New guidance issued

In 2016, the European Union (EU) Code of Conduct Group initiated a review of the tax policies of non-EU countries to determine whether they met EU standards of good governance and fair taxation. Subsequently, a number of jurisdictions were required to introduce legislation to make sure that the tax benefits under those regimes (i.e., low or no corporate income tax) were not granted to entities lacking appropriate economic substance. To guide companies, the EU released a scoping paper in June 2018 outlining how economic substance matters might be addressed.

The general principle is that entities within scope of the rules (“relevant entities”) that carry out certain business activities (“relevant activities”) in the jurisdiction must comply with the following requirements: each relevant activity must have adequate economic substance, with its “core income generating activities” carried out in the jurisdiction and those relevant entities must comply with reporting requirements to demonstrate adherence to the rules. Companies that carry on more than one relevant activity must satisfy the requirements in relation to each activity.

The Cayman Islands enacted the International Tax Co-Operation (Economic Substance) Law on 31 December 2018, effective 1 January 2019, with related guidance issued on 22 February 2019. Companies in existence prior to 1 January 2019 have a six-month transition period to comply with the new rules.

How do the Cayman Islands rules apply?

The Cayman Islands Ministry of Finance further issued guidance to assist in understanding the requirements to satisfy the economic substance test, as well as the meaning of “adequate” and “appropriate” for purposes of the law.

Relevant entities

All relevant entities are subject to the economic substance parameters; meaning a company, LLC or LLP, other than a domestic company, that is incorporated under the Companies Law (2018 Revision), Limited Liability Companies Law 2017 or Limited Liability Partnership Law (2018 Revision).

This does not include investment funds or entities that are tax resident outside the Cayman Islands.

► Investment fund business means the business of operating as an investment fund, which is an entity whose principal business is the issuing of investment interests and includes any entity through which an investment fund directly or indirectly invests or operates.

► If a company, LLC or LLP that is incorporated or established in the Cayman Islands is tax resident in another jurisdiction, the Tax Information Authority (the Authority) may exclude this entity from economic substance requirements locally, if it produces satisfactory evidence to substantiate this claim (e.g., tax identification number, tax residence certificate and assessment or payment of a tax liability, as well as details of the ultimate parent company where applicable).

Domestic entities are not relevant entities for purposes of the economic substance test. Please refer to the Cayman guidance issued for the defined terms.
Relevant activities and income

Principal business activities identified within certain industry functions will be considered relevant activities and shall include banking, distribution and service centers, financing and leasing, fund management, headquarters, holding companies, insurance, intellectual property and shipping businesses.

For each of these categories, the various enacted rules define what sort of activities constitute core income-generating activities (CIGA). A relevant entity must conduct Cayman Islands CIGA in the Cayman Islands, as these activities are of crucial importance to a relevant entity for income generation. It is not necessary for the relevant entity to perform every function of a relevant activity within the Cayman Islands, but only those that are key to the business structure and function. Please refer to Table 1, Section III.A.2 of the Cayman guidance. For this purpose, “relevant income” means all the gross income derived from these stated relevant activities.

Provisions are made to allow for outsourcing to other parties, including third parties, within the jurisdiction provided the relevant entity outsourcing the activity retains suitable control and supervision. Outsourcing, in this context, includes outsourcing, contracting or delegating to third parties or to entities in the same group. The relevant entity must demonstrate that it has adequate supervision of the outsourced activities and that those Cayman Islands CIGA are undertaken in the Cayman Islands, i.e., to a local service provider who will perform these functions. Where a Cayman Islands CIGA is outsourced, the resources of the service provider in the Cayman Islands will be taken into consideration when determining whether the people and premises test is met, without double-counting activities.

Upon liquidation, relevant entities shall continue to meet the economic substance rules outlined above, as long as it exists, including the period in which it still carries on the relevant activities and CIGA identified to the Authority.

Economic substance test

The relevant entity satisfies the economic substance test in relation to a relevant activity, if the relevant entity conducts Cayman Islands CIGA and is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity.

To the extent the relevant income is derived from the relevant activities in scope, the entity must also demonstrate these are “adequate” and “appropriate” and in regard to operating expenditures incurred in the Cayman Islands, physical premise and number of full-time employees located in the Cayman Islands. “Adequate” in this case meaning as much is good as necessary to the relevant requirement or purpose and “appropriate” in this case meaning suitable or fitting for a particular purpose. The guidance does not prescribe a minimum number of employees for a particular level of relevant income either generally or for any particular type of relevant activity.

Certain relevant entities will require reduced or increased requirements to meet the local economic substance test:

- **Pure equity holding companies** may adhere to reduced requirements, submit all filing requirements under Companies Law (2018 Revision) and have “adequate” human resources and premise in the Cayman Islands for holding and managing the equity participations. However, the entity may engage its registered office to satisfy the reduced requirements where this entity is passively holding equity interests in other entities only.

- **High-risk intellectual property (IP)** where the business holds, exploits or receives income from intellectual property assets. Evidential thresholds require further documentation for detailed business plan, employee information, including level of experience, as well as evidence that key and strategic decision-making is occurring in the Cayman Islands.
Timeline and next steps

The rules are effective as of 1 January 2019, with a six-month transition period until 1 July 2019. Relevant entities carrying on relevant activities within the Cayman Islands are required to submit formal declaration to the Authority within 12 months after the last day of the financial year commencing on or after 1 January 2019. This declaration will outline whether the entity carries on relevant activities and whether any part of the gross income related to each relevant activity is subject to tax outside the Cayman Islands.

The Authority will specify a time for the required notification and in a manner approved by the Authority (i.e., the Cayman Islands Substance Portal). Submission will be in standardized Organization for Economic Co-operation and Development (OECD) XML Schema for proper exchange mechanisms.

To determine if the relevant entity has met the substance requirements, the Cayman Islands will administer a “principle-based” approach and review process. Failure to comply will result in civil penalties starting at CI $10,000 ($12,000 USD) per relevant entity, with registrar announcement to the Cayman Islands Grand Court after two consecutive years of failure to comply. A six-year limitation period shall apply unless the Authority is not able to make a determination by reason of any material misrepresentation.