

Cayman Islands revised its substance legislation and guidance

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In brief

The Tax Information Authority of Cayman Islands issued a revised guidance on the economic substance requirements (i.e. Guidance Version 2.0) on 30 April 2019. The revised guidance replaces the original guidance issued on 22 February 2019. In addition to the revised guidance, a regulation (being the third one since the enactment of the substance law) came into force on the same date to make various changes to the substance law that became effective on 1 January 2019.

One significant change brought about by the regulation and the revised guidance is the expansion of the scope of “fund management business”. Under the expanded scope, not only fund managers licensed in the Cayman Islands but persons who are otherwise authorised to conduct fund management business in the Cayman Islands may be required to meet the substance requirements. At the same time, it is understood that the Cayman government plans to broaden the regulatory regime for securities and investments in the Cayman Islands.

Business groups operating in the fund industry should stay tuned of the upcoming changes to the Cayman regulatory regime for investment managers and how the new regime interacts with the substance requirements. Other business groups with entities in the Cayman Islands should also closely monitor any future developments in the Cayman economic substance requirements as further changes to the substance legislation and the guidance are possible depending on the review comments of the Organisation for Economic Co-operation and Development (OECD) and the European Union (EU).

In detail

Legislation and guidance on the substance requirements

In response to the document published by the OECD entitled “Resumption of Application of Substantial Activities Factor to No or only Nominal Tax Jurisdictions” (the OECD Document) in November 2018¹, various tax neutral jurisdictions (including the Cayman Islands) have enacted their domestic substance legislation to implement the OECD’s substance requirements. Below is a list of legislation and guidance issued by the Cayman Islands as of April 2019 for reference.

Law and regulations issued²

- The International Tax Co-operation (Economic Substance) Law, 2018 (i.e. the ES Law) (came into force on 1 January 2019);
- The International Tax Co-operation (Economic Substance) (Prescribed Dates) Regulations, 2018 (came into force on 1 January 2019);
- The International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2019 (i.e. 2019 ES Regulations No. 1) (came into force on 22 February 2019); and
- The International Tax Co-operation (Economic Substance) (Amendment of Schedule) (No. 2) Regulations, 2019 (i.e. 2019 ES Regulations No. 2) (came into force on 30 April 2019).

For a discussion of the OECD Document and ES Law, please refer to *PwC China Tax and Business News Flash [2019] Issue 4*³.

Guidance issued²

- Cayman Islands Economic Substance Guidance Version 1.0 issued on 22 February 2019; and
- Cayman Islands Economic Substance Guidance Version 2.0 issued on 30 April 2019.

The Guidance Version 2.0 replaces the original guidance issued in February 2019. For a discussion of the original guidance, please refer to *Hong Kong Corporate Services News Flash, March 2019*⁴.

Key changes introduced by 2019 ES Regulations and the revised guidance

The key changes/clarifications included in the 2019 ES Regulations (i.e. 2019 ES Regulations No. 1 and 2019 ES Regulations No. 2) and Guidance Version 2.0 are summarised in the table below.

2019 ES Regulations / Guidance v2.0	Items concerned	Key amendments / clarifications
2019 ES Regulations No. 1	Definition of relevant entity	The definition of relevant entity is amended - An entity is not a relevant entity as far as it is a tax resident outside of the Islands. It does not need to be centrally managed and controlled in a jurisdiction outside the Islands.
2019 ES Regulations No. 2	Definitions of various terms, including (i) domestic company, (ii) fund management business, (iii) investment fund, (iv) high risk intellectual property (IP) business, (v) shipping business and (vi) relevant income, etc.	The definitions of the following (and other) terms are amended: <ul style="list-style-type: none"> • Domestic company – the requirement of not being part of a MNE Group is removed and the definition no longer includes a subsidiary of a domestic company. • Fund management business – means securities management business carried on by entities that are licensed or otherwise authorised to conduct business under the Cayman Securities Investment Business Law⁵ (2019 Revision) for an investment fund. • Investment fund – excludes an entity that is itself the ultimate investment held by the fund. • High risk IP business – excludes an IP business carried on by an entity that does not carry out research and development, branding or distribution as part of its core income generating activities (CIGA). • Shipping business – excludes “the owning, operating or chartering of a pleasure yacht” (instead of “the operating of a pleasure vessel” as in the original guidance). • Relevant income – means all of an entity’s gross income from its relevant activities and recorded in its books and records under applicable accounting standards.
Guidance v2.0	Investment fund	The words “through which an investment fund directly or indirectly invests or operates” refer to any entity which functions solely as part of the investment fund structure which is not carrying on an operating business (i.e. its purpose is passive in nature).
	Distribution and service centre business	Service centre business only refers to provision of services to another entity in the same group where the relevant entity is operating as a service centre for entities in the same group.
	Tax resident outside the Islands	The entity needs to be subject to corporate income tax on all of its income from a relevant activity by virtue of its tax residence, domicile or any other criteria of a similar nature in that other jurisdiction. Specific guidance on “disregarded entity” for US tax purpose is added.
	Relevant activities	The term “relevant activity” does not require an entity to be actively engaged in any of the nine mobile businesses i.e. passive collection of income from one of those businesses would be a relevant activity.
	Compliance with the ES test	A relevant entity that carries on a relevant activity with no relevant income is not obliged to meet the ES test but still has the notification and reporting obligations under the ES Law (e.g. the report filed will be akin to a ‘nil’ return).

