

Cayman Islands: Review of Cayman Islands and U.S. Laws Applicable to U.S. Persons' Financial Activity in the Cayman Islands, (GAO-08-1028SP), an E-supplement to GAO-08-778, July 2008)

Read the Full Report: *Cayman Islands: Business and Tax Advantages Attract U.S. Persons but Enforcement Challenges Exist* (GAO-08-778)

Background Information

The Cayman Islands is a major center for financial activity and entities such as corporations, partnerships, and trusts can all play roles in those activities. U.S. taxpayers have a range of relationships to those entities, including as owners, as investors, as partners, and as beneficiaries of trusts. The activities of Cayman Islands entities can have tax consequences for under U.S. law. To understand more about the nature of financial activity in the Cayman Islands and its consequences under U.S. tax law, we examined relevant portions of Cayman Islands and U.S. law. This supplement discusses four areas of Cayman Islands and U.S. law. Part I is an overview of Cayman Islands law governing corporations, partnerships, and trusts. It also discusses the function of the registered office under Cayman Islands law. Part II presents an overview of Cayman Islands law governing the sharing of information by the Cayman Islands government with the U.S. government. Part III discusses certain Cayman Islands monetary authority and anti-money-laundering laws and compares specific Cayman Islands and United States regulations designed to combat money laundering. Finally, Part IV describes some of the obligations that can arise under U.S. tax law for Cayman Islands entities and for U.S. owners of Cayman Islands entities.

Part I: Cayman Islands Law Governing Corporations, Partnerships, and Trusts

The law governing Cayman Islands corporations, partnerships, and trusts is derived from English common law, but is now largely statutory. Under Cayman Islands law, each entity form has a variety of types which are described below.

A. Corporations

The fundamental feature of a corporation under Cayman Islands law, like in the United States, is the limited liability of its shareholders, who are referred to as “members” under Cayman Islands law. A corporation is a legal person that must be created in conformance with formal statutory requirements including registration with the government. All Cayman Island corporations are governed by the Cayman Islands Companies Law (2007 Revision). To form a corporation, a memorandum of association must be filed containing the name of the proposed corporation, the location in the Cayman Islands of its registered office, the number of shares each shareholder takes, and the objects or purposes of the corporation. The memorandum of association is filed with the Cayman Registrar.

All Cayman Islands corporations must have a registered office in the Cayman Islands. U.S. states typically have similar requirements for registered offices or registered agents. Cayman Islands law, like many U.S. states’ laws, does not require or presume that any business activity of the corporation occurs at the registered office other than the receipt of service or other notices and keeping of certain records. The requirements of a registered office are discussed in further detail below in Part I(D) of this supplement.

All Cayman Islands corporations must maintain certain records, although not all must be filed with the Registrar or kept at the registered office, as discussed below. A Cayman Islands corporation must maintain a register of shareholders, a register of mortgages and charges, a register of directors, proper books of account, and minutes of all proceedings and resolutions of its shareholders, directors, or managers. Proper books of accounts must be able to give a true and fair view of the state of the corporation’s affairs and explain its transactions.

Cayman Islands corporations can be ordinary, exempted, or foreign companies. The differences among these types of companies are explained below.

(1) Ordinary companies

Ordinary companies are subject to both the Cayman Islands Companies Law and the Local Companies (Control) Law (1999 Revision). The name of ordinary companies must include “Limited” or “LTD.” Each year the company must file with the Registrar its list of shareholders and directors and hold a general meeting of shareholders. The list of shareholders must include the names, addresses, and number of shares held by each shareholder. In addition, ordinary companies must keep a register of shareholders including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders. This register must be open to the public during certain hours every business day at the registered office of the ordinary company upon payment of certain fees. The register of directors and officers must also be kept at the registered office.

Ordinary companies can be resident or non-resident. An ordinary resident company is usually formed to engage in business in the Cayman Islands. An ordinary resident company may conduct business in the Cayman Islands but an ordinary non-resident company may not. A resident company may become a non-resident company if the Cayman Islands Financial Secretary is satisfied that the corporation will not conduct business in the Cayman Islands and grants a certificate of non-residence to the corporation. While both ordinary resident and non-resident companies must file a list of shareholders annually with the Registrar, ordinary

resident companies must also file an annual list of shares held by Cayman Islands residents with the relevant Cayman Islands Immigration board to enforce the Local Companies (Control) Law requirement that 60 percent of shares of an ordinary resident company have Cayman Islands ownership.

(2) Exempted companies

When being formed, any Cayman Islands corporation can apply to the Registrar to be an exempted company. Unless granted a license under Local Companies (Control) Law, an exempted company is prohibited from engaging in business in the Cayman Islands except in furtherance of the business of the corporation carried on outside the Cayman Islands, and must make annual declarations to that effect. This restriction does not prevent exempted companies from making contracts in the Cayman Islands or from offering goods, services, or information over the Internet. An exempted company cannot offer stock to the Cayman public unless it is listed on the Cayman Islands Stock Exchange.

An exempted company is excluded from a number of requirements applicable to ordinary corporations. An exempted company is required to keep a register of shareholders, including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders. The names and addresses of directors and officers must be maintained at the registered office and filed with the Registrar. However, unlike an ordinary company, an exempted company need not open this register to the public, keep it in the Cayman Islands,¹ or send the list of shareholders to the Registrar. Additionally, an exempted company need not hold an annual general meeting of shareholders.

An exempted company may issue shares in bearer form, a type of share whose certificate does not record the owner's name and that is owned by whoever holds the certificate. However, since April 2001 Cayman Islands law has sharply curtailed the use of bearer shares; they may only be issued to or held by licensed or recognized custodians such as a holder of companies service license. As of April 2002, all companies, unless granted an extension, were to ensure that all bearer shares were deposited with a custodian or the shares would become null and void.

