

IT'S TIME FOR CAYMAN SHELL ENTITIES TO COME OUT OF THEIR SHELLS AND SHOW ECONOMIC SUBSTANCE

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INTRODUCTION

In response to the O.E.C.D.'s B.E.P.S. recommendations and the conclusions and concerns identified by the E.U. Code of Conduct Group of Business Taxation, the Cayman Islands enacted the International Tax Cooperation (Economic Substance) Law, 2018 ("E.S. Law") on December 27, 2018. The law was supplemented by the Economic Substance for Geographically Mobile Activities Guidance (the "Guidance") released on February 22, 2019.¹

The Cayman Islands, being one of the O.E.C.D.-compliant "no or only nominal tax" jurisdictions, committed to take active steps to change its tax regime in order to stay out of the E.U.'s list of non-cooperative jurisdictions for tax purposes.

The E.S. Law was designed to address offshore structures attracting profits to the Islands and mandate economic substance there. The E.S. Law identifies "Relevant Entities" who conduct "Relevant Activities" and applies the law only to these entities. Notification and reporting obligations also apply.

To satisfy the economic substance test contained in the law, these entities must show that they undertake sufficient income generating activities and have sufficient operating expenditures, physical presence, and full-time employees to substantiate an economic nexus in the Cayman Islands.

OVERVIEW

Generally, the E.S. Law provides that certain entities (*i.e.*, Relevant Entities) that carry out identified business activities (*i.e.*, Relevant Activities) in the Cayman Islands must comply with the following:

- Each Relevant Activity must have adequate economic substance (explained below).
- The core income generating activities ("C.I.G. Activities") in relation to the Relevant Activities must be carried out in the Islands.
- Each Relevant Entity must comply with reporting requirements to demonstrate adherence to the E.S. Law.

Relevant Entities carrying on more than one Relevant Activity must satisfy the requirements separately in relation to each Relevant Activity.

¹ Reference to the E.S. Law throughout this article includes the Guidance.

WHAT ENTITIES FALL WITHIN THE AMBIT OF THE E.S. LAW?

A Relevant Entity is any of the following entities:

- A company that is incorporated under the Companies Law (2018 Revision) or a limited liability company (“L.L.C.”) registered under the Limited Liability Companies Law (2018 Revision)
- A limited liability partnership (“L.L.P.”) registered in accordance with the Limited Liability Partnership Law, 2017
- A company incorporated outside the Cayman Islands and registered under the Companies Law (2018 Revision)

WHAT ENTITIES ARE EXEMPT?

The E.S. Law does not apply to domestic Cayman Islands corporations, investment funds, or entities that are tax resident outside the Cayman Islands.²

A domestic company is a company that is engaged in a business in the Cayman Islands and complies with the local laws.³ However, a company that meets the above requirement but is a part of a multinational enterprise (“M.N.E.”) Group (*i.e.*, a group with annual revenues of at least \$850 million) is not a domestic company. Also, a company not carrying on any business is not a domestic company even if it complies with the local laws.

An investment fund means an entity in the business of operating as an investment fund. The principal business of an investment fund is the issuing of investment interests (*i.e.*, shares, trust units, partnership interests, or other rights carrying an entitlement to participate in the profits or gains of the entity) to raise funds with the aim of enabling the holder of the interest to benefit from the profits or gains from the entity’s acquisition, holding, management, or disposal of investments. Mutual funds licensed or registered with the Cayman Islands Monetary Authority are also treated as investment funds.

A company, L.L.C. or L.L.P. that is incorporated or established in the Cayman Islands and is a tax resident in another jurisdiction is not subject to the E.S. Law if it produces satisfactory evidence to substantiate the claim (*e.g.*, the tax identification number, tax residence certificate, and evidence of assessment or payment of a tax liability as well as details of the details of its parent company, ultimate parent company, and ultimate beneficial owners, including their respective jurisdictions of tax residence).

WHAT ARE THE IDENTIFIED BUSINESS ACTIVITIES UNDER THE E.S. LAW?

A Relevant Entity must be engaged in a Relevant Activity for the E.S. Law to apply.

² Section II.A.2 of the Guidance.

³ Section 4(1) of the Local Companies (Control) Law (2015 Revision) or Section 3(a) of the Trade and Business Licensing Law (2018 Revision).

