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OUTCOME OF PROCEEDINGS

From:	General Secretariat of the Council
To:	Delegations
Subject:	The EU list of non-cooperative jurisdictions for tax purposes • Cayman Islands: final legislation and assessment under criterion 2.2

A/ FINAL LEGISLATION:

Bill for a law to amend the companies law (2018):

http://www.legislativeassembly.ky/portal/pls/portal/docs/1/12740509.PDF

The International Tax Cooperation (Economic Substance) Law, 2018 was published on 27 December 2018, an Amendment of Schedule to these Regulations was adopted and published on 22 February 2019 and a Guidance was published on the same day:

http://www.tia.gov.ky/pdf/Economic_Substance.pdf

B/ FINAL ASSESSMENT:

The dialogue with the Cayman Islands was constant and constructive with several conference calls and meetings. The Commission Services reported regularly to Member States on the progress of the discussion with the Cayman Islands. The Cayman Islands shared several versions of their draft legislation and sought feedback from the Code of Conduct Group.

The following assessment only highlights the remaining issues identified and still pending at the beginning of 2019 following such feedback.

I – On ring fencing

The "Bill for a law to amend the companies law (2018)" was published on 6 December 2018. This legislation suppresses Section 174 of the Companies Law that prohibited exempted companies to carry on business in the Cayman Islands.

Conclusion:

The Cayman Islands eliminated the ring-fencing elements of their legislation.

II – On substance requirements

1 – Identification of the relevant activities and included entities

1.1 – On relevant activities

The Cayman Islands have identified the relevant sectors of activity in line with the 2.2 SP.

Regarding holding activities, the Cayman Islands had included the specific requirements for pure equity holding companies in Section 4(5) but eliminated the reference to other holding companies that may carry on relevant activities and should fulfil substance requirements applicable to such relevant activities.

The Cayman Islands have included a new subsection 4(6) clarifying that an entity that is carrying on more than one relevant activity is required to satisfy the economic substance test in relation to each relevant activity.

The Guidance published on 22 February 2019 further specifies that a relevant entity must satisfy the substance test in relation to each of the relevant activities in addition to the specific test for its pure equity holding activity.

Conclusion:

This issue is settled.

1.2 – On included entities

The Cayman Islands have introduced substance requirements for companies, limited liability companies and limited liability partnerships.

Following a request from the Commission services, the Cayman Islands have clarified that there are four types of partnerships in the Cayman Islands: general partnerships, limited partnerships, exempted limited partnerships and limited liability partnerships (the note provided by the Cayman Islands is attached to this report).

The Cayman Islands have indicated that only limited liability partnerships are legal persons in their own right, can hold or own assets in their own right and can contract in their own right. They are also not fiscally transparent. The Cayman Islands consider that those are the only ones relevant for substance requirements.

Conclusion:

This issue is clarified and the risk of BEPS should be limited. It however needs to be monitored, in the coming months, whether it is considered necessary to include all partnerships in the scope of substance requirements.

2 – Imposition of substance requirements

2.1 – Income threshold

The Cayman Islands have deleted the reference to an income threshold in their legislation.

Conclusion:

This issue is settled.

2.2 – Tax residence

The Cayman Islands have adopted an International Tax Cooperation (Economic Substance) (Amendment of Schedule) Regulation[1] that amends the definition of relevant entities so as to include companies, LLC, LLP and companies incorporated outside the Cayman Islands but registered in the Cayman Islands.

Entities that are tax resident outside the Cayman Islands are excluded from the scope of substance requirements.

Section 7(1)(b) of the Act indicates that a relevant entity shall notify the Authority annually whether or not all or part of the relevant entity's gross income in relation to a relevant activity is subject to tax in a jurisdiction outside of the Islands. If so, it shall provide appropriate evidence to support that tax residence as may be required by the Authority.

The Guidance published on 22 February 2019 provides that the Authority will require any entity claiming to be tax resident to produce satisfactory evidence such as a tax identification number, a tax residence certificate and assessment or payment of tax liability.

