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DECLASSIFICATION

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Delegations will find attached the declassified version of the above document.

The text of this document is identical to the previous version.

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RESTREINT UE/EU RESTRICTED

FISC 307

NOTE

From:	Commission services
To:	Code of Conduct Group (Business Taxation)
Subject:	Progress report Cayman Islands

Delegations will find attached a document by the Commission services.

PROGRESS REPORT - THE CAYMAN ISLANDS

Code of Conduct Subgroup – 5 July 2019

Background

Cayman Islands was found to be compliant with its 2018 commitments at the February 2019 COCG as its legislation on economic substance requirements met the expectations under criterion 2.2.

It was removed from Annex II for this criteria at the March ECOFIN, although it remains on Annex II for CIVs.

The legislation assessed as positive includes:

- International Tax Co-operation (Economic Substance) Law, 2018;
- International Tax Co-Operation (Economic Substance) Regulations, 2019 and
- the Economic Substance for Geographically Mobile Activities, Guidance Version 1.0).

However, Cayman Islands recently informed the Commission services of amendments to this legislation on economic substance requirements, which are outlined in the report below.

Recent developments

On 3 May 2019, the Cayman Islands adopted a new Regulation and a new Guidance, amending the legislative framework on economic substance requirements that had previously been cleared by the COCG. The new legislation includes:

(i) The International Tax Co-Operation (Economic Substance) (Amendment of Schedule) (No.2) Regulations, 2019; and
(ii) The Economic Substance for Geographically Mobile Activities, Guidance Version 2.0.

During the June FHTP meeting, the new legislative framework of the Cayman Islands was cleared, with the issue of domestic companies to be monitored.

The Cayman Islands also opted to be assessed as having a 'fully equipped monitoring mechanism" (FEMM). The FHTP agreed that the Cayman Islands could be considered as having a FEMM, while noting that special monitoring of the implementation of certain aspects of the FEMM was required for this jurisdiction because they would be implemented for the first time after the assessment.

The state-of-play

The Commission services had reported some concerns regarding the amendments made by Cayman Islands to its previously approved legislation.

1/ New definition of relevant income by reference to "applicable accounting standards"

The first version of the new Regulation and Guidance included a definition of relevant income for a relevant entity as meaning "*all of that entity's gross income arising in the Islands from a relevant activity*".

The Commission services raised concerns about the condition "arising in the Islands" for income of a relevant entity to be considered as relevant income.

The adopted version of the Regulation and Guidance defines relevant income as meaning "*all of that entity's gross income from its relevant activities and recorded in its books and records under applicable accounting standards*". This definition no longer makes reference to a geographical link with the Cayman Islands for income to be relevant with respect to entities in the scope of substance requirements.

In the discussion with the Cayman Islands, the Commission services enquired about the accounting standards that are applicable in the Cayman Islands. The Cayman Islands confirmed that there were no defined accounting standards in the Cayman Islands and entities were free to choose their accounting standards. The Cayman Islands have provided statistics showing that 63% of regulated entities follow US GAAP, 31% follow IFRS and 3% use the Luxembourg GAAP. This leaves open the question of unregulated entities, as well as the remaining 3% of regulated entities that use neither the US GAAS, IFRS nor Luxembourg GAAP.

Following a question from Commission services in this respect, the Cayman Islands agreed that this information would be useful to monitor and will consider how to incorporate the collection of this data in the reporting requirements for relevant entities.

Suggested way forward

We suggest a positive feedback on this issue conditional upon monitoring, in the coming years, of the accounting standards used by relevant entities to recognise expenditure and revenues.

2/ New definition of Cayman CIGAs

The new Regulation and Guidance define Cayman CIGAs as "*activities that are of central importance to a relevant entity in terms of generating relevant income and, if carried on by a relevant entity in respect of a relevant activity, must be carried on in the Islands*".

The Commission services have concerns that this new circular definition may create a conditionality, whereby a CIGA has to be carried out by a relevant entity for it to be obliged to carry it out in the jurisdiction.

In other words, if the relevant activity is not conducted by the relevant entity but is outsourced – which is allowed – then the substance test does not need to be complied with and the outsourcing can take place outside the Cayman Islands.

This wording could allow an entity to carry out its CIGAs in another jurisdiction if these are not carried out by a relevant entity. This creates opportunities for outsourcing without the outsourcing safeguards. The words "*and if*" therefore create a condition to the application of the rule "*must be carried out in the Cayman Islands*", and open a potential loophole.

Following exchanges with Cayman Islands, they have taken note of this issue and agreed to modify the problematic wording in the definition. An amendment in currently being drafted and will be shared with the Commission services once it has been prepared.

