

# FATCA: Impact on Cayman Islands Entities

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## Preface

This publication provides a brief overview of the impact on entities incorporated in the Cayman Islands of the foreign account tax compliance provisions (“**FATCA**”) of the Hiring Incentives to Restore Employment Act, 2010 of the United States of America (the “**US**”) and the Tax Information Authority (International Compliance) (United States of America) Regulations (as amended) of the Cayman Islands.

This publication is not intended to be a substitute for legal advice or a legal opinion. It deals in broad terms only and is intended to merely provide a brief overview and give general information. Conyers is only able to advise as to the Cayman Islands law aspects of the US IGA (as defined herein), and its Cayman enabling legislation. Advice should be sought from US counsel as to the interpretation of FATCA under US law.

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## 1. BACKGROUND

FATCA is a US federal law that aims to reduce tax evasion by US persons. FATCA has significant extra-territorial implications and, most notably, requires foreign financial institutions (“**FFIs**”, discussed further below) to report information on accounts of US taxpayers to the US Internal Revenue Service (“**IRS**”). If an FFI fails to enter into the necessary reporting arrangements with the IRS, a 30% withholding tax is imposed on US source income and other US related payments of the FFI.

In order to facilitate reporting under and reduce the burden of compliance with FATCA, the Cayman Islands has signed a Model 1B intergovernmental agreement with the US (the “**US IGA**”). The US IGA allows Cayman Islands entities that are FFIs to comply with the reporting obligations imposed by FATCA without having to enter into an agreement directly with the IRS. Instead, a Cayman Islands FFI may report directly to the Cayman Islands Tax Information Authority (the “**TIA**”) and, provided it complies with the relevant procedures and reporting obligations, will be treated as a deemed compliant FFI that is not subject to automatic withholding on US source income and other US related payments.

This publication is principally focused on FATCA. Clients should also have regard to notification and reporting requirements relating to the Common Reporting Standard which are set out in our publication entitled “The Cayman Islands and the Common Reporting Standard Issued by the Organisation for Economic Co-Operation and Development”.

## 2. WHAT DOES FATCA MEAN FOR YOUR CAYMAN ISLANDS ENTITY?

The impact FATCA will have on a Cayman Islands entity fundamentally depends on one key question: is the Cayman Islands entity an FFI?

While FATCA has significant implications for Cayman Islands entities that are FFIs - such as banks, custodians, hedge funds, private equity funds, certain trust companies, trusts and other regulated entities - a typical Cayman Islands holding company or joint venture vehicle will not generally be an FFI and should not be materially affected by FATCA.

Accordingly, the first step a Cayman Islands entity needs to take is to determine its FATCA classification and in particular whether or not it is an FFI. A broad summary of how to determine whether your Cayman Islands entity is an FFI, and a description of the steps that must be taken if the Cayman Islands entity is an FFI, are addressed in sections 3 and 5 below.

Any Cayman Islands entity that is not an FFI – such as a typical Cayman Islands holding company - will be a non-financial foreign entity (an “**NFFE**”) for the purposes of FATCA. Cayman Islands NFFEs are not generally subject to registration or reporting requirements under FATCA, but they will be required to self-certify their status to financial institutions and other withholding agents with whom they maintain accounts to avoid FATCA withholding. This is discussed further in section 4 below.

### 3. WHEN WILL A CAYMAN ISLANDS ENTITY BE CLASSIFIED AS A FOREIGN FINANCIAL INSTITUTION?

FATCA is very complex and a detailed analysis is required in each case to determine if a Cayman Islands entity is in fact an FFI. However, generally, the following four categories of Cayman Islands entities will be FFIs and will be directly affected by FATCA's registration and reporting requirements:

- **Investment Entities:** Broadly, an entity that conducts (or is managed by an entity that conducts) trading or portfolio and investment management activities as a business on behalf of a customer or otherwise invests, administers or manages funds or money on behalf of other persons.
- **Custodial Institutions:** An entity that holds, as a substantial portion of its business (broadly, more than 20% of gross revenues), financial assets for the account of others.
- **Depository Institutions:** An entity that accepts deposits in the ordinary course of a banking or similar business and regularly engages in one or more of the following activities (i) provision of credit; (ii) trading in receivables, notes or similar instruments; (iii) issues letters of credit; (iv) provides trust or fiduciary services; (v) finances foreign exchange transactions; or (vi) deals in finance leases or leased assets.
- **Specified Insurance Companies:** An insurance company (or its holding company) that issues, or is liable under, certain cash value or annuity contracts.