An exempted company may also apply to be registered as an exempted limited duration company. The exempted limited duration company form was created mainly to qualify for partnership tax treatment in other jurisdictions; however, the special features of the exempted limited duration exempted company are no longer necessary to qualify for partnership treatment under the U.S. Internal Revenue Code. The memorandum of association of exempted limited duration companies must limit the duration of the corporation to 30 years or less. An exempted limited duration company is considered to have commenced a voluntary winding up and dissolution when the period of duration is complete, when the members pass a special resolution to wind up voluntarily, or 90 days from certain events such as the death, resignation, or bankruptcy of a member. An exempted limited duration company must have at least two members and include "Limited Duration Company" or "LDC" in its name.

Exempted companies, including exempted limited duration companies, and any company applying to be an exempted company, can also apply to be a segregated portfolio company. Some of the assets and liabilities of a segregated portfolio company are divided into separate "portfolios"; assets in one portfolio are not available to meet liabilities and creditors of other portfolios. Assets of a segregated portfolio company not assigned to a portfolio are general assets and are available to meet the liabilities of any portfolio. A portfolio is not a separate legal entity. To apply to be a segregated portfolio company, a corporation must file with the Registrar a statement setting out the assets and liabilities of the company and recent transactions or events causing material changes to the assets or liabilities; the name of each portfolio; which assets and liabilities will be held

¹ The registered office of an exempt corporation may be compelled to produce this or other records held outside the Cayman Islands by Cayman Islands authorities.

by which portfolio; assurances that each portfolio will be solvent; and the written consent of all creditors of the company to the creation of segregated portfolios.² A segregated portfolio company must include “SPC” or “Segregated Portfolio Company” in its name. In addition to the normal annual fees paid to Cayman Islands authorities, a segregated portfolio company must pay a special segregated portfolio company fee and fees for each portfolio.

(3) Foreign companies

Foreign companies are companies that are organized under the law of a jurisdiction other than the Cayman Islands, but have chosen to register with the Cayman Registrar.³ Any corporation incorporated under the law of another jurisdiction which establishes a place of business or commences in carrying on a business in the Cayman Islands must register in the Cayman Islands as a foreign company. To register in the Cayman Islands, a foreign company must pay an annual fee and provide the Registrar a certified copy of its organizing instrument in English; a list of directors; and the name and address of a registered agent present in the Cayman Islands.⁴ Service of legal process or notice on the registered agent of a foreign company is deemed legally sufficient.

B. Partnerships

Partnerships, other than limited partnerships discussed below, are different from corporations in that their existence does not depend on registration with the government. Under Cayman Islands Partnership Law, a partnership exists between two or more persons carrying on a for-profit business in common unless the business is incorporated. In general, under both U.S. and Cayman law, a fundamental difference between partnerships and corporations is that the liability of partners in a partnership is not limited.

Cayman Islands law also allows for limited partnerships, a familiar concept in many U.S. states. Limited partnerships have at least one general partner with unlimited liability and at least one limited partner with limited liability. Unlike an ordinary partnership, a limited partnership must register with the Cayman Islands Registrar. The registration documents must include the name of the partnership, the general nature of the business, the principal place of business, the names and residences of the general partners, the term of partnership if any, a statement that the partnership is limited, and the contribution of each limited partner. Cayman Islands law prohibits limited partners from engaging in some activities, such as management of the partnership, that general partners can undertake.

Cayman Islands law also allows limited partnerships to register as exempted limited partnerships. An exempted limited partnership is prohibited from undertaking business with the public in the Cayman Islands except in furtherance of carrying on business outside the Cayman Islands and is governed by the Exempted Limited Partnership Law (2007 Revision). Corporations and partnerships can be partners in an exempted limited partnership. However, at least one general partner must be an individual resident of the Cayman Islands or a corporation or partnership registered in the Cayman Islands. A non-Cayman Islands corporation can satisfy this requirement by registering as a foreign company with the Cayman Islands Registrar. Exempted limited partnerships must register with the Cayman Islands Registrar just like ordinary limited partnerships.

² As an alternative to all creditors consenting in writing, the applicant can send written notice to all creditors having a claim against the corporation exceeding \$1,000. The consent of creditors holding 95 percent of the liabilities of the corporation is then sufficient.

³ One reason a corporation might choose to register as a foreign company is to be a general partner in a Cayman Islands partnership. Cayman Islands law requires exempted limited partnerships to have at least one general partner registered in the Cayman Islands.

⁴ Foreign companies have registered agents. Other types of entities, including ordinary companies, exempt companies, and exempt partnerships have registered offices.

Limited partnerships must have a registered address and maintain at that office the names and addresses of each partner and the partners' contributions to and receipts from the partnership.

C. Trusts and trust companies

Trusts are a unique legal concept originating in the common law, and are recognized in both the United States and the Cayman Islands. A trust is a fiduciary relationship rather than a separate legal entity. A trust is created when the settlor, or creator of the trust, transfers property to the trustee to be held for the benefit of the beneficiary. A trust is sometimes said to divide ownership of the trust property into two parts: legal ownership, which goes to the trustee, and beneficial ownership, which goes to the beneficiary. A trustee under Cayman Islands law has the same power as an ordinary owner of property to sell, transfer, mortgage, invest, insure, or take any other action with respect to the trust property, subject to the trustee's fiduciary duties. A trustee has a fiduciary duty to act with the highest degree of honesty and integrity with respect to the trust property and the beneficiary, and is liable for violations of this duty.