Suggested way forward

Given that the Cayman Islands is willing to amend its legislation but has not yet done so, we suggest maintaining a negative position on this issue until it is resolved.

3/ New definition of domestic companies

The new definition of "domestic companies" that are excluded from the scope of substance requirements has removed the stipulation that a domestic company cannot be part of a MNE Group. This new wording could open a loophole in the substance requirements in cases where a domestic company undertakes both local and foreign business.

The Cayman Islands have explained that the key requirement for an entity to qualify as a domestic company for the substance test purpose is that it must be "carrying on business in the Islands". The Cayman Islands clarified that the Local Companies (Control) Law (2015 Revisions) provides a definition of "carrying on business in the Islands". The definition specifically excludes "*the carrying on, from a principal place of business in the Islands, business exterior to the Islands*".

However, in another exchange of emails, the Cayman Islands explained that this new definition is based on the fact that a large number of local businesses also have presence in the USA, where they will be subject to tax on their income. With the previous definition, they would also fall into the scope of Cayman Island's substance requirements.

For the Commission services, this argument related to businesses being taxed in the US contradicts the previous explanation that Cayman companies "*carrying on, from a principal place of business in the Islands, business exterior to the Islands"* cannot qualify as domestic companies.

- Either domestic companies that are part of an MNE Group cannot carry out business exterior to the Islands and, in such case, the example of a Cayman company also doing business in the US should not qualify as domestic company.
- Or domestic companies that are part of an MNE Group can carry out business exterior to the Islands (mixed business) and this then opens a loophole in the substance requirements framework that should be addressed.

Suggested way forward

The Commission services suggest negative feedback on this issue for now, pending further clarifications from Cayman Islands.

4/ New definition of high-risk IP cases

The former definition of high-risk IP cases included entities that do not carry out R&D, branding or distribution CIGAs, irrespective of whether the IP was acquired and licensed to related parties. This definition went further than the EU standard on high-risk IP.

The new definition of high-risk IP cases removed this additional element and now only related party IP cases are covered as high-risk IP scenarios. This is still in line with the EU definition of high-risk IP scenarios.

Suggested way forward

We suggest positive feedback on this issue.

5/ Tax Residence

The new Guidance Note includes additional wording stating that: *"In the event that the entity is a disregarded entity for U.S. income tax purposes, and has a U.S. corporation as its parent, the Authority will consider the entity as tax resident outside of the Islands if satisfactory evidence is provided (...). For example, the evidence may include a Tax Identification Number, tax residence certificate and assessment or payment of a corporate income tax liability on all of that entity's income in the Islands from a relevant activity, or, in the case of a disregarded entity for U.S. income tax purposes, a signed statement under penalty of perjury from an external tax advisor or 'C' level officer stating that all of that entity's income has been included on the corporate tax return of the U.S. parent company*".

The Cayman Islands have explained that certain Cayman subsidiaries of U.S. companies file a tax election with the IRS, in order to be considered a disregarded entity (DE) for U.S. income tax purposes. The U.S. tax impact of the DE election is that the Cayman subsidiary is treated as a branch of the U.S. owner and the U.S. owner is required to report, on an annual basis, all the income and expenses of the Cayman subsidiary on their U.S. corporate tax return. Therefore, in this particular case, the Cayman entity is not considered tax resident in the U.S, however, it is subject to tax in the U.S.

Suggested way forward

We suggest positive feedback on this issue.

6/ Exchange of information template for high-risk IP

The new Guidance Note mentions that the modalities for the exchange framework, including the terminology used in the framework, timing for such exchanges, the precise data points, the mechanism for opting in, and the development of a standardised template and XML schema, will be used by the Authority in the form approved by the OECD.

The Commission services requested confirmation that in all cases of high risk IP an entity would be required to provide full reporting in one-step and that this information would be subject to spontaneous exchange with the relevant Member States.

The Cayman Islands have confirmed that Section 7(4) of their legislation outlines the specific information to be reported by high-risk IP entities, as well as the additional information required from entities who wish to rebut the presumption of non-compliance.

They confirmed that the information to be exchanged will be in line with the proposed NTJ XML schema being developed by FHTP WP10.

Considering that the Cayman Islands have been assessed as having a FEMM, it was very important to make sure that, in relation to Member States, they would still be able to provide a full report to relevant Member States in a one-step process, in all cases of high-risk IP.

In recent discussions at the FHTP WP 10, it was agreed that a number of changes would be introduced in the XML schema and the opt-in template for notification, to enable EOI in the context of the EU standard on high-risk IP scenarios.

Suggested way forward

Considering that the mechanism developed by the FHTP (WP10) should include all information needed for the EU standard on high-risk IP and will allow for an exchange with Member States in a one-step process, we suggest positive feedback on this issue.