In the absence of such evidence, the Authority will regard the entity as a relevant entity that is subject to the economic substance law. The economic substance test must be satisfied with respect to any part of relevant income that is not subject to income tax of a jurisdiction other than the Islands.

Finally, the Guidance also clarifies that in case of claimed tax residence in another jurisdiction, information will be exchanged with the jurisdiction of the legal or beneficial owner as well as the jurisdiction where the entity claims to be tax resident.

Conclusion:

This issue is settled.

[1] International Tax Cooperation (Economic Substance) (Amendment of Schedule) Regulations, 2019 as adopted and published on 22 February 2019.

2.3 – CIGAs in or from within the jurisdiction

It was reported to the Cayman Islands that the legislation should provide that entities carrying on relevant activities should conduct CIGAs in the Cayman Islands.

The Cayman Islands now defines Cayman Islands CIGAs as the activities of central importance to a relevant entity in terms of generating income and that are being carried out in the Islands.

Conclusion:

This issue is settled.

2.4 – CIGAs to be performed

It was reported to the Cayman Islands that their draft guidance should clarify that although it can't be considered absolutely necessary to perform all the CIGAs listed for each relevant activity, the performing of the appropriate CIGAs for the type of relevant activity carried out by the entity should be carefully considered as part of the assessment of substance in the jurisdiction.

The new guidance published on 22 February 2019 clarifies that a relevant entity must conduct the appropriate elements under the Cayman Islands CIGA for the particular type of relevant activity that it is carrying on; it is not necessary for the relevant entity to perform every element listed for the relevant activity in the definition of the Cayman Islands CIGA. The assessment of substance in the Islands should include careful consideration of what elements of Cayman Islands CIGA the relevant entity is carrying on in the Islands.

Suggested way forward

This issue is settled.

2.5 – Outsourcing safeguards

As agreed by the Code of Conduct Group, outsourcing should not be a practice used to circumvent the need for economic substance within a jurisdiction. Therefore, the outsourcing of core income generating activities is only permitted to occur within the jurisdiction concerned. In addition the primary entity should have the capacity to properly supervise and control the work of the entity to which the core functions have been outsourced; and the substance of the outsourcing provider (employees, expenditure and premises) should not be used multiple times by multiple primary entities that outsource to the same outsourcing provider.

The Cayman Islands legislation itself only prescribes that a relevant entity satisfies the substance test in relation to a relevant activity if its Cayman Islands CIGAs are conducted by another person and the relevant entity is able to monitor and control the carrying out of the Cayman CIGAs by that other person. The legislation therefore does not contain a reference to the prohibition of double counting.

On 22 February 2019, the Cayman Islands published a Guidance, which provides that only that part of the relevant activity of the service provider that is attributable to generating income for the relevant entity shall be taken into account in considering whether the relevant entity satisfies the substance test. The draft guidance also mentions that there must be no double counting of the resources of the service provider in the Islands if the services are provided to more than one relevant entity carrying out relevant activities.

As for evidencing, the guidance mentions that the relevant entity will include precise details of the resources employed by its service providers, for example based on the use of timesheets.

Conclusion:

This issue is settled.

3 – Enforcement and sanction mechanism

The sanctions framework of the Cayman Islands was still considered as not dissuasive enough as the level of sanctions started quite low with possible fixed amounts of $10,000 for the first notice of non-compliance and an additional possible $100,000 for the second notice. The second notice could only occur in a financial year following a financial year in which a first notice was issued. In the case of a second notice, the authority shall report to the Registrar that may, itself, make an order to the Court to ask for strike-off the register the non-compliant entity.

The Cayman Islands have now made it mandatory to impose the fixed amounts of penalty in each notice of non-compliance and made it mandatory, after the second notice of non-compliance, to make an order to the Court in order to ask for a strike off the register of the non-compliant entity.

The Cayman Islands have clarified that, on advice of the Attorney General of the Cayman Islands, they did not make it mandatory for the Court to make such order as constitutionally it would not be possible for the Substance Bill to direct the actions of the Grand Court of the Cayman Islands.