A Relevant Activity includes each of the following:⁴

- 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

As mentioned earlier, the C.I.G. Activities in relation to the Relevant Activities must be carried out in the Cayman Islands. The C.I.G. Activities are activities that are of central importance to a Relevant Entity in terms of generating income.⁵ It is not necessary for the Relevant Entity to perform every C.I.G. Activity with respect to a Relevant Activity in the Cayman Islands. However, the assessment of whether a Relevant Entity has economic substance in the Cayman Islands will include careful consideration of what elements of the C.I.G. Activities are being carried out by the Relevant Entity in the Cayman Islands.

The Relevant Activities and their associated C.I.G. Activities are shown in the series of tables below:

“The C.I.G. Activities are activities that are of central importance to a Relevant Entity in terms of generating income.”

Relevant activity	Definition	Cayman Islands CIGA
banking business	has the meaning given to that expression by section 2 of the Banks and Trust Companies Law (2018 Revision) <i>[where “banking business” means 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]</i>	(i) raising funds, managing risk including credit, currency and interest risk; (ii) taking hedging positions; (iii) providing loans, credit or other financial services to customers; (iv) managing capital and preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both
distribution and service centre business	means the business of either or both of the following - (a) purchasing from an entity in the same Group - (i) component parts or materials for goods; or (ii) goods ready for sale, and reselling such component parts, materials or goods outside the Islands; (b) providing services to an entity in the same Group in connection with the business outside the Islands, but does not include any activity included in any other relevant activity except holding company business	(i) transporting and storing goods, components and materials; (ii) managing stocks; (iii) taking orders; (iv) providing consulting or other administrative services

⁴ Section II.B of the Guidance.

⁵ Section III.A.2 of the Guidance.

Relevant activity	Definition	Cayman Islands CIGA
financing and leasing business	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, banking business, fund management business or insurance business	(i) negotiating or agreeing funding terms; (ii) identifying and acquiring assets to be leased; (iii) setting the terms and duration of financing or leasing; (iv) monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements
fund management business	means the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2015 Revision) carried on by a relevant entity licensed under that Law for an investment fund <i>["Managing Securities" means managing securities belonging to another person in circumstances involving the exercise of discretion.]</i>	(i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking decisions on currency or interest fluctuations and hedging positions; (iv) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both
Relevant activity	Definition	Cayman Islands CIGA
headquarters business	means the business of providing any of the following services to an entity in the same Group - (a) the provision of senior management; (b) the assumption or control of material risk for activities carried out by any of those entities in the same Group; or (c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b), but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business	(i) taking relevant management decisions; (ii) incurring expenditures on behalf of other entities in the Group; (iii) co-ordinating activities of the Group
holding company business	the business of a pure equity holding company <i>["pure equity holding company" means a company that only holds equity participations in other entities and only earns dividends and capital gains]</i>	all activities related to that business
insurance business	has the meaning given to that expression by section 2 of the Insurance Law, 2010 <i>[where "insurance business" means 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]</i>	(i) predicting or calculating risk or oversight of prediction or calculation of risk; (ii) insuring or re-insuring against risk; (iii) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both
Relevant activity	Definition	Cayman Islands CIGA
intellectual property business	means the business of holding, exploiting or receiving income from intellectual property assets; <i>["intellectual property asset" means an intellectual property right including a copyright, design right, patent and trademark]</i>	(i) where the intellectual property asset is a - (A) patent or an asset that is similar to a patent, research and development; or (B) non-trade or intangible (including a trademark), branding, marketing and distribution (ii) in exceptional cases, except if the relevant activity is a high risk intellectual property business, other core income generating activities relevant to the business and the intellectual property assets, which may include - (A) taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income; (B) taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset; (C) carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties.