Trusts in the Cayman Islands are governed by the Trusts Law (2007 Revision). Like partnerships and unlike corporations, the existence of a trust, other than an exempted trust as described below, does not depend on registration with the government. Under Cayman Islands law, a settlor can reserve the power to revoke or amend a trust, give binding directions to trustees, appoint or remove trustees or beneficiaries, and restrict the powers and discretion of trustees. A settlor of a trust also can be a beneficiary of the trust and a director or officer of a company owned by the trust. Courts in the Cayman Islands, when determining which jurisdiction's law governs a trust, will first look to the terms of the trust and the intentions of the parties regardless of whether the property in question is present in the Cayman Islands. A clause of a trust document that expressly selects the laws of the Cayman Islands to govern a trust is valid, effectively and conclusively, regardless of any other circumstances. A trust governed by Cayman Islands law will not be invalid in the Cayman Islands because of a foreign law that does not recognize the legal concept of a trust, or because the trust avoids or defeats rights of other persons in the trust property under foreign laws based on personal relationships or heirship.⁵

Cayman Islands trusts can be ordinary, exempted, or special. An exempted trust differs from an ordinary trust in that it may be given a tax-exemption certificate from the Cayman Islands government stating that no Cayman Islands tax or duty relating to income, capital gains, inheritance, or estate, should such tax be introduced in the future, would apply to the trust property for 50 years. As is the case in relation to all persons, current Cayman Islands law imposes no such tax or duty on either ordinary or exempted trusts. Unlike ordinary trusts, an exempted trust must be registered with the Registrar. Registration includes the filing of trust documents with the Registrar and the payment of a fee. The Registrar's file on an exempted trust is open to inspection by trustees or other persons authorized by the trust documents to inspect the file, but not to the general public. Also, an exempted trust cannot have any beneficiaries who are domiciled in or residents of the Cayman Islands.⁶

A special trust, also called a STAR trust, differs from an ordinary trust in several ways. First, a beneficiary of an ordinary trust has the right to seek enforcement of terms of the trust in court, while a beneficiary of a special trust does not have such a right. Instead, a special trust has one or more persons called "enforcers" who are either named in the trust documents or appointed by the court. Enforcers may be beneficiaries, but need not be, and are generally presumed to have a fiduciary duty for the proper execution of the trust. An enforcer of a special trust has the same rights as a beneficiary of an ordinary trust to bring administrative and

⁵ Personal relationship means any relationship by blood or marriage, including former marriage. Heirship right means any right, claim, or interest in or against property of a person because of that person's death other than a right created by a will or other voluntary disposition.

⁶ This excludes objects of charitable trusts and non-resident companies and exempt companies registered under the Companies Law.

other legal actions, make applications to the court, be informed of the terms of the trust, receive information concerning the trust and its administration from the trustee, and inspect and copy trust documents.

Second, a trustee of a special trust has the power to resolve uncertainties as to the trust's objects or mode of execution, while a trustee of an ordinary trust must seek judicial intervention to resolve such uncertainties. Reciprocally, Cayman Islands courts can vary or revoke an ordinary trust or enlarge the power of trustees upon application by certain beneficiaries, whereas they do not have such power over special trusts. However, trustees of special trusts can apply to Cayman Islands courts under some circumstances to reform the trust.

In addition, every special trust must have at least one trustee which is a trust company licensed under the Cayman Islands Bank and Trust Companies Law (2007 Revision). Finally, a special trust cannot hold real estate in the Cayman Islands, but may hold an interest in a corporation, partnership, or other entity which owns land in the Cayman Islands. A special trust may also apply to be an exempted trust.

Anyone can serve as a trustee of a trust. However, under Cayman Islands law, any company engaged in the business of acting as a trustee, executor, or administrator must be licensed and regulated as a trust company and is subject to Cayman Islands anti-money-laundering and know-your-customer requirements. To be licensed, a trust company's principal office must be in the Cayman Islands and have a Cayman Islands corporation or two Cayman Islands residents as local agents. There are two types of trust company licenses in the Cayman Islands. A holder of an unrestricted trust company license can act as trustee for any trust. A holder of a restricted trust company license is restricted to the activity specified in its approved business plan and can only be a trustee for trusts listed on the license application, typically limited to 20 trusts or less. A nominee trust company is a wholly owned subsidiary of a licensed trust company whose sole purpose is to act as the trust company's nominee. All license holders must have annual audits by a professionally qualified audit firm approved by CIMA.

D. Registered offices and company management businesses

Cayman Islands corporations and exempted limited partnerships must have a registered office located in the Cayman Islands, whose address is publicly available from the Registrar. U.S. states have similar requirements. The registered office is the place where all official communication with the entity must be sent, including any legal writ, notice, order, or other legal document. Proper service by another party, such as a creditor, of legal documents on a corporation or exempted limited partnership, a necessary step in legal proceedings, can be accomplished by delivery of the documents to its registered address. Other documents that can be sent to the corporation's registered office include a creditor's demand for payment, shareholder proxies and powers of attorney, and a shareholder statement of dissent from winding up. A primary function of a registered office under Cayman Islands law is the protection of creditors of a corporation.

Cayman Islands law does not require or presume that any business activity of the entity occurs at the registered office other than the handling of the communications discussed above and keeping of some records. Specifically, under Cayman Islands law, all corporations must keep at their registered offices (1) a register of all mortgages on the property of the corporation, which is open to members and creditors of the corporation; and (2) an up-to-date list of the names and addresses of directors and officers of the corporation. Ordinary companies must keep a register of shareholders, including names, addresses, amounts paid for shares, and dates when shareholders became and ceased to be shareholders at the registered office. This register must be open to the public during certain hours every business day upon payment of certain fees. Limited partnerships must have a registered address and maintain at that office the names and addresses of each partner and the partners' contributions to and receipts from the partnership.

There are businesses in the Cayman Islands, as there are in the United States, that provide registered office services for a fee. In the Cayman Islands, as in the United States, the address of the firm providing registered

office services is usually the registered address for the firm's clients. Under the Companies Management Law (2003 Revision), a business that provides registered office services must be licensed by the Cayman Islands Monetary Authority (CIMA). These company service providers must also follow the requirements of Cayman Islands law with regard to anti-money-laundering and "know-your-customer" laws, which are discussed in Part III of this supplement. In brief, Cayman Islands law requires company service providers to keep records of the beneficial ownership of entities to which they provide services.

