

# KIRKLAND & ELLIS

Kirkland Alert

## Cayman Islands Removed From EU Blacklist

07 October 2020

On 6 October 2020, the EU removed the Cayman Islands from the EU blacklist of non-cooperative jurisdictions for tax purposes (the “EU Blacklist”). Sponsors should be aware, however, that the Cayman Islands remains on some local country blacklists.

### The EU Blacklist and Local Country Blacklists

#### The EU Blacklist

As outlined in our [previous alert](#) (19 February 2020), the Cayman Islands was added to the EU Blacklist earlier this year as a result of a failure to introduce appropriate measures aimed at ensuring minimum levels of economic substance for collective investment vehicles (“CIVs”). The Cayman Islands Private Funds Law and The Mutual Funds (Amendment) Law were enacted on 7 February 2020 and introduced certain regulatory requirements applicable to private funds addressing the EU concerns for CIVs. So whilst too late to prevent Cayman from being added to the EU Blacklist in February, it seems that the EU’s economic substance concerns have been appropriately addressed.

#### Local Country Blacklists

Despite being removed from the EU Blacklist, the Cayman Islands may still be added to, or remain on, local blacklists in certain European jurisdictions. Whilst local blacklists often follow the EU Blacklist, removal from local blacklists is not necessarily automatic. Where this is the case, there could still be adverse implications for Cayman fund vehicles, or Cayman finance or holding companies, on the repatriation of returns through European structures to Cayman.

In particular, the Netherlands has its own blacklist of low-tax jurisdictions, which currently includes the Cayman Islands, for the purposes of enforcing certain of its anti-avoidance rules. The list is independent of the EU Blacklist and was last updated at the end of 2019. As a result, where fund vehicles are established in Cayman a Dutch holding platform becomes very challenging.

## Cayman Economic Substance Requirements

The need to meet additional substance requirements may be viewed as the price of Cayman's removal from the EU Blacklist.

Since 1 January 2019, there have been increased economic substance requirements in the Cayman Islands which can apply to fund management and holding companies. For example, Cayman fund management entities must (i) actually carry out in Cayman activities which are central to the business of fund management (e.g., investment decisions, hedging, investor and regulatory reporting); (ii) be directed and managed in Cayman; and (iii) have adequate op-ex, physical presence and personnel in Cayman. Holding companies are subject to a reduced economic substance test. For further detail, please see our Appendix below.

## Moving Forward

The removal of the Cayman Islands from the EU Blacklist is a helpful development, but one that may not completely reverse the recent trend of a move away from Cayman in structures. This is particularly likely to hold true where the sponsor has either European based LPs or underlying European based portfolio companies, or a combination of both.

## Appendix

### Cayman Islands Economic Substance Requirements

The Cayman economic substance law ("ES Law")<sup>1</sup> applies in respect of certain Cayman entities ("relevant entities") carrying out particular types of activities ("relevant activities"). Where the legislation applies, such entities need to comply with certain notification and reporting requirements as well as satisfy an economic

substance test in respect of each relevant activity. There are a range of sanctions for breaches of the ES Law, including financial penalties and potential striking-off. (These requirements apply in addition to, and may overlap with, applicable Cayman Islands regulatory requirements.)

Relevant entities include (i) a Cayman Islands company, LLC or LLP, or (ii) a foreign company registered in the Cayman Islands, but do not include private equity funds or other “investment funds” (as defined), or entities tax resident outside of the Cayman Islands.

Relevant activities include, amongst others, fund management business<sup>2</sup> (but not investment fund business) and holding company business.<sup>3</sup>

For entities seeking to carry out fund management activities in Cayman, the economic substance test requires that entity:

1. conducts core income generating activities (“CIGA”) in relation to its fund management business
  - i.e., activities that are of central importance to the fund management business in terms of generating relevant income and must be carried on in the Cayman Islands
  - this includes: taking decisions on the holding and selling of investments, calculating risk and reserves, taking decisions on currency or interest fluctuations and hedging positions, preparing reports and/or returns to investors or the Cayman Islands Monetary Authority
2. is directed and managed in an appropriate manner in the Cayman Islands in relation to its fund management business
  - which requires, amongst other things, its board of directors (as a whole) to have appropriate knowledge and expertise, meetings of the board of directors to be held in the Cayman Islands at ‘adequate frequencies’ given the level of decision making required, a quorum of directors present in the Cayman Islands during those meetings, minutes recording strategic decisions that are kept in Cayman
3. having regard to the level of relevant income derived from the fund management business carried out in the Cayman Islands, has ‘adequate’ (i) operating expenditure, (ii) physical presence (including maintaining a place of business) and (iii) fulltime employees or other personnel with appropriate qualifications, in the Cayman Islands.