Relevant activity	Definition	Cayman Islands CIGA
shipping business	<p>means any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Islands or between the Islands -</p> <p>(a) the business of transporting, by sea, passengers or animals, goods or mail for a charge;</p> <p>(b) the renting or chartering of ships for the purpose described in paragraph (a);</p> <p>(c) the sale of travel tickets and ancillary ticket related services connected with the operation of a ship;</p> <p>(d) 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</p> <p>(e) the functioning as a private seafarer recruitment and placement service,</p> <p>but does not include a holding company business or the operating of a pleasure vessel</p>	<p>(i) managing crew (including hiring, paying and overseeing crew members);</p> <p>(ii) overhauling and maintaining ships;</p> <p>(iii) overseeing and tracking deliveries;</p> <p>(iv) determining what goods to order and when to deliver them, organising and overseeing voyages</p>

WHAT SHOULD A RELEVANT ENTITY DO TO MEET THE ECONOMIC SUBSTANCE TEST?

A Relevant Entity is required to satisfy the economic substance test with respect to each Relevant Activity and is said to do so if the following conditions exist:⁶

- The Relevant Entity conducts some or all the C.I.G. Activities in relation to the Relevant Activity in the Cayman Islands.

The assessment of economic substance in the Cayman Islands will include careful consideration of what elements of the C.I.G. Activities are being carried out in the Cayman Islands.

The economic substance test does not preclude Relevant Entities seeking expert professional advice or engaging the services of specialists in other jurisdictions provided that any activities performed by advisors or specialists in other jurisdictions are not C.I.G. Activities and that the “Relevant Income” is commensurate with the C.I.G. Activity undertaken in the Cayman Islands.

- The Relevant Income (*i.e.*, the income excluded from corporate income tax in the Islands) derived from the Relevant Activity carried out in the Cayman Islands also meets certain thresholds:
 - The Relevant Entity incurs an adequate amount of operating expenditure in the Cayman Islands.
 - It has an adequate physical presence (including a place of business or plant, property, and equipment) in the Islands.
 - It has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

The meanings of the words “adequate” and “appropriate” have not been quantified and are subject to facts and circumstances. The Guidance provides

⁶ Section III.A.1 of the Guidance.



that adequate means “as much or as good as necessary to the relevant requirement or purpose” and that appropriate means “suitable or fitting for a particular purpose.”⁷ No minimum number of employees for a particular level of relevant income is prescribed either generally or for any particular type of Relevant Activity.

- The Relevant Entity is directed and managed in an appropriate manner in the Cayman Islands in relation to that Relevant Activity.

A Relevant Entity is said to be directed and managed in an appropriate manner in the Cayman Islands in relation to a Relevant Activity if certain conditions are met:⁸

- Its board of directors, as a whole, has the appropriate knowledge and expertise to discharge its duties as a board of directors.
- The meetings of the board of directors are held in the Cayman Islands with adequate frequency given the level of decision making required.
- There is a quorum of directors present in the Islands during any such meetings.
- The minutes of those meetings record strategic decision making for the Relevant Entity occurring at the meeting.
- Meeting minutes and appropriate records are kept in the Islands.

This “directed and managed test” is designed to ensure that there are an adequate number of board meetings held and attended in the Cayman Islands (although it is not necessary for all of meetings to be held in the Cayman Islands). What constitutes an adequate number of meetings depends on the Relevant Activities of the company. However, it is generally expected that the majority of board meetings be held in the Cayman Islands.

DO SPECIFIC RELEVANT ENTITIES HAVE REDUCED OR INCREASED REQUIREMENTS?

Yes. Certain Relevant Entities face reduced or increased requirements to meet the local economic substance test.⁹

- A pure equity holding company (defined in the table above) satisfies the economic substance test if it merely complies with all the filing requirements under Companies Law (2018 Revision) and has adequate human resources and premises in the Cayman Islands for holding and managing the equity participations. Furthermore, the entity may engage its registered office service provider to satisfy these reduced requirements if the entity is passively holding equity interests in other entities only.

⁷ Section III.A.3 of the Guidance.

⁸ Section III.A.5 of the Guidance.

⁹ Section III.B of the Guidance.

“C.I.G. Activities must be conducted in the Cayman Islands, and the Relevant Entity should be able to monitor and control the carrying out of the C.I.G. Activities by that other person.”