Under Cayman Islands law, there are two types of company management licenses: a corporate services license and a companies management license. The holder of a corporate services license may only act as a company formation agent; provide registered office services; file statutory forms, resolutions, returns, and notices; and accept legal service of process for a foreign company. The holder of a companies management license can provide for their clients all the services of a corporate services license and, in addition, can provide nominee shareholders and officers and directors; act as a custodian of bearer shares; and control all or a substantial part of the assets of the corporation. Nominee shareholders are individuals whose names appear on the corporate forms filed with the Registrar but are not the beneficial owners. The existence of nominees does not relieve the company service provider from its obligation to know the beneficial owner under Cayman Islands anti-money-laundering and know-your-customer rules.

In addition to holders of corporate services licenses and companies management licenses, holders of trust company licenses, insurance managers licenses, and mutual fund licenses may provide registered office and other services consistent with the terms of those licenses.

Providing such services without a license is a criminal offense and can result in fines and imprisonment. To receive a license, the applicant must satisfy CIMA that it has sufficient expertise to carry on the business and that the business will be conducted by persons who are "fit and proper" for their roles as directors, officers, or managers. To assess whether a person is fit and proper, the statute requires CIMA to assess the person's honesty, integrity, and reputation; competence and capability; and financial soundness. License holders undergo annual audits by a CIMA-approved auditor who is a member of a major auditing professional organization. Every year the license holder must also submit to the regulator copies of its accounts and the results of the audit. CIMA has the power to conduct reviews, including on-site reviews, of the business of any license holder. CIMA can also inspect the records of anyone it reasonably suspects of carrying on a company management business without a license.

Part II: Cayman Islands Law Governing Sharing of Information With Foreign Governments

A. MLAT and implementing statute

In July 1986, the United States and the United Kingdom, including the government of the Cayman Islands, signed a Mutual Legal Assistance Treaty (MLAT) that requires the United States and the Cayman Islands to provide legal assistance to each other at the request of the other party in criminal matters. However, assistance is generally not provided under the MLAT if the request deals with alleged criminal activity relating to the imposition, calculation, and collection of taxes, or if the criminal matter is not punishable by at least one year of imprisonment. Assistance can be provided under the MLAT if the alleged criminal activity concerns willfully or dishonestly obtaining assets by committing fraud in connection with benefits available under tax laws or concerns willful or dishonest false statements about a tax matter concerning the unlawful proceeds of a criminal offense. Legal assistance may include taking testimony of individuals, providing documents or other evidence, locating persons and transferring persons in custody, executing searches and seizures, and freezing assets. Additionally, if one party has reason to believe the proceeds of a criminal offense are located in the territory of the other party, assistance may include forfeiture of the proceeds of the criminal offense, payments of restitution to the victim, and the collection of fines. Requests for assistance must originate from the

Attorney General or his designees in the United States and from the Cayman Mutual Legal Assistance Authority in the Cayman Islands.

Senate ratification of the MLAT did not occur until October 1989, with the treaty entering into force under U.S. law in March 1990. However, the Cayman Islands began providing legal assistance immediately after the September 1986 enactment of their implementing statute, known as the Mutual Legal Assistance (United States of America) Law (1999 Revision). This law established the Chief Justice, or another Judge of the Grand Court, as the designated Cayman Mutual Legal Assistance Authority. Additionally, the statute gives the Cayman Authority the power to compel persons to testify or produce documents, and it requires confidentiality from individuals who are involved in a legal assistance request. Failure to produce documents or maintain confidentiality can result in criminal penalties.

Subsequent to the MLAT agreement with the United States, the Cayman Islands enacted in 1997 what is now titled the Criminal Justice (International Cooperation) Law (2004 Revision), thereby permitting the Cayman Islands to provide similar legal assistance to most countries in the world. Under the law, mutual legal assistance may be provided if there is a criminal offense under Cayman Islands law or if there is conduct which would have constituted a criminal offense had it occurred within the Cayman Islands. Upon receiving a request for assistance, Cayman Islands authorities may take statements, serve documents, execute searches and seizures, provide evidence and documents, identify and examine objects and sites, freeze assets, and assist in proceedings related to forfeiture and restitution.

B. TIEA and implementing statute

In November 2001, the United States and the United Kingdom, including the government of the Cayman Islands, signed a Tax Information Exchange Agreement (TIEA) designed to facilitate the exchange of tax information between the United States and the Cayman Islands. Each party agreed to provide, at the request of the other, information relating to the administration and enforcement of domestic federal income tax laws, although other types of tax laws may also be included by later agreement. Each party to the agreement is required to ensure it has the domestic legal authority to obtain information from financial institutions regarding nominees, trustees, beneficial owners, units of interests of investment funds, and other similar information. While requests can be made concerning the activities of any individual regardless of residency or nationality, the request must be specific enough to identify the taxpayer and the tax purpose for which the information is sought, as well as state the reasonable grounds for believing the information is in the territory of the other party. In some circumstances, representatives from one party may enter the territory of the other party in order to interview persons and examine records. Requests for information must originate from the Secretary of the Treasury or his designees in the United States and from the Tax Information Authority in the Cayman Islands. All information provided or received by either party must be kept confidential and may only be used for the enforcement of tax laws. The agreement entered into force for criminal tax evasion matters on January 1, 2004, and for all other noncriminal tax matters on January 1, 2006.