Conclusion:

This issue is settled and the evaluation of the efficient enforcement is subject to monitoring in the upcoming years.

Conclusion

Leaving aside the issue of collective investment funds, the Cayman Islands have implemented their commitment to introduce substance requirements.

ANNEX 1: assessment by COCG experts in 2017

ANNEX 1

ASSESSMENT BY COCG EXPERTS IN 2017

	1a	1b	2a	2b	3	4	5
CAYMAN ISLANDS	V	X	V	X	V	?	X
Criterion 2.2: "The jurisdiction should not facilitate offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction" In light of the assessment made under all Code criteria applied by analogy, the tax system of CAYMAN ISLANDS should be considered overall harmful from a Code of Conduct point of view. The main concerns on deviations from the Code of Conduct criteria as applied by analogy relate to the lack of legal substance requirements and the de facto lack of substance In addition there are legal or de facto mechanisms that enable the granting of advantages only to non-residents or in respect of transactions carried out with non-residents.						Overall: V	

Explanation

Absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero:

In this respect, where criterion 2.1 is inapplicable solely due to the fact that the jurisdiction concerned does not meet the gateway criterion under Paragraph B of the Code of Conduct, because of the "absence of a corporate tax system or applying a nominal corporate tax rate equal to zero or almost zero", then the five factors identified in paragraph B of the Code of Conduct should be applied by analogy to assess whether the criterion 2.2 has been met.

Relevant questions (Q 1.2)

CAYMAN ISLANDS does not apply any corporate tax system. We therefore suggest this jurisdiction to meet the gateway test of the criterion 2.2.

Criterion 1:

"whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents"

Relevant questions (Q 2.1, Q 2.2, Q 2.3, Q 1.1, Q 1.2, Q 1.5, Q 1.8,)

The absence of CIT is de lege available to both residents and non-residents and does not require that the beneficiaries carry out transactions only with non-residents. However, the vast majority of companies must operate mainly outside the CAYMAN ISLANDS and only under this condition is granted an assurance of not being taxed in the future. We would therefore propose a tick ("V" - harmful) for criterion 1a).

So-called "exempted companies" must do business mainly outside the CAYMAN ISLANDS. They are allowed to operate in the CAYMAN ISLANDS only to the extent that such local operation is in furtherance of its international business. CAYMAN ISLANDS claim that these companies by law and by administrative practices are mainly treated in the same way as other types of (domestic) companies but they also state that exempted companies are generally granted a 20 year assurance that they will not be subject to direct taxation in the CAYMAN ISLANDS in the event direct taxation would be introduced in the future.

The fact that the legal framework of Anguilla provides for the incorporation of companies that can benefit from a zero-rate taxation but are not allowed to interfere with the domestic market justifies alone a conclusion on de lege ring-fencing.

We would therefore propose a tick ("V" - harmful) for criterion 1a).

The question whether the advantage of the absence of CIT de facto is accorded only or almost only to non-residents was not answered. CAYMAN ISLANDS argued that information on the number of companies controlled by non-residents were not available. However, out of the overall number of companies (92,269 as of 2016) 80,658 = 87.4 % are exempted companies, while "resident companies" make up for only 6,399 = 6.9 % of all companies registered in the CAYMAN ISLANDS. According to the given criteria that de facto ringfencing is given by a percentage of more than 90 %, the situation in CAYMAN ISLANDS should not constitute de facto ring-fencing.

We would therefore propose a X ("X") for criterion 1b).

Criterion 2:

"whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base"

Relevant questions (Q 2.1, Q 2.2, Q 2.3, Q 1.1, Q 1.2, Q 1.5, Q 1.8,)

By analogy to the assessment against criterion 1a/b. We would propose a tick ("V" – harmful) for criterion 2a) and a X ("X") for criterion 2b).