2019 ES Regulations / Guidance v2.0	Items concerned	Key amendments / clarifications
	Cayman Islands CIGA	Cayman Islands CIGA in relation to each relevant activity are neither exhaustive nor mandatory. For holding company business, the CIGA is now the reduced ES test instead of “all activities related to that business” as in the original guidance. Additional guidance is provided on how to count the employee time when Cayman Islands CIGA are outsourced to a service provider.
	Directed and managed	The expectation that (1) the majority of board meetings will be held in the Islands and (2) at least one board meeting per year for companies with a minimal level of activities is removed.
	Sharing of information	To activate the spontaneous exchange of information with the relevant competent authorities, the recipient jurisdictions would need to opt in to receive the information.

The takeaway

The 2019 ES Regulations No. 2 and Guidance v2.0 have clarified and revised the definitions of several terms in the ES Law, and also provided further elaboration on the outsourcing of CIGA. Business groups operating in Cayman Islands should immediately assess the implications on their compliance and global structures.

Specifically, entities claiming to be “tax residents outside the Islands” should pay attention to the interpretation of the Tax Information Authority of Cayman Islands in respect of “being subject to corporate income tax on all of its income from a relevant activity”. Meanwhile, they should also start to gather relevant evidence to substantiate the claim.

For entities considering to establish economic substance in Cayman Islands, it is necessary to discuss how to carry out CIGA, the feasibility of outsourcing CIGA, and the appropriate frequency and form of the board meetings.

Besides, the impact on fund industry is particularly significant. Under the expanded definition of “fund management business”, not only licensed fund managers, but persons who are otherwise authorised to conduct fund management business in the Cayman Islands may be required to meet the ES requirements. As a related matter, the Cayman government plans to broaden the regulatory regime for securities and investments in the Cayman Islands and has proposed a bill to amend the Securities Investment Business Law. The bill proposes a regulatory and supervisory framework for entities that are previously excluded from the licensing requirements under the aforementioned Law (e.g. a Cayman subsidiary of a parent company which is located in another jurisdiction and regulated in that home jurisdiction). Considering the trend to expand the applicable scope of the ES requirements, fund industry should keep a close eye on the developments in this regard.

Other relevant entities conducting relevant activities in Cayman Islands should also closely monitor any future developments in the Cayman ES requirements and the review comments of the OECD and EU. In the meantime, it is essential to reconsider the advantage of a Cayman Islands structure and explore other alternatives.

Endnote

1. The OECD document can be accessed via this link:
<http://www.oecd.org/tax/beps/resumption-of-application-of-substantial-activities-factor.pdf>
2. The substance legislation and guidance of Cayman Islands can be accessed via this link:
http://www.tia.gov.ky/pdf/Economic_Substance.pdf
3. The *PwC China Tax and Business News Flash [2019] Issue 4* can be accessed via this link:
<https://www.pwccn.com/en/china-tax-news/2019q1/chinatax-news-jan2019-4.pdf>
4. The *Corporate Services News Flash, March 2019*, can be accessed via this link:
<https://www.pwchk.com/en/tax/corporate-services/the-cayman-islands-substance-requirements.pdf>
5. The bill, named “Securities Investment Business (Amendment) Bill, 2019”, can be accessed via this link:
<http://www.gov.ky/portal/pls/portal/docs/1/12782501.PDF>



Let's talk

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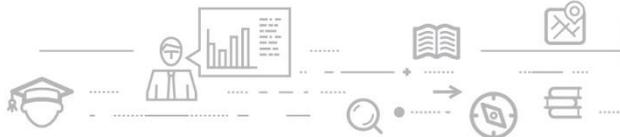
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