The U.S. Department of Treasury performs U.S. obligations under the agreement pursuant to existing authority in U.S. law. In March 2005, the Cayman Islands passed a domestic implementing statute, the Tax Information Authority Law, 2005. Under this law, the Cayman Islands Financial Secretary was designated the Tax Information Authority. His functions and powers under the Law were formally delegated to an administrative unit of the same name, including the power to take testimony, provide evidence, serve documents, and execute searches and seizures. Individuals who fail to produce required information or maintain confidentiality are subject to criminal penalties.

Part III: Cayman Islands Monetary Authority Law; Cayman Islands and U.S. Anti-Money laundering Laws

A. CI Monetary Authority Law

In 1997, the Monetary Authority Law (2004 Revision) established the Cayman Islands Monetary Authority (CIMA) as the Cayman Islands primary financial services regulatory body. Led by a Board of Directors, CIMA has four primary areas of functional responsibility. First, pursuant to its monetary functions, CIMA is the sole issuer of the legal tender of the Cayman Islands and manages the country's Currency Reserve. The Monetary Authority Law specifies that the official currency is the Cayman dollar, the value of which is tied by order to the American dollar. Second, CIMA regulates and supervises financial services businesses, monitors compliance with anti-money-laundering regulations, issues and amends rules and statements of guidance including relating to money laundering, and performs other regulatory duties. The Guidance Notes on the Prevention and Detection of Money Laundering in the Cayman Islands are considered to be issued under this grant of authority. Third, CIMA is responsible for providing assistance to overseas regulatory authorities. In deciding whether to provide assistance, CIMA is instructed to consider whether corresponding assistance would be given by the requesting party, whether the request relates to a breach of law which has an equivalent within the Cayman Islands, and other factors. If it provides assistance to an overseas regulatory authority, CIMA may disclose information within its possession as well as direct any other person that it considers has relevant information to provide specific information, documents, or other assistance as may be needed. Fourth, CIMA provides an advisory function by advising the government on the regulatory laws and cooperative functions.

As part of its general powers, CIMA may open and maintain accounts with banks, purchase and sell foreign currencies and foreign Treasury bills, purchase and sell securities and other investments, borrow money, and more. CIMA activities are led by a Board of Directors and a Management Committee, and CIMA is fully and solely responsible for all licensing and enforcement activity. The Governor-in-Cabinet appoints all directors and may provide general directions on policy as it may consider necessary in the public interest, after consultation with the Board. The Monetary Authority Law includes a schedule of fees for certain CIMA activities, including fees for the issuance of letters that confirm the registration and licensing of regulated entities.

B. Anti-Money-Laundering Laws

The Proceeds of Criminal Conduct Law (2007 Revision) was first enacted in 1996 and, along with the Terrorism Law, 2003, forms the basis of the Cayman Islands anti-money-laundering and antiterrorist financing legal framework. Under the Proceeds of Criminal Conduct Law, criminal "money laundering" involves the possession, use, concealment, or transfer of the proceeds of criminal conduct, or an act which assists another retain the proceeds of criminal conduct. Proceeds from criminal conduct performed outside the territory of the Cayman Islands also fall within the definition if the act would have been an offense had it been performed within the Cayman Islands.

Additionally, "tipping off" an individual that he or she is being investigated for money laundering or is the subject of a suspicious activity report (SAR) constitutes a criminal offense, as does the failure to report a case of suspected money laundering unless the information was obtained under privileged circumstances.⁷ The law also establishes a financial intelligence unit called the Financial Reporting Authority which is responsible for the receiving, analyzing, and onward disclosure of information related to proceeds of criminal conduct. The

⁷ These relate to the provision of legal advice to a client or to any person in contemplation of legal proceedings or for the purposes of such proceedings, except where a criminal purpose is being furthered.

Financial Reporting Authority must retain information for a minimum of 5 years and may enter into agreements with overseas financial intelligence units.

Pursuant to the authority granted in the Proceeds of Criminal Conduct Law, regulations were promulgated to further strengthen the money laundering framework. Known as the Money Laundering Regulations (current version is the 2006 Revision), these regulations were first enacted in April 2000 and apply to all relevant financial business as defined by the Financial Action Task Force Recommendations, such as those involved in banking, trust business, insurance, mutual funds, company formation and registered office services, and other designated activity in the Cayman Islands. To facilitate interpretation of the requirements this law imposes on financial institutions and other relevant financial business, CIMA has also issued supplementary enforceable Guidance Notes that provide further clarification on what is required to be compliant with the Regulations.

The Regulations and Guidance Notes include a number of important provisions designed to combat money laundering and terrorist financing.⁸ For example, the Regulations require financial businesses to know the identity of their customers⁹ and to maintain identity records for at least 5 years. The Guidance Notes indicate that to comply with the Regulations, the information obtained should include name, address, date and place of birth, nationality, occupation, purpose of the account, estimated level of turnover for the account, the source of funds, and, in some cases, a reference from another financial institution. In relation to legal entities, underlying beneficial ownership and control must be identified and verified as must, in relation to trusts, the settler and any ascertainable beneficiaries¹⁰ and the source of trust property. The Regulations also require financial businesses to create an internal report if there is knowledge or a suspicion that an individual is engaged in money laundering or terrorist financing. If, after considering all information and following certain procedures, the financial business knows or suspects money laundering, then a suspicious activity report must be submitted to the Cayman Islands Financial Reporting Authority. The Guidance Notes offer examples of potentially suspicious activity and a sample Suspicious Activity Reporting Form used to report such activities to the Financial Reporting Authority. There is no monetary threshold for reporting where there is knowledge or suspicion of money laundering or terrorist financing—any such knowledge or suspicion must be reported, regardless of the amount of money involved.¹¹

These laws are similar to U.S. regulations, which require financial institutions to implement Customer Identification Programs intended to allow the institutions to form a reasonable belief as to the true identity of each customer. Under U.S. regulations, financial institutions must verify the identity of customers by collecting certain information, maintain identification records for at least 5 years, and cross-reference customers against lists of known or suspected terrorists. Additional enhanced procedures apply for accounts held by non-U.S. persons, such as mandatory attempts to ascertain the beneficial owners of accounts, the source of funds deposited into accounts, and additional procedures for monitoring accounts for evidence of money laundering.

