

# LEGAL ALERT

## Economic Substance requirements for Cayman Islands companies

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The Cayman Islands International Tax Co-operation (Economic Substance) Law, 2018 (the “**Economic Substance Law**”), which is part of the OECD’s global Base Erosion and Profit Shifting (BEPS) initiative, was passed on 17 December 2018 and came into effect on 1 January 2019. The Economic Substance Law will be implemented, including by further regulations and guidance to be provided, by the Cayman Islands Tax Information Authority (“**TIA**”). All international offshore financial centres (including Bermuda, BVI, Jersey, Guernsey and Hong Kong) already have or will implement similar legislation.

### To whom does the new Economic Substance Law apply?

All companies incorporated under the Companies Law (2018 Revision) (the “**Companies Law**”), limited liability companies registered under the Limited Liability Companies Law (2018 Revision) (the “**LLC Law**”), limited liability partnerships registered in accordance with the Limited Liability Partnership Law (2018 Revision) (the “**LLP Law**”), or companies incorporated outside of the Cayman Islands and registered under the Companies Law, which are registered as *exempted* will fall under the scope of the new Economic Substance Law (collectively referred to as “**Relevant Entities**”).

Relevant Entities which carry out certain activities (defined as “**Relevant Activities**”) will have several reporting obligations and will be required to satisfy an economic substance test in relation to each Relevant Activity carried out. As defined in Schedule 2 of the Economic Substance Law, the Relevant Activities are (i) banking<sup>1</sup> (ii) distribution and service centre<sup>2</sup>, (iii) financing and leasing<sup>3</sup>, (iv) fund management<sup>4</sup>, (v) headquarters business<sup>5</sup>, (vi) holding company, (vi) insurance, (vii) intellectual property (IP)<sup>6</sup>, and (viii) shipping.

In this Alert, we highlight the principal requirements and obligations imposed on Relevant Entities under the Economic Substance Law, which is applicable to existing Relevant Entities from 1<sup>st</sup> July 2019, and immediately applicable for newly created entities<sup>7</sup>. Existing Relevant Entities have accordingly been granted a six (6) months transitional period to review their activities and corporate organization in the Cayman Islands and determine what (if any) steps are needed for compliance purposes. Further guidance will be provided by the TIA on certain aspects as indicated below.

### Who are excluded from the application of the new Economic Substance Law?

The new Economic Substance Law will not apply to Relevant Entities where:

- i. their business is centrally managed and controlled in a jurisdiction outside the Cayman Islands and the Relevant Entities themselves are a tax resident of another jurisdiction; or
- ii. the Relevant Entities are investment funds or an investment vehicle (SPVs)<sup>8</sup>.

## Main Requirements and Obligations of the new Economic Substance Law

**1. Relevant Entities are required to satisfy an economic substance test with respect to each Relevant Activity carried out by them.** Section 4 of the Economic Substance Law sets out the specific requirements which have to be met in order to satisfy the economic substance test, as follows:

- (a) The Relevant Entity is required to conduct Cayman Islands core income generating activities (“**CIGAs**”) in relation to that Relevant Activity. CIGAs are defined as being activities which are of central importance in terms of generating income and which are being carried out in the Cayman Islands. Specific examples of such activities are included for each Relevant Activity. For example, in relation to fund management business, such activities include making investment decisions (i.e. regarding holding or selling investments), calculating risk and reserves, making decisions on currency or interest fluctuations and hedging positions, preparing reports or returns, or both, to investors or to the Cayman Islands Monetary Authority (“**CIMA**”), or both. In relation to headquarters business, such activities include making relevant management decisions, incurring expenditures on behalf of group entities, and coordinating group activities. In relation to intellectual property business, such activities include research and development and/or branding, marketing and distribution, and in certain cases making strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the IP, to acquisition by third parties and subsequent exploitation and protection of the IP, and/or carrying on the underlying trading activities through which IP rights are exploited.
- (b) The Relevant Entity is required to be directed and managed in an appropriate manner in the Cayman Islands in relation to that Relevant Activity. The specific requirements with respect to management are:
  - i. the board of directors, as a whole, should have the appropriate knowledge and expertise to discharge its duties as a board of directors<sup>9</sup>;
  - ii. meetings of the board of directors should be held in the Cayman Islands at adequate frequencies given the level of decision making required;
  - iii. during a meeting of the board of directors a quorum of directors should be present in the Cayman Islands for such meetings<sup>10</sup>;
  - iv. the minutes of the meetings of the board of directors should record the making of strategic decisions at the meeting; and
  - v. the minutes of all meetings of the board of directors and appropriate records should be kept in the Cayman Islands.
- (c) Having regard to the level of relevant income derived from the Relevant Activity carried out in the Cayman Islands:
  - i. the books of the Relevant Entity should record an adequate amount of operating expenditure incurred in the Cayman Islands;
  - ii. the Relevant Entity should have an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and

- iii. the Relevant Entity should have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

*Service Provider Arrangements* - The Relevant Entity may also satisfy the economic substance test if its CIGAs are conducted by another person in the Cayman Islands, provided that the Relevant Entity is able to monitor and control the carrying out of the CIGAs by such other person. Service provider arrangements may therefore be used for purposes of maintaining a sufficient physical presence in the Cayman Islands.

