

Alert

Cayman Islands Updated Economic Substance Guidance

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Version 3.0 of the Cayman Islands guidance notes (“Guidance”) on the Cayman Islands’ economic substance legislation provides additional assistance in interpreting the International Tax Co-operation (Economic Substance) Law¹ (the “ES Law”).

The Guidance now includes a framework of industry-specific case studies along with an explanation of how the Tax Information Authority (“TIA”) will interpret the ES Law terms “adequate” and “appropriate” in relation to the ES Law’s requirements for economic substance (the “ES Test”, described in more detail below). The release of the Guidance follows a period of industry collaboration and demonstrates the Cayman Islands’ continued commitment to a reputable economic substance regime in line with global standards.

Notification Obligations

“Entities” to notify under the ES Law

The ES Law requires that every “entity” (see below) must notify the TIA annually by way of an Economic Substance Notification (“ESN”) whether or not it is carrying on a “relevant activity” (see below) under the ES Law and if so, whether or not it is a “relevant entity”. The ESN must be filed as a prerequisite to an entity filing its annual return with the Cayman Islands General Registry’s Corporate Administration Portal, in each case by 31 March. Going forward, we strongly recommended that both the ESN and the annual return are filed prior to 31 January each year, otherwise an entity’s ability to obtain a certificate of good standing from the Cayman Islands General Registry authorities will be impaired. Foreign companies must also file an ESN by the same deadline, notwithstanding that such entities are not required to file an annual return.

“Entities” required to file an ESN include all legal persons registered with the Cayman Islands General Registry. This includes companies incorporated under the Companies Law (the “Companies Law”), limited liability companies registered under the Limited Liability Companies Law, limited liability partnerships registered in accordance with the Limited Liability Partnership Law, 2017 and companies incorporated outside of the Cayman Islands and registered under the Companies Law.

Entities that are not Relevant Entities

The Guidance provides that domestic companies, investment funds (including private funds registered under the Private Funds Law, 2020) and entities that are tax resident outside the Cayman Islands are not “relevant entities” for the purposes of the ES Law. These entities are obliged to provide an ESN as outlined above but are not required to satisfy the ES Test.

Under the most recent regulations adopted in amendment of the ES Law, companies limited by guarantee under the Companies Law are no longer exempt from the requirement to meet the ES Test, except in strict circumstances. To be so exempt, a company limited by guarantee must otherwise satisfy the criteria for the definition of “domestic company”, i.e. the company is not part of an MNE Group²

¹ All references to legislation being to the most recent revision of the same, as amended.

² The Guidance states that the term “MNE Group” means any Group that includes two or more enterprises for which the tax residence is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another

and only carries on business in the Cayman Islands in compliance with section 4(1) of the Local Companies (Control) Law, section 3(a) of the Trade and Business Licensing Law, or is registered pursuant to section 80 of the Companies Law (i.e. a “not for profit” company).

Entities tax resident outside the Cayman Islands

An entity that is tax resident outside the Cayman Islands must also disclose the name and address of its immediate and ultimate parents and the ultimate beneficial owner(s) to the TIA. The jurisdiction in which the entity is claiming to be tax resident, and supporting evidence of such, must also be provided.

The TIA is obliged to provide information to a competent authority in the jurisdiction in which an entity states it is tax resident or in which its immediate parent, ultimate parent or ultimate beneficial owner(s) resides as well as to the competent authority of the relevant jurisdiction where the entity is incorporated.

Reporting Obligations for relevant entities carrying on a relevant activity

A relevant entity carrying on a relevant activity³ must report information (“**ES Return**”) electronically via the Cayman Islands Economic Substance Portal in relation to the entity’s satisfaction of the ES Test in relation to that relevant activity. If a relevant entity is carrying on more than one relevant activity, it must satisfy the ES Test in respect of each relevant activity it undertakes and provide supporting details of such in the ES Return. The ES Return must be made within 12 months after the last day of the end of each financial year of the relevant entity commencing on or after 1 January 2019. The Guidance describes the reporting process and the nature of information required to complete the ES Return in more detail.