What is adequate here will be fact, and business activity, dependent and it is important that the business maintains appropriate records in this regard. Outsourcing arrangements should also be carefully considered so as not to fail the economic substance, in particular the CIGA, requirements.

Relevant entities carrying out a (pure equity) holding company business are subject to a reduced economic substance test, requiring compliance with certain company law filing requirements and maintaining adequate human resources and premises in the Cayman Islands for holding and managing its equity participations. This latter requirement, again, will be fact, and business activity, dependent and may potentially be satisfied by maintaining a registered office in the Cayman Islands and engaging a registered office service provider in accordance with applicable company law. This will, however, be dependent on the level and complexity of the activity required to operate its business. Guidance helpfully clarifies that the entity is not required to be directed and managed in Cayman.

### **Additional Requirements — the Revised Guidance — July 2020**

The revised Guidance published in July 2020 places increased obligations on entities operating in Cayman, modifying the approach to notification and reporting. Relevant entities (including foreign entities registered in the Cayman Islands) will now be required to file an annual Economic Substance Notification ("ESN") as a prerequisite to submission of Annual Returns (foreign companies registered in the Cayman Islands must also file an ESN, despite not being required to file Annual Returns). Further, a relevant entity that has indicated in its ESN that it is carrying on a relevant activity, and is subject to the economic substance requirements under the ES Law, is required to report certain information on its relevant activities on an annual basis to the Cayman Islands Department for International Tax Cooperation (the "DITC") (the "ES Return").

In addition, an entity that is carrying on a relevant activity but is not a relevant entity due to being tax resident outside of the Cayman Islands (and is therefore not required to submit an ES Return or comply with the economic substance test) is now required to supply certain information, including with respect to the jurisdiction in which it is claiming to be tax resident, its immediate ownership and ultimate beneficial ownership and its financial year end date, as part of its ESN. It will also be required to provide additional information and appropriate evidence in support. There are also requirements on outsource service providers in respect of outsourced functions.

The Guidance provides that the Tax Information Authority will monitor arrangements which appear to be circumvention mechanisms and will investigate cases where a person has entered into any arrangement that the main purpose or one of the main purposes of which is to circumvent any obligation under the ES Law. An example is provided of an entity which seeks to manipulate or artificially suppress its income to circumvent substance requirements.

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1. The International Tax Co-operation (Economic Substance) Law (2020 Revision) (as amended by relevant regulations). The ES Law is supplemented by Economic Substance Guidance Notes (the "Guidance"), which were recently updated on 13 July 2020, to further develop the reporting and economic substance requirements introduced by the ES Law.↔

2. Broadly, the business of managing securities as set out in the Cayman Securities Investment Business Law (2020 Revision) ("SIBL") carried on by a relevant entity licensed or otherwise authorised to conduct business under that Law for an investment fund. In summary, the definition of fund management business encompasses relevant entities which, as a business, manage securities belonging to another person, being an investment fund, in circumstances involving the exercise of discretion pursuant to SIBL.↔

3. The business of a 'pure equity holding company' (broadly, a company that only holds equity participations in other entities and only earns dividends and capital gains).↔

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## Related Services

### Practices

- Tax
- Investment Funds

## Suggested Reading

- 04 November 2020 & 05 November 2020 Kirkland Seminar Kirkland Liquidity Solutions Academy
- 07 October 2020 Press Release Kirkland Advises Hg on £425 Million Financing of Hg Genesis 8 Portfolio
- 06 October 2020 In the News Exiting Portfolio Companies

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