Cayman Islands regulations also require financial businesses to create an internal report if they have knowledge or suspicion that an individual is engaged in money laundering. If, after considering all information

⁸ Cayman Island regulators refer to these requirements as AML/CFT or anti-money-laundering/combating the financing of terrorism regulations. Both the anti-money-laundering and the combating terrorism financing tracks include know-your-customer requirements.

⁹ Identity needs to be proven (1) where the parties form an ongoing business relationship, (2) where there is a one-off transaction and the person handling the transaction suspects money laundering, (3) where there is a one-off transaction in the amount of \$15,000 or more, or (4) where there are two or more one-off transactions which appear linked and which total \$15,000 or more.

¹⁰ Some trusts will not have immediately ascertainable beneficiaries such as in cases where the beneficiaries have not yet born.

¹¹ Cayman Island regulations also cover cross-border cash transactions of more than \$15,000 and contain specific know-your-customer rules for wire transfers.

and following certain procedures, the financial business knows or suspects money laundering, then a suspicious activity report must be submitted to the Cayman Islands Financial Reporting Authority. The Guidance Notes offer examples of potentially suspicious activity and a sample Suspicious Activity Reporting Form used to report such activities to the Financial Reporting Authority.

In the United States, financial institutions are required to file two different types of reports with the Department of the Treasury. The first, Currency Transaction Reports (CTRs), are required for a single cash transaction of more than \$10,000, or multiple smaller cash transactions that appear to be related and total more than \$10,000. The second, type of report, a Suspicious Activity Report (SAR), is triggered by transactions that involve, in the aggregate, at least \$5,000 if the financial institution has reason to suspect that the transaction involves funds derived from illegal activities, is designed to evade the law, or is unusual for the customer and there is no reasonable explanation for it. Financial institutions are not permitted to disclose to any person involved in the transaction that a SAR has been filed regarding the transaction.

Part IV: U.S. Tax Obligations and Cayman islands Entities

In general, the U.S. Internal Revenue Code (the Code) taxes income earned worldwide by U.S. citizens, U.S. residents, and U.S. corporations wherever earned. Nonresident aliens and foreign corporations are subject to U.S. taxation on certain amounts received from sources within the United States and income which is effectively connected with a trade or business in the United States.

U.S. income tax obligations exist in relation to entities organized in the Cayman Islands in two main circumstances. The first is when the activities of the entity trigger U.S. income tax obligations, such as when a Cayman Islands corporation earns income that is effectively connected to a trade or business in the United States. The second circumstance is when earnings of an entity trigger obligations on behalf of its owners, such as when a Cayman Islands corporation makes a dividend payment to a U.S. taxpayer.

A. Classification of entities for U.S. tax purposes

How a Cayman Islands entity is classified for purposes of the U.S. tax system affects its obligations. A business entity organized as a corporation or a partnership under Cayman Islands law may be treated as such or may elect to be treated otherwise under U.S. tax law. Similarly, Cayman Islands trusts may or may not be treated as trusts for purposes of U.S. tax law, as discussed below.

Whether an entity is treated as a partnership or a corporation is determined by the Department of the Treasury's "check-the-box" regulations. 26 C.F.R §§ 301.7701-1 to -4. Under these regulations, eligible entities,¹² both foreign and domestic, may choose their classification as a corporation, partnership, or a single member entity.¹³ Only business entities are governed by the "check-the-box" rules. Some business and investment trusts meet the definition of a business entity. Eligible entities with two or more members may choose to be treated as partnerships or corporations. Eligible entities with only one member may choose to be treated as single member entities or corporations. Certain entities are not eligible to choose their classification; they are always taxed as corporations.

Corporations are separate legal entities and the United States imposes the U.S. corporate income tax on their profits. Partnerships and other disregarded entities are generally not taxed; the income earned by the entity is

¹² Certain types of entities, including some foreign entities, are per se corporations and do not have the option to be treated as partnerships or single member entities.

¹³ A single member entity is a disregarded entity similar to a partnership for tax purposes, but has only one member. The activities of disregarded entities are taxed in the same manner as a sole proprietorship, branch, or division of the owner.

taken into account on the owners' tax returns. The tax obligations of trusts¹⁴ are handled separately by the Code and will be discussed below.

B. Taxation of entities

(1) Corporations

If a foreign corporation conducts a U.S. trade or business, the income that is effectively connected to that trade or business (ECI) is taxed as if the corporation was a U.S. corporation. 26 U.S.C. § 882. Foreign corporations that own and operate businesses in the United States that sell services, products, or merchandise, are, with certain exceptions, engaged in a U.S. trade or business. Generally, any income from such a business is considered to be ECI and subject to the U.S. corporate tax. Foreign source income attributable to an office or fixed place of business in the United States, such as rents and royalties for the use of certain intangible personal property, is treated as ECI. Foreign corporations engaged in a trade or business in the United States must file a tax return every year even if they have no ECI. 26 U.S.C. § 6012.

(2) Partnerships

Partnerships, whether foreign or domestic, are not taxed on partnership income; the partnership is disregarded and the income is imputed to the partners, who owe taxes on their share of the partnership income at their own applicable rates. In general, a domestic partnership must file a Form 1065, the "U.S. Return of Partnership Income," reporting on the partnership's income, but a foreign partnership only files a Form 1065 if it has ECI or income derived from sources in the United States. 26 U.S.C. § 6031(e).