Relevant entities carrying on relevant activities must also now provide the name and address of the officer who is responsible for providing information to the TIA. At the date of this Alert, the Cayman Islands Department for International Tax Cooperation (“**DITC**”) Portal had not yet been launched, although the TIA has stated it will be launched in Q3 2020 to facilitate electronic reporting to the TIA and its sharing of information with other competent authorities in accordance with the ES Law.

The ES Test remains unchanged and requires that a relevant entity conducting a relevant activity:

- a. conducts core income generating activities (“**CIGA**”) in relation to that relevant activity;
- b. is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity; and
- c. having regard to the level of relevant income derived from the relevant activity carried out in the Islands, has an adequate –
 - i. amount of operating expenditure incurred in the Cayman Islands;
 - ii. physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
 - iii. number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

The TIA may impose a penalty of CI\$5,000.00 where a relevant entity fails to prepare and submit the ES Return within the specified timeframe. An additional penalty of CI\$500.00 per day applies for every day that the relevant entity fails to comply. Civil penalties of up to CI\$100,000/US\$121,950 apply in relation to non-compliance with the ES Test.

Interpreting “Adequate” and “Appropriate”

The ES Test makes use of the words adequate and appropriate, without definition. The Guidance now provides that, in each case these words shall have the meaning set out beside them:

- “**adequate**” shall mean “as much or as good as necessary for the relevant requirement or purpose”; and
- “**appropriate**” shall mean “suitable or fitting for a particular purpose, person, or occasion”.

What is adequate or appropriate for each relevant entity will be dependent on the particular facts of that entity and its business activity. The Guidance anticipates that the directors (or equivalent) of a relevant entity consider these questions and make their determination in good faith. Additionally, each relevant entity should maintain appropriate records to demonstrate the adequacy and appropriateness of the resources utilized and expenditures incurred.

jurisdiction. A “Group” is a collection of enterprises related through ownership or control required to prepare consolidated financial statements for financial reporting purposes or that would be so required if equity interests in any of the enterprises were traded on a public securities exchange in its jurisdiction of tax residence.

³ “Relevant activities” are defined to include the following businesses (i) banking; (ii) distribution and service centres; (iii) financing and leasing; (iv) fund management; (v) headquarters (vi) holding companies (vii) insurance; (viii) intellectual property; and (ix) shipping.

Verification of Outsourcing

Where a relevant entity outsources CIGA, the TIA will only accept the relevant entity's claim to have satisfied the ES Test by means of domestic outsourcing if the information is verified by the service provider. Such verification must be made within thirty days of the relevant entity providing the same information to the TIA. Service providers undertaking outsourced functions are also required to register with the DITC. This will enable the DITC to independently verify the engagement of service providers and the nature of the services they carry out.

Circumvention

The Guidance draws particular attention to arrangements which may be entered into for the main purpose or one of the purposes of which is to circumvent economic substance obligations under the ES Law. The TIA monitors any mechanisms which may result in circumvention, for example, an entity which seeks to manipulate or artificially suppress its income or falsely claims to be tax resident in another jurisdiction in respect of all of its income in the Islands from a relevant activity. Knowingly or willfully supplying false or misleading information to the TIA is also an offence under the ES Law and is punishable on summary conviction by a fine of CI\$10,000/US\$12,195 or with imprisonment for a term of five years, or both.

Sector Specific Guidance

The Schedule contained in the Guidance gives high-level information on each of the "relevant activities" within the scope of the ES Law. The scope of each sector is outlined along with industry-specific CIGA, compliance issues facing certain industries and examples of the application of the ES Law in factual scenarios. The examples are intended as hypothetical case studies and the Guidance emphasizes that whether a relevant entity passes or fails the ES Test will depend on the application of ES Law principles and the specific facts of each case.

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