Criterion 3:

"whether advantages are granted even without any real economic activity and substantial economic presence within the jurisdiction offering such tax advantages"

Relevant questions (Q 1.1, Q 1.7, Q 1.9, Q 2.4, Q 2.5, Q 2.6, Q 2.7, Q 2.8)

- *Facts*

Only certain types of regulated banking and insurance companies are required to maintain a certain level of senior officers and physical presence in the Cayman Islands. According to the answer of CAYMAN ISLANDS to question 2.4 all other businesses do not need to full fill any requirements. The CAYMAN Islands could not give more details for the requirements for

regulated banking and insurance companies. In particular they did not provide any requirements than maintaining a "certain level of senior officers and physical presence in the CAYMAN Islands".

Number of Companies as of 2016:

Total: 92,269

Financial Institutions: 23,694

Number of employees as of 2016:

Total: 40,411

Financial Sector: 3,424

According to Public Country-by-Country-Reporting data for 2015 the biggest European banks with operations in the CAYMAN ISLANDS, some have no employees and earn €171 million in profit.

A full-time employee of the biggest European banks in the CAYMAN ISLANDS appears to generate on average a profit of €6,298,000 in 2015 while the global average is €45,000. The profitability per employee and per country in the CAYMAN ISLANDS appears to be the highest all over the world.

CAYMAN ISLANDS did not explain in detail and in a convincing way why and how those Cayman Islands subsidiaries earning profits in the CAYMAN ISLANDS without having any employees are operated fully from other countries or jurisdictions. The public country-by-country reporting data indicate that at least €171 million profits have been declared in the Cayman Islands without any substantial economic presence.

CAYMAN ISLANDS also did not explain in a satisfactory way what they believe are the reasons for the enormous differences in labour productivity. The CAYMAN ISLANDS do not investigate the carrying out of real economic activities.

- *Assessment*

The majority of panel III would propose a tick ("V" – harmful) for criterion 3.

In general, the legal conditions attached to the tax advantages at stake (e.g. requirements for incorporation or operations) do not include any express requirement for real economic activity or substantial economic presence. This alone justifies a conclusion on the lack of substance.

From the facts that have been provided by the Cayman Islands it follows that it is highly questionable whether there is an adequate de facto link between profits and underlying substance.

Conclusions on the factual situation regarding substantial economic presence of EU banks in the CAYMAN ISLANDS may also be drawn from the public country-by-country reporting for EU banks. In accordance with the 2013 EU Capital Requirement Directive (Art. 89), European banks are obliged to disclose information about business operations on a country-by-country basis. According to data disclosed in 2016 for the year 2015, it appears that in some jurisdictions, banks registered profits without having any employees. Among the biggest European banks with operations in the CAYMAN ISLANDS, some have no employees and earn €171 million in profit. In some jurisdictions, profitability per employee of European banks' subsidiaries is particularly high compared with profitability in the countries where their ultimate parent companies are resident or compared with the global average profitability. A full-time employee of the biggest European banks in the CAYMAN ISLANDS appears to generate on average a profit of €6,298,000 in 2015 while the global average is €45,000. The profitability per employee and per country in the CAYMAN ISLANDS appears to be the highest all over the world.

The CAYMAN ISLANDS did not confirm these data and provided an internal analysis. They argued as follows: "The statements above do not provide any analysis as to whether the functional activities of EU banks are comparable to those of banks located in the CAYMAN ISLANDS. Some of the issues raised are similar to those raised by Oxfam International in a report titled "Opening the Vaults: The Use of Tax Havens by Europe's biggest banks" and the CAYMAN ISLANDS Monetary Authority has conducted an in-house analysis of the report. Relevant extracts from their work are attached. This analysis demonstrates that CAYMAN ISLANDS licensed banks may have employees in other jurisdictions which are not currently being included in the relevant data (and we note that such employees may give the CAYMAN ISLANDS company a permanent establishment in the relevant jurisdiction which is subject to

taxation in that jurisdiction); that the non-reporting of operating expenses may inflate the profit before taxes analysis artificially and the reporting of taxes at branch level can be misinterpreted as meaning that the Head Office does not pay taxes in circumstances where it actually does pay such taxes – it is just that these taxes are reported at the Head Office level."