- A high-risk intellectual property business¹⁰ is presumed not to have met the economic substance test even if the C.I.G. Activities relevant to the business are being carried out in the Islands, unless both the following conditions are met:
 - The Relevant Entity demonstrates that there was a high degree of control over the development, exploitation, maintenance, enhancement, and protection of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Cayman Islands.
 - The Relevant Entity provides sufficient information to the Tax Information Authority (“Authority”) in relation to the financial year to rebut the presumption that it does not have sufficient economic substance. To rebut the presumption, a Relevant Entity with a high-risk intellectual property business must produce materials to demonstrate that development, enhancement, maintenance, protection, and exploitation functions have been under its control, where the business holds, exploits, or receives income from intellectual property assets. Evidential thresholds require further documentation, such as a detailed business plan and employee information (including level of experience), as well as evidence that key and strategic decision-making occurs in the Cayman Islands.

CAN A RELEVANT ENTITY OUTSOURCE C.I.G. ACTIVITIES AND STILL MEET THE ECONOMIC SUBSTANCE TEST?

Yes. A Relevant Entity satisfies the economic substance test in relation to a Relevant Activity even if the related C.I.G. Activities are conducted by any other person.¹¹ However, the C.I.G. Activities must be conducted in the Cayman Islands, and the Relevant Entity should be able to monitor and control the carrying out of the C.I.G. Activities by that other person. Outsourcing, in this context, includes outsourcing, contracting, or delegating to third parties in the Islands or to entities in the same corporate group.

¹⁰ A high-risk intellectual property business means an intellectual property business carried on by one of the following:

- An entity that (i) did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business, (ii) acquired the intellectual property from an entity in the same M.N.E. Group or in consideration for funding research and development by another person situated in a country or territory other than the Islands, and (iii) licenses the intellectual property to one or more entities in the same M.N.E. Group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same M.N.E. Group
- An entity that does not carry out research and development, branding, or distribution as part of its C.I.G. Activities

¹¹ Section III.A.4 of the Guidance.

The Guidance is silent as to whether the C.I.G. Activity can be outsourced to a foreign entity. The Guidance imposes a restriction on the place of performance, not on the residential status of the entity. Therefore, it may be argued that a Relevant Entity meets the economic substance test even if the C.I.G. Activity is outsourced to a foreign affiliate, as long as the activity is performed in the Cayman Islands and the Relevant Entity is able to monitor the activity.

Relevant Entities carrying on banking, insurance, or fund management business will be subject to the Cayman Islands Monetary Authority's "Statement of Guidance: Outsourcing Regulated Entities" in addition to the principles set out above under the economic substance test. Further, outsourced activities other than C.I.G. Activities are not subject to the economic substance test.

WHAT ARE THE REPORTING OBLIGATIONS FOR A RELEVANT ENTITY?

A Relevant Entity carrying on a Relevant Activity is required to prepare and submit a report to the Authority in order for it to determine whether the economic substance test has been satisfied for that Relevant Activity. The report must be made annually within 12 months of the last day of each financial year commencing on or after January 1, 2019.¹² The Guidance provides a long list of information to be provided by the Relevant Entity in the report.

WHAT ARE THE CONSEQUENCES OF FAILURE TO SATISFY THE ECONOMIC SUBSTANCE TEST?

If a Relevant Entity subject to the provisions of the E.S. Law fails to fulfill the economic substance requirements related to a Relevant Activity, the Authority shall inform the Relevant Entity of its failure, the reasons for the determination, the details regarding the penalty (if any), any action to be taken to satisfy the economic substance test, and its right to appeal. The Authority may impose a penalty of \$10,000 or \$100,000 if the entity fails to satisfy the test in the financial year after the initial notice of failure.¹³

WHAT IS THE EFFECTIVE DATE OF THE E.S. LAW?

A relevant entity is required to satisfy the economic substance test¹⁴

- by July 1, 2019, if it was in existence before January 1, 2019, or
- on the date on which it commences the Relevant Activity, if it was not in existence prior to January 1, 2019.

It should be reiterated that the reporting deadline is separate from the deadline for compliance with the economic substance test.

¹² Section IV.B of the Guidance.

¹³ Section V.A of the Guidance.

¹⁴ Section III.A.1 of the Guidance.

CONCLUSION

The guidance published earlier this year is detailed and academic in nature. While it provides for some definitions, it does not offer any practical examples and leaves room for interpretation. Structures that include Relevant Entities must pay immediate attention to the new legislation and determine whether these entities are engaged in Relevant Activities and whether measures must be taken prior to the fast-approaching effective date of July 1, 2019.



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