(3) Withholding taxes on investments

Foreign corporations and non-U.S. partners may also be subject to a tax on U.S.-source investment income not effectively connected to a trade or business. Fixed or determinable annual or periodical gains, profits, and income (called investment income or FDAP income) from U.S. sources earned by a nonresident not in connection to a trade or business is typically subject to a 30 percent tax.¹⁵ 26 U.S.C. §§ 871(a), 881. Since this tax may be difficult to enforce against a foreign taxpayer with few assets in the United States, the U.S. payer of such income may be required to withhold 30 percent to pay this tax. 26 U.S.C. §§ 1441, 1442. A withholding agent who fails to withhold becomes personally liable for the tax and any penalties or interest. The withholding tax on FDAP income is a tax on gross income, unlike the tax on income effectively connected to a U.S. trade or business, which is a tax on net income. A non-U.S. recipient of FDAP income must file a form with the payer (for example, a W-8BEN) stating the amount to be withheld.

(4) Transfer pricing

The Internal Revenue Service (IRS) is authorized to allocate gross income, deductions, credits, and allowances between related taxpayers to the extent necessary to prevent the evasion of taxes or to clearly reflect the income of the taxpayers. 26 U.S.C. § 482. This authority applies both to domestic and foreign taxpayers. IRS examines transfer prices between related taxpayers using the arm's length standard (i.e. in comparison to what transfer prices between unrelated taxpayers for comparable transactions would be), so the transfer pricing rules are governed by complex economic and legal principles. In the case of any transfer or license of intangible property between related tax payers, the income with respect to such transfer or license must be commensurate with the income attributable to the intangible. In some cases, taxpayers and IRS negotiate

¹⁴ The Internal Revenue Code has a limited definition of trust. Some trusts organized under Cayman Islands law may not be taxed as trusts, but as business entities under the "check-the-box" rules.

¹⁵ The level of withholding may be reduced by applicable income tax treaties with certain foreign jurisdictions. However, no such treaty exists between the Cayman Islands and the United States.

advance pricing agreements. The Advance Pricing Agreement Program provides a voluntary process whereby the IRS and taxpayers may resolve transfer pricing issues (under section 482 of the Code, the regulations thereunder, and relevant income tax treaties) on a prospective basis.

C. Taxation of owners

(1) Corporations

As stated above, the United States generally taxes U.S. taxpayers on their worldwide income. When a U.S. taxpayer owns part of a Cayman Islands corporation, distributions, such as dividends to the owner, are part of the owner's taxable income. In general, the United States does not tax or place reporting burdens on foreign corporations solely because they have U.S. taxpayers as shareholders. If a shareholder of a Cayman Islands corporation is a U.S. taxpayer, that U.S. taxpayer is obligated to report any income earned from the Cayman Island corporation, typically dividends. Shareholders may also earn capital gains from the sale of stock. Unless an exception applies, as discussed below, a shareholder is not taxed on earnings of a corporation in which he owns shares until the corporation makes a distribution, such as a dividend. This can allow some taxpayers to defer some tax obligations.

The Code has a number of exceptions to the general rules regarding the taxation of U.S. shareholders of foreign corporations, including the accumulated earnings tax, the controlled foreign corporations (CFC) rules, and the passive foreign investment companies (PFIC) rules. Some of these exceptions treat the foreign corporation as a disregarded entity or partially disregarded entity and impute the earnings of the foreign corporation to the U.S. taxpayer. Other exceptions allow for the deferment of income but impose additional tax penalties or burdens by converting capital gains into ordinary income or by charging interest.

In addition to the ordinary corporate tax, Cayman Islands corporations may be subject to an accumulated earnings tax of 15 percent tax, in addition to the ordinary corporate income tax, on accumulated earnings "beyond the reasonable needs of the business". 26 U.S.C. § 531. This accumulated earnings tax will apply to a Cayman Islands corporation that meets several conditions. First, the corporation must be formed for the purpose of avoiding shareholders' income tax by permitting earnings and profits to accumulate instead of being divided or distributed; and it must not be a personal holding company, tax-exempt corporation, or passive foreign investment company. Second, the foreign corporation's shareholders must be subject to U.S. tax on the distributions of the corporation because they are U.S. citizens or residents, nonresident alien individuals receiving FDAP, or foreign corporations owned directly or indirectly by any shareholder described above. Further, the accumulated income tax applies to income derived from sources within the United States.

Cayman Islands corporations may also meet the definition of a PFIC. Generally, a foreign corporation is a PFIC if 75 percent of the corporation's income is passive income or if 50 percent of the corporation's assets are passive assets. 26 U.S.C. § 1297. Unlike other types of foreign corporations discussed herein, the definition of a PFIC does not depend on any level of stock ownership. Each U.S. shareholder of a PFIC can choose to be taxed in one of two (or, in the case of marketable stock, one of three) ways. A U.S. shareholder of a PFIC may make a qualified electing fund election or, with respect to marketable stock, a mark to market election with respect to the PFIC. U.S. shareholders of qualified electing funds are taxed currently on the PFIC's earnings. Alternatively, U.S. shareholders of a qualified electing fund may choose to defer the tax on the PFIC's earnings but will pay an interest charge. U.S. shareholders of marketable stock who make a mark to market election are taxed annually on the appreciation in the value of the stock, or are allowed a deduction in the case of depreciation in the value of the stock, but only to the extent that they have had prior year inclusions under the mark to market election. Special rules prevent an amount that is taken into account under the qualified electing fund or mark to market elections from being taken into account again upon a payment of a dividend by the PFIC or a disposition of the PFIC stock by the U.S. shareholder. A U.S. shareholder of a PFIC that does not make a qualified electing fund election or a mark to market election is not taxed until the PFIC makes a

distribution or until the U.S. shareholder disposes of the PFIC stock, but is taxed at top rates and is charged interest.