CAYMAN ISLANDS did not explain in detail and in a convincing way why and how those Cayman Islands subsidiaries earning profits in the CAYMAN ISLANDS without having any employees are operated fully from other countries or jurisdictions. The public country-by-country reporting data indicate that at least €171 million profits have been declared in the Cayman Islands without any substantial economic presence.

CAYMAN ISLANDS also did not explain in a satisfactory way what they believe are the reasons for the enormous differences in labor productivity. Such enormous differences in labor productivity indicate a large discrepancy between the profits made by EU banks in the CAYMAN ISLANDS and the level of real economic activity that they undertake in this jurisdiction.

In addition, that there are no investigations on the carrying out of real economic activity in the CAYMAN ISLANDS could also lead to the conclusion that there is no requirement in practice.

This part of Panel III would therefore propose a tick ("V" – harmful) for Criterion 3.

<u>Addendum by one expert only:</u>

If you divide the number of employees, which is 40,411 (as of 2016), by the number of companies, which is 92,269 (as of 2016), there are on average only 0.44 employees per company. It is unclear from the data submitted whether these are full-time employees who are working only for one company. If you divide only employees working in the financial sector, the ratio is 0.14. From our perspective, these disproportionate figures strongly highlight the questions arising in respect of substance.

<u>One other expert of the Panel provided the following assessment:</u>

The agreed terms of reference for the assessment of jurisdictions under Criterion 2.2 states the following:

A jurisdiction can only be deemed to have failed the assessment under this criterion when 'offshore structures and arrangements attracting profits which do not reflect real economic activity in the jurisdiction' are due to rules or practices, including outside the taxation area, which a jurisdiction can reasonably be asked to amend, or are due to a lack of those rules and requirements needed to be compliant with this test that a jurisdiction can reasonably be asked to introduce.

The introduction of a CIT system or a positive CIT rate is not amongst the actions that a third country jurisdiction can be asked to take in order to be in line with the requirements under this test, since the absence of a corporate tax base or a zero or almost zero level tax rate cannot by itself be deemed as criterion for evaluating a jurisdiction as non-compliant.

- *This states that a jurisdiction can only be deemed to have failed the assessment under Criterion 2.2 where reasonable/proportionate actions have been identified that a jurisdiction could take to avoid being listed.*

- *It remains unclear what exactly we would be asking jurisdictions to amend/introduce in response to their deemed failure under Criterion 3. It might be suggested that a jurisdiction should have a de jure requirement for substance as part of their company law, but it's not clear what that would entail i.e. what the test of substance would be, when that test of substance would be applied, what the implication would be of a company failing that test.*

- *Those are important questions in being able to test the reasonableness of such a requirement.*

- *If we can't demonstrate that such requirements are reasonable, and we can't demonstrate that they are commonly replicated by other countries/Member States, then the failing of a jurisdiction due to the lack of such a requirement would amount to a failing of a jurisdiction on the basis of it not having a CIT regime which is incompatible with the terms of reference. This part of Panel III would therefore propose a question mark ("?") for Criterion 3 until this has been discussed further.*

Criterion 4: "whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD"
<u>Relevant questions (Q 2.9, Q 2.10, Q 2.11, Q 2.12)</u> *CAYMAN ISLANDS does not apply neither OECD transfer pricing rules nor alternative transfer pricing rules for profit determination in line with internationally accepted principles. This situation seems to negatively affect a proper allocation of profits. However, the panel is not sure, whether it is adequate to ask countries without a CIT-system to set rules for profit determination in respect of activities within a MNE in place or if the commitment to CbCR, which gives relevant information to the other states, should be enough to fulfill criterion 4. Hence Cayman Islands has committed to BEPS minimum standard and including CbCR this year, we propose a question mark ("?") for Criterion 4.*

Criterion 5: "whether the features of the tax system lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way"
<u>Relevant questions (Q 2.13, Q 2.14, Q 2.15, Q 2.16)</u> *All the elements of the legal system which are relevant for benefitting from the advantages at stake (including rules for the granting of tax residence or the setting up of companies) appear to be clearly set by the law and the practice does not appear to involve any administrative discretion. We would therefore propose a cross ("X" – not harmful) for criterion 5.*