

Economic Substance Requirements in the Cayman Islands

Overview

As a result of the OECD'S global Base Erosion and Profit Shifting ("BEPS") initiative and the EU Code of Conduct Group substance requirements modelled on BEPS Action 5, the Cayman Islands has enacted *The International Tax Co-operation (Economic Substance) Law, 2018* (the "ES Law") and issued related Regulations and Guidance Notes. Similar legislation has been introduced in numerous jurisdictions, including the Channel Islands and the British Virgin Islands.

Under the ES Law, certain vehicles formed or registered in the Cayman Islands are required to have economic substance in the Cayman Islands. The requirement to show economic substance is primarily aimed at preventing what is called "base erosion and profit shifting". This constitutes, in the OECD's view, the artificial shifting of profits to places where there is little or no economic activity or taxation. The ES Law seeks to remedy the OECD's concerns by requiring relevant entities to have sufficient substance in the Cayman Islands.

Which entities will be affected?

The ES law applies to the following "relevant entities":

- companies (both Cayman Islands incorporated and foreign companies registered in the Cayman Islands);
- limited liability companies ("LLCs") registered in the Cayman Islands; and
- limited liability partnerships ("LLPs") registered in the Cayman Islands.

Investment funds are specifically excluded from the definition of relevant entity and, as such, they are not within the scope of the ES Law. The definition of "investment fund" is broad and will include a wide range of investment funds, including those that are not licensed or registered with the Cayman Islands Monetary Authority.

The ES Law does not apply to "domestic companies" (as defined in the ES Law). In addition, entities that are tax resident outside of the Cayman Islands do not need to comply with the economic substance requirements but will need to provide satisfactory evidence of their tax residency.

What activities are covered?

Relevant entities that are subject to the ES Law will be required to satisfy the economic substance test if they are carrying on any "relevant activities". Relevant activities include the following types of business: **banking, fund**

management, insurance, intellectual property, shipping (excluding pleasure yachts), financing and leasing, headquarters, holding company and distribution and service centre.

Timing

A relevant entity subject to the ES Law must satisfy the economic substance test (“**ES Test**”) as follows:

- for relevant entities in existence prior to 1 January 2019 – from **1 July 2019**;
- for relevant entities established on or after 1 January 2019 – from the date on which the relevant entity commences the relevant activity.

Entities will be required to register with the Tax Information Authority (“**TIA**”) by September 2020 and then file a report containing prescribed information on income and expenditure within 12 months after the end of their financial year commencing in 2019. In practice, this means that entities with a financial year commencing on 1 January 2019 will need to file the report by 31 December 2020.

Economic substance test

The ES Test may be met by a relevant entity in relation to any relevant activity by:

- conducting core income generating activities (“**CIGA**”) in the Cayman Islands;
- being directed and managed in an appropriate manner in the Cayman Islands; and
- having an adequate amount of expenditure, physical presence and employees or other personnel in the Cayman Islands.

Alternatively, it is possible to outsource some or all of the CIGA provided the relevant entity is able to demonstrate that it is able to monitor and control the outsourced activities and that those activities are undertaken in the Cayman Islands.

Certain relevant activities, such as the business of pure equity holding companies and high risk intellectual property business, have specific rules and guidance applicable to them under the ES Law.

Enforcement and penalties

The ES Law contains penalties for failure to satisfy the ES Test including:

- for the first accounting period of default, a penalty of \$10,000 (US\$12,195);
- in a subsequent accounting period, a penalty of \$100,000 (US\$121,951);
- where an entity has failed to meet the ES Test in two consecutive years, the TIA shall report details of the failure to meet the ES Test to the Registrar of Companies who shall then apply to the Grand Court for an order requiring the entity to take the requisite action to satisfy the ES Test or for the dissolution of the

Cayman Islands entity.

What to do now?

Campbells is closely monitoring the implementation of the ES Law and its application to the industry. It is expected that the Guidance Notes will be developed in due course. Although substantive steps may not need to be taken now, preliminary work to identify affected entities should be undertaken in preparation for when the rules become fully effective later this year.

Clients are advised to consider whether a company, LLC or LLP which may be affected is carrying on a 'relevant activity'. All relevant entities carrying on relevant activities will need to undertake an internal review to determine what measures, if any, they might need to take in order to achieve compliance. In most cases, we believe that compliance will be a straightforward matter. Campbells will be able to recommend solutions on these options available over the next few months as more guidance becomes available.

Further information

Campbells can advise and assist on compliance with the requirements of the economic substance regime. For further information, please contact your usual Campbells contact or visit our [website](#).



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