A Cayman Islands corporation may be considered a CFC. 26 U.S.C. §§ 951, 957. Certain U.S. shareholders of CFCs are taxed on their pro rata share of certain income and other amounts of the CFC immediately, not when the CFC makes a distribution. An entity is a CFC if “U.S. shareholders” own more than 50 percent of the total combined voting power of its stock or more than 50 percent of the stock’s total value. To be considered a “U.S. shareholder” for the purposes of this definition, a U.S. person must own at least 10 percent of the total combined voting power of the corporation’s stock.¹⁶ In calculating ownership, the statute considers direct, indirect, and constructive ownership. U.S. persons are deemed to own stock held by their wholly owned subsidiaries or by certain related persons. If a Cayman entity is a CFC, then each U.S. shareholder owning 10 percent or more of the voting stock must include in income his share of certain income of the CFC. The income of the CFC to be includible to the U.S. shareholder includes the income defined in subpart F (often called Subpart F income) and earnings of the CFC invested in U.S. property. Major types of Subpart F income include income from passive investments, income from transactions with entities related to the CFC, and insurance income. There are special rules discussed below that alter the definition of CFC for foreign insurance companies making it more likely that foreign insurance companies will qualify as CFCs.

Certain individual or corporate shareholders, officers, and directors of foreign corporations are required to file Form 5471, the “Information Return of U.S. Persons with Respect To Certain Foreign Corporations.” U.S. persons who control a foreign corporation or U.S. shareholders of a CFC must file a Form 5471. Direct and indirect PFIC shareholders must file a Form 8621, the “Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund,” if they (1) recognize gain on the sale of PFIC stock, (2) receive a PFIC distribution, or (3) make an election on Form 8621. For stock of a CFC that is also a PFIC, PFIC shareholders do not have to file Form 8621 if they include in income subpart F income, which is generally done by filing Form 5471.

(3) Partnerships

U.S. taxpayers who are partners in a Cayman Islands partnership will owe taxes on their share of the partnership income no matter what the source of the income is. Foreign partners of a Cayman Islands partnership will only owe tax on the portion of the partnership income that is ECI. Partners in a partnership are engaged in a U.S. trade or business if the partnership is so engaged. A partnership is engaged in a U.S. trade or business if a partner is so engaged and is acting as an agent of the partnership. Partnerships that have ECI must pay a withholding tax generally at a rate of 35 percent for corporate partners and 35 percent for other partners on the ECI allocable to those partners. If the partnership fails to withhold, any general partner can be liable.

(4) Tax-exempt entities

There are also tax consequences for U.S. tax-exempt entities, such as pension funds and university endowments, who are shareholders in Cayman Islands corporations. In general, if a tax-exempt entity is a partner in a for-profit partnership engaged in a trade or business unrelated to the tax-exempt entity’s purpose, then the tax-exempt entity is subject to the unrelated business income tax (UBIT) on income from that partnership. 26 U.S.C. § 512. However, tax-exempt entities that are minority shareholders in corporations are generally not subject to UBIT on dividends. While domestic corporations are subject to the U.S. corporate income tax, which decreases the amount available to be paid out to shareholders, foreign corporations are generally not subject to U.S. corporate income tax on income that is not effectively connected to a U.S. trade or

¹⁶ If 11 unrelated U.S. shareholders hold all the shares of a foreign corporation equally, that corporation is not a CFC because no shareholder is considered a “U.S. shareholder.”

business. Therefore, U.S. tax-exempt entities may secure tax advantages with respect to dividend income from foreign corporations that is not ECI.

(5) Insurance

The Code contains special rules for the treatment of foreign corporations' insurance income. 26 U.S.C. § 953. First, insurance income is a type of subpart F income, which means that U.S. shareholders of foreign corporations qualifying as CFCs are taxed on the CFC's insurance income. Second, foreign insurance companies are more likely to be considered CFCs because the definition of a CFC is different in the context of insurance. A foreign corporation not otherwise considered a CFC may qualify as a CFC if U.S. shareholders own 25 percent or more (rather than more than 50 percent) of the corporation's stock and it receives 75 percent of its premium-type income from insuring risks outside the Cayman Islands. Third, foreign corporations that insure the risks of related persons, such as captive insurance companies, are even more likely to be considered CFCs because for these companies, the definition of "U.S. shareholder" is different. In the normal determination of whether a foreign corporation is a CFC, only U.S. shareholders directly or indirectly owning 10 percent or more of the corporate stock are counted. However, for insurance companies insuring related parties, any U.S. shareholder is counted. The altered definition of "U.S. shareholder" further means that the subpart F income of the CFC will be included to all U.S. shareholders, not just those owning 10 percent or more. Certain foreign corporations may choose to pay U.S. corporate taxes on related-party insurance income to save their U.S. shareholders from owing tax on included income. IRS has also contested payments made to captive insurance companies under section 162 as not being actual insurance payments, but capital contributions.

Trusts

Distributions paid by foreign non-grantor trusts to U.S. beneficiaries are generally taxable income to the beneficiaries. Income earned by a grantor trust is taxed to the grantor; the Code disregards the trust as a separate taxable entity. Some foreign trusts may be business entities to which the "check-the-box" rules apply, and will be taxed as partnerships or corporations.

Transfers by a U.S. person to a foreign non-grantor trust are treated under the Code as a sale, which means that the U.S. person will owe tax on any capital gains and the basis in the property is adjusted. 26 U.S.C. § 684. However, there are exceptions to this rule.

Generally, any U.S. person who, during the tax year, creates a foreign trust or transfers money or property to a foreign trust must file a Form 3520, the "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts." The return must be filed whether or not the trust has a U.S. beneficiary and whether or not the trust has a U.S. owner. Foreign trusts with U.S. beneficiaries are required to file Form 3520-A, the "Annual Information Return of Foreign Trust with a U.S. Owner," although a foreign trustee outside the jurisdiction of IRS might not file.

U.S. "owners" of foreign trusts must file a Form 3520 on their trusts for each tax year or