrative fine of up to \$10,000 or up to \$100,000 if it is not satisfied in the subsequent financial year after the initial notice of failure.

If there are two consecutive years of failure, the Authority will refer the matter to the Registrar of Companies, who shall then apply to the Grand Court, which, if it is satisfied that the entity is an in-scope entity that has failed to satisfy the economic substance test, may such order as it sees fit, including -

- (a) an order requiring the relevant entity to take a specified action, including for the purpose of satisfying such economic substance test; or
- (b) in the case of a relevant entity that is -
 - i) a company, an order that it is a defunct company under Part VI of the *Companies Law*;
 - ii) a limited liability company, an order that it is a defunct company under section 40 of the *Limited Liability Companies Law*; or

⁹ High risk intellectual property business essentially involves intellectual property ("IP") business where the IP asset(s) involved were not created by research & development activity or branding, marketing and distribution activity, as the case may be, undertaken directly by the relevant entity itself.

- iii) a limited liability partnership, an order that the limited liability partnership be struck off as a 'defunct' partnership in accordance with section 31 of the *Limited Liability Partnership Law*.

It is an offence under the ES Law for a person to knowingly or wilfully supply false or misleading information to the Authority, punishable on summary conviction by a fine of up to \$10,000 or by imprisonment for a term of up to five years, or both.

The Authority is empowered to share information provided to it under the ES Law with other competent authorities in respect of in-scope entities that fail to satisfy the economic substance test and in relation to high risk intellectual property business and for other compliance purposes, subject to applicable law.

This client memorandum is intended to provide only general information for the clients and professional contacts of Travers Thorp Alberga. It does not purport to be comprehensive or to render legal advice. Please do not hesitate to contact Travers Thorp Alberga at any time if you have any specific questions or would like more detail on any of the points made in this memorandum.