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The International Tax Co-operation (Economic Substance) Law, 2018

On 1 January 2019, the Cayman Islands introduced The International Tax Co-operation (Economic Substance) Law, 2018 (the "Law"). The Law has been issued in response to the Cayman Islands' commitment to the global initiative to combat base erosion and profit shifting.

The International Tax Co-operation (Economic Substance) Law, 2018

The Law requires certain Cayman Islands entities (and foreign entities registered in the Cayman Islands) (known as '**Relevant Entities**') that carry on certain activities (known as '**Relevant Activities**') to report on such activities to the Cayman Islands Government on an annual basis and to have economic substance in the Cayman Islands. All Relevant Entities (including those that do not carry on a Relevant Activity) will be required to make a notification to the Tax Information Authority in the Cayman Islands (the "**TIA**") on an annual basis. In addition to the notification obligation, a Relevant Entity that is carrying on a Relevant Activity will generally be required to satisfy the applicable economic substance test (the "**ES Test**"). Where a Relevant Entity carries on more than one Relevant Activity then it will be required to satisfy the ES Test in respect of each activity.

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Relevant Entity

A "Relevant Entity" means –

1. a company that is –
    a. incorporated under the Companies Law (2018 Revision); or
    b. a limited liability company registered under the Limited Liability Companies Law (2018 Revision);
2. a limited liability partnership that is registered in accordance with the Limited Liability Partnership Law, 2017;
3. a company that is incorporated outside of the Islands and registered under the Companies Law (2018 Revision);

but does not include –

1. an investment fund; or
2. a domestic company; or
3. an entity that is tax resident outside the Cayman Islands.

Relevant Activity

"Relevant Activities" includes the following businesses:

1. **"banking business"** which has the meaning given to that expression by section of the Banks and Trust Companies Law (2018 Revision);
2. "**distribution and service centre business**" which means the business of either or both of the following -
    a. purchasing from an entity in the same group of entities –
        i. component parts or materials for goods; or
        ii. goods ready for sale, and
        iii. iii reselling such component parts, materials or goods outside the Islands;
    b. providing services to an entity in the same group of entities in connection with the business outside the Islands,

    but does not include any activity included in any other relevant activity except holding company business;

3. "**financing and leasing business**" which 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;
4. "**fund management business**" which means the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2019 Revision) ("SIBL") carried on by a relevant entity licensed or otherwise authorised to conduct business under that Law for an investment fund;
5. "**holding company business**" which means the business of a pure equity holding company, and "pure equity holding company" means a company that only holds equity participations in other entities and only earns dividends and capital gains;
6. "**headquarters business**" means the business of providing any of the following services to an entity in the same group of entities –
    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 of entities; 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;
7. "**insurance business**" which has the meaning given to that expression by section 2 of the Insurance Law, 2010;
8. "**intellectual property business**" which means the business of holding, exploiting or receiving income from intellectual property assets;
9. "**shipping business**" which 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 –
    a. the business of transporting, by sea, passengers or animals, goods or mail for a charge;
    b. the renting or chartering of ships for the purpose described in paragraph (a);
    c. the sale of travel tickets and ancillary services connected with the operation of a ship;
    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
    e. the management of the crew of a ship.

ES Test

Under the Law, the ES Test varies depending on the Relevant Activity being conducted. Generally speaking, in order to satisfy the ES Test, a Relevant Entity will need to show that it: (i) conducts core income-generating activities in relation to that Relevant Activity in the Cayman Islands; (ii) is directed or managed in an appropriate manner in or from the Cayman Islands in relation to that Relevant Activity (iii) incurs an adequate amount of operating expenditure in the Cayman Islands; (iv) has an adequate physical presence in the Cayman Islands; and (v) has an adequate number of full time employees or other personnel with appropriate qualifications in the Cayman Islands. Sector-Specific Guidance has been issued for each Relevant Activity.

Entities which perform holding company business are subject to a 'reduced' ES Test. Such entities will satisfy the ES Test if they have complied with all applicable filing requirements under the Companies Law and have adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities. A pure equity holding company maintaining a registered office in the Cayman Islands engaging its registered office service provider in accordance with the Companies Law may be able to satisfy the reduced ES Test where such entity is passively holding equity interests in other entities depending on the level and complexity of activity required to operate its business.

The Law contains more rigorous requirements for so-called "high risk intellectual property" businesses. These include entities that hold intellectual property they did not create and acquired either from an entity in the same group or another entity outside of the Cayman Islands, and then license the intellectual property to related entities.

Certain aspects of the economic substance requirements will be able to be outsourced to another entity in the Cayman Islands under appropriate monitoring and control. Stuarts Corporate Services Ltd. ("SCS") is able to provide various services to assist Relevant Entities with meeting their respective economic substance requirements.

Notification and Reporting

All Cayman entities with legal personality are required to make a notification in compliance with the Law to the Cayman Islands General Registry prior to making its annual return. SCS will provide all of its registered office clients who have Cayman entities with legal personality with a declaration in order to make such filing. The first notification will be due at the beginning of 2020. In addition, starting in 2020 a Relevant Entity shall notify the TIA annually of - (a) whether or not it is carrying on a Relevant Activity; (b) if the Relevant Entity is carrying on a Relevant Activity, whether or not all or any part of the Relevant Entity's gross income in relation to the Relevant Activity is subject to tax in a jurisdiction outside of the Cayman Islands and, if so, shall provide appropriate evidence to support that tax residence as may be required by the TIA; and (c) the date of the end of its financial year. Such annual report to the TIA will be made by way of an online portal (the "ES Portal") that is expected to be available in Q3 2020. The TIA will issue user guidance in respect of the ES Portal in the coming months. Such report on the ES Portal can be made either by SCS as the registered office provider or by an authorised director (or equivalent) of the Relevant Entity. It is expected that the first notification requirement will be in September 2020.

Fines and Penalties

If the TIA determines that a Relevant Entity has failed to satisfy the ES Test for a financial year it shall issue a notice to that entity notifying it of such determination, giving the reasons, directing any action to be taken to satisfy the ES Test and advising it of its right to appeal. The TIA shall impose a penalty of approx. US$12,500 on a Relevant Entity for failing to satisfy the ES Test or approx. US$125,000 if it is not satisfied in the subsequent financial year after the initial notice of failure. After two consecutive years of failure the Grand Court in the Cayman Islands may make an order requiring the Relevant Entity to take specified action to satisfy the ES Test or an order that it is defunct or to be struck off.

In addition, under the Law it is an offence for a person to knowingly or wilfully supply false or misleading information to the TIA. Such an offence is punishable on summary

conviction by a fine of approx. US$12,500 or with imprisonment for a term of five years, or both. It is also an offence to disclose information relating to the affairs of the TIA, a Relevant Entity or any officer, customer, investor, member, client or policyholder of a Relevant Entity. Such an offence is punishable with a fine and/or imprisonment.

What is required in terms of reporting?

Entities which are carrying out relevant business activities must, no later than 12 months after the last day of each financial year, prepare and submit a report to the Tax Information Authority in the Cayman Islands. Stuarts can assist with such reporting.

What should we be doing now?

At this time, we recommend that our clients notify us if their Cayman Islands entity is carrying out any relevant business activities and to seek our advice on the possible implications. If you wish to speak to someone in the meantime, please contact Chris Humphries or Jonathan McLean.

Contact

This publication is for general guidance and is not intended to be a substitute for specific legal advice. Specialist advice should be sought about specific circumstances. If you require further information, please contact us at info@stuartslaw.com or email one of attorneys below:

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