Also, provisions have been included for holding companies (including intellectual property holding companies), taking account of the specific nature of their activities.

Finally, further guidance will be issued by TIA on satisfying the economic substance test.

**2. Relevant Entities are required to report to TIA on an annual basis.** Relevant Entities will be required to notify the TIA annually<sup>11</sup> as (i) to whether or not they are carrying on one or more Relevant Activities, (ii) if any portion of the gross related income is taxed in any jurisdiction outside of the Cayman Islands<sup>12</sup>, and (iii) the date of the end of their financial year. Relevant Entities will also be required, within twelve (12) months after the end of each financial year commencing on or after 1 January 2019<sup>13</sup>, to make a detailed annual report to the TIA<sup>14</sup> regarding any Relevant Activities carried out during the year, which will include information with respect to income, assets, expenses, location of the business in the Cayman Islands, employees, CIGAs, information with respect to the group (if applicable), as well as certain other information if the Relevant Activity is defined as a high risk intellectual property business. In addition, the TIA has authority to request further information and the Relevant Entities have an obligation to provide such further information, and also retain all records related to the economic substance test for a period of six (6) years.

### **3. Relevant Entities which fail to report or provide information or are deemed by TIA not to satisfy the economic substance test will be sanctioned.**

If a Relevant Entity fails, in the determination of the TIA, to satisfy the economic substance test for a financial year, TIA will issue a notice to that effect<sup>15</sup>, advise the Relevant Entity of what actions would be required, and impose a penalty of CI\$10,000 (approximately USD\$12,200), to be paid within twenty-eight (28) days after the date of issue of the notice. If the TIA determines that such Relevant Entity has failed the economic substance test for the following year as well, then a further notice with an increased penalty of CI\$100,000 (approximately USD\$122,000) is issued and a report is filed by the TIA with the Registrar of Companies (which is then required by law to apply to the Grand Court to have an order issued against the Relevant Entity or have it declared defunct<sup>16</sup>). The TIA's decisions are subject to appeal<sup>17</sup>.

Directors, managers or managing members of Relevant Entities may also be liable for offenses, including in case of neglecting their duties<sup>18</sup>. Finally, persons failing to provide information upon a request by the TIA or which knowingly or wilfully alter, destroy or remove information commit an offence and are liable on summary conviction to a fine of CI\$10,000 (approximately USD\$12,200) or to imprisonment for a term of two (2) years, or to both<sup>19</sup>.

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<sup>1</sup> Banking is defined by reference to Section 2 of the Cayman Islands Banks and Trust Companies Law (2018 Revision), according to which banking is 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.

<sup>2</sup> Distribution and service centre business means either or both 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, and/or providing services to an entity in the same group in connection with the business outside the Cayman Islands.

<sup>3</sup> Financing and leasing means 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.

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<sup>4</sup> Fund management means the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2015 Revision) (“SIBL”), carried on by a Relevant Entity licensed under SIBL for an investment fund.

<sup>5</sup> Headquarters business means providing, to an entity in the same group, senior management services, assumption or control of material risk for activities carried out, or the provision of substantive advice in connection with the assumption or control of risk.

<sup>6</sup> Intellectual property business means holding, exploiting or receiving income from intellectual property assets, i.e. an intellectual property right including a copyright, design right, patent and trademark.

<sup>7</sup> See The International Tax Co-operation (Economic Substance) (Prescribed Dates) Regulations, 2018.

<sup>8</sup> For the purposes of the Economic Substance Law, an “investment fund” means 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, but does not include a person licensed under the Cayman Islands Banks and Trust Companies Law (2018 Revision) or the Cayman Islands Insurance Law, 2010, or a person registered under the Cayman Islands Building Societies Law (2014 Revision) or the Cayman Islands Friendly Societies Law (1998 Revision).

<sup>9</sup> It is, however, unclear on what basis the TIA would be able to decide if this requirement is met. It is likely that for any entities already licensed by CIMA this requirement would be deemed as having been met.

<sup>10</sup> The Companies Law is generally permissive of Board meetings in any video- or conference call format and typically does not require a certain frequency for meetings. Due to the new requirements set out by the Section 4(3) of the Economic Substance Law, the Memorandum and Articles of Association of the relevant Entities may need to be amended on these aspects. For LLCs and partnerships, these new requirements would be adjusted based on the corporate governance structure of such entities.

<sup>11</sup> Section 7(1) of the Economic Substance Law

<sup>12</sup> Evidence to be provided to TIA to support such declaration of tax residence.

<sup>13</sup> See The International Tax Co-operation (Economic Substance) (Prescribed Dates) Regulations, 2018.

<sup>14</sup> Sections 7(3) and 7(4) of the Economic Substance Law

<sup>15</sup> Section 8(1) of the Economic Substance Law

<sup>16</sup> Sections 8(10) and 8(11) of the Economic Substance Law

<sup>17</sup> Section 8(9) of the Economic Substance Law

<sup>18</sup> Section 14 of the Economic Substance Law

<sup>19</sup> Section 7(9) of the Economic Substance Law