Set out below are categories of Cayman Islands entities that Conyers frequently deal with alongside some basic guidance on whether such Cayman Islands entities will be FFIs. In cases where such entities may be FFIs, we also consider whether any exemption to registration and reporting may be available.

#### (a) Hedge funds and private equity funds

Almost all hedge funds and private equity funds will be Investment Entities and therefore qualify as FFIs under FATCA. The one exception is that funds where more than 50% of the gross revenues are from real estate (or other non-financial assets) will generally fall outside the definition of Investment Entity (and therefore FFI) for the purposes of FATCA<sup>1</sup>. There are some other limited exemptions available to hedge funds and private equity funds, but these are expected to be of limited practical use for the vast majority of such funds.

It is important to note that, where a master-feeder structure is used, both the master fund and the feeder fund will be FFIs. Furthermore, a subsidiary Cayman Islands trading entity of a hedge fund is also likely to be an Investment Entity and therefore an FFI<sup>2</sup>. In section 6 below, we discuss the possibility of using a "Sponsoring Entity" to facilitate FATCA compliance for structures with multiple FFIs.

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<sup>1</sup> In the private equity context, this "gross revenues" test may also exempt Cayman Islands portfolio companies from being Investment Entities.

<sup>2</sup> The position is more complex for Cayman Islands subsidiaries of private equity funds and advice should be sought.

**(b) Cayman Islands managers and advisers of hedge funds and private equity funds**

Cayman Islands entities that act solely as managers and advisers of hedge funds and private equity funds will typically not need to register and report as FFIs.

Although Cayman Islands managers and advisers fall within the definition of Investment Entity (and therefore FFI), the US IGA contains an exemption for a Cayman Islands FFI that qualifies as an Investment Entity solely because it (a) renders investment advice to, and acts on behalf of, or (b) manages portfolios for, and acts on behalf of, a customer for the purposes of investing, managing, or administering funds deposited in the name of the customer with a participating FFI. Accordingly, Cayman Islands managers and advisers will generally not be required to register with the IRS and report on their own account. They may, however, be required to self-certify as NFFEs.

**(c) Cayman Islands holding companies and joint ventures**

As noted above, a typical Cayman Islands holding company or joint venture vehicle that owns assets on its own account and does not operate as an investment fund would not generally be expected to be an FFI for the purposes of FATCA. Rather, this type of Cayman Islands holding company will generally be a NFFE (discussed in section 4 below).

However, the directors of a Cayman Islands holding company that has or wishes to open a bank or securities account will still need to consider their FATCA classification carefully. Such a Cayman Islands holding company will likely be required to certify their status to the relevant financial institution to avoid withholding, as discussed in section 4 below.

**(d) Cayman Islands securitisation vehicles**

A typical Cayman Islands securitisation vehicle will normally be an Investment Entity and therefore an FFI for the purposes of FATCA, subject to limited transitional relief for pre-existing vehicles.

**(e) Financing SPVs**

Cayman Islands entities that are established solely for the purpose of borrowing or granting security in relation to the provision of debt finance to an underlying business typically will not be FFIs. Similarly, Cayman Islands entities which are established to own and finance aircraft, ships or other form of moveable asset of a similar nature would not typically fall within the definition of an FFI.

**(f) Trusts with a Cayman Islands trustee**

The treatment of trusts under FATCA is complex. The Cayman Islands FATCA rules only apply to a trust if the trustee is a Cayman Islands entity or is an individual resident in the Cayman Islands. Subject to some complex optionality for trustees, the majority of trusts that have a Cayman Islands trust company acting as trustee will likely be FFIs for FATCA purposes.

Private trust companies (“**PTCs**”) may also be FFIs for the purposes of FATCA, although this needs to be considered in each case. In particular, if the PTC and its directors are not remunerated for acting as trustee, the PTC and the underlying trust may conclude that it does not meet the definition of an FFI on the basis that the PTC is not conducting business. This is a topic that should be discussed with your adviser.

Clients with trusts that have Cayman Islands trustees or a Cayman PTC are advised to liaise with their advisers to determine the most appropriate course of action for their trust.

(g) **Insurance companies**

Only insurance companies that issue or are required to make payments with respect to a cash value insurance contract or an annuity contract will be FFIs pursuant to FATCA. Captive insurers and insurance companies that do not write annuities or whole life insurance products will generally be NFFEs.

(h) **Branches and foreign subsidiaries**

Branches of entities are treated separately for FATCA purposes. An overseas branch of a Cayman Islands FFI will not be covered by the Cayman Islands IGA and must consider the rules applicable in that branch’s jurisdiction, whether under an IGA or the US regulations. A foreign subsidiary of a Cayman Islands FFI must also comply with the FATCA rules in its home jurisdiction.

#### 4. **CAYMAN ISLANDS ENTITIES THAT ARE NOT FFIS**

As noted above, any Cayman Islands entity that is not an FFI – such as a typical Cayman Islands holding company – will be an NFFE. Although NFFEs are not generally subject to registration or reporting requirements, they will still be required to self-certify their status to financial institutions with whom they maintain financial accounts to avoid FATCA withholding.

In this regard, the US W8-BEN-E form requires entities to confirm their FATCA classification to US withholding agents and provide related information with respect thereto. Cayman Islands entities that hold accounts with financial institutions can certainly expect to complete these W8-BEN-E forms and provide other FATCA related certifications.

There are two categories of NFFE:

- (a) **Active NFFE:** The criteria which would qualify a NFFE as being an Active NFFE are numerous, and include where less than 50% of its gross income for the preceding calendar year is passive income (such as dividends, interest, royalties, annuities and rent) and less than 50% of the assets held during the preceding calendar year or other appropriate reporting period are assets that produce or are held for the production of passive income. For Active NFFEs, completion of the W8-BEN-E form essentially only requires completing the information on the first page, ticking “Active NFFE” on question 5 and then certifying that the entity is an Active NFFE in question 39.

- (b) **Passive NFFE:** Broadly, a Passive NFFE is an NFFE that is not an Active NFFE. For Passive NFFEs, the W8-BEN-E form also requires the NFFE to certify (having done appropriate due diligence) whether or not it has any substantial US owners (broadly, a US person with a 10% or more interest). To the extent it has substantial US owners, the name, address and US taxpayer identification number of each substantial US owner must be provided.

It is important that each Cayman Islands NFFE establishes which category it falls into so it can provide the necessary certification to financial institutions with which it maintains accounts. The W8-BEN-E form is signed under penalty of perjury.

## 5. WHAT DOES A CAYMAN ISLANDS FFI NEED TO DO TO COMPLY WITH FATCA?

If your Cayman Islands entity is an FFI for which an exemption is not available, you will need to take the following steps:

- (a) **Obtain a Global Intermediary Identification Number (“GIIN”):** Any Cayman Islands reporting FFI (or “registered deemed-compliant” FI required to be registered with the IRS) should liaise with its primary US FATCA advisers to register via the IRS portal (<https://sa2.www4.irs.gov/fatca-rup/>) and obtain a GIIN as soon as possible, to minimize any risk of incurring US withholding tax on payments it receives and, in the case of a Cayman Islands reporting FFI, to qualify for the benefit of the US IGA as regards FATCA withholding.
- (b) **Identify Reportable Accounts:** FATCA and the US IGA impose an obligation on Cayman Islands reporting FFIs to identify and report details of “reportable accounts” to the TIA. “Reportable accounts” are financial accounts where the account holder is either a “Specified US Person” (broadly, any US person or person liable to pay US tax with some exceptions) or is a non-US entity the controlling persons of which include one or more Specified US Persons. Financial accounts include any depositary or custodial accounts and also, in the case of certain Investment Entities, any debt or equity holdings in the FFI. In the case of Cayman Islands funds, the relevant account is the shares/interests each investor holds in the fund. Existing accounts (maintained as at 30 June 2014) should have been identified and due diligence obtained.

*New account procedures and due diligence:* For all new accounts opened with a FFI **after 1 July 2014**, it has been necessary to carry out due diligence and obtain self-certification regarding whether the account holder is a Specified US Person. If US Indicia are found that suggest the person may be a US taxpayer, prescribed steps will need to be taken to confirm this. For accounts opened by another participating FFI, the FFI’s GIIN should be obtained and verified against the publicly available IRS FFI list. In general terms, all Cayman Islands FFIs should have revised their account opening forms and/or subscription agreements to ensure they comply with FATCA rules in relation to new accounts. For funds, it is also important to have updated offering and constitutional documents to ensure FATCA is appropriately addressed.

- (c) **Notification:** All Cayman Islands FFIs that have reporting obligations under FATCA are required to notify the TIA of that fact no later than **30 April** in the first calendar year in which the Cayman Islands FFI was required to comply with the reporting obligations. Thereafter, the information set out in the notification should be immediately notified to the TIA. Changes to the information supplied must be immediately notified to the TIA. Where the Cayman Islands FFI ceases to have a GIIN it is required to notify the TIA.
- (d) **Reporting:** On or before **31 July** in each year, Cayman Islands FFIs should report to the TIA in relation to accounts held by Specified US Persons or a non-US entity with one or more controlling persons that are Specified US Persons. The US IGA prescribes the information that needs to be reported. Most significantly, it requires the balance of value of the relevant account held by the Specified US Person to be reported. Upon receipt of a report, the TIA will pass the reported information to the IRS.
- (e) **Point of Contact:** Cayman Islands FFIs must identify and authorise a person in their organisation to be the principal point of contact for all compliance-related purposes. Except in circumstances specified by the TIA, an additional person should also be appointed to give change notices for its principal point of contact.

## 6. SIMPLIFIED REPORTING FOR GROUPS OF FFIS

If a group has one or more eligible Investment Entities, the group may elect to register one “Sponsoring Entity” for FATCA reporting purposes. The appointment of a Sponsoring Entity effectively allows all FATCA compliance and reporting to be delegated to one entity in the group. To appoint a Sponsoring Entity:

- (a) The Sponsoring Entity must be authorized to act on behalf of the sponsored Investment Entities and agree to carry out all due diligence and reporting obligations on behalf of the sponsored Investment Entities.
- (b) The Sponsoring Entity has to register and obtain a sponsoring GIIN.
- (c) If the sponsored Investment Entities hold reportable accounts, the Sponsoring Entity will ultimately be required to register each Sponsored Investment Entity that it manages.

A Sponsoring Entity must report to the TIA all reportable accounts of its sponsored Cayman Islands Investment Entities.

## 7. CONCLUSION

All Cayman Islands FFIs should have robust systems in place to comply with FATCA.

For those Cayman Islands entities which are not FFIs, it is very much a case of “business as usual”. Other than having to determine their FATCA classification and certify/evidence their status to financial institutions with which they hold accounts, FATCA should hopefully have a limited impact on day-to-day operations.

If you have any queries regarding FATCA, please get in touch with your regular contact at Conyers who can advise further, or if required, refer you to appropriate US advisers.

*This publication should not be construed as legal advice and is not intended to be relied upon in relation to any specific matter. It deals in broad terms only and is intended merely to provide a brief overview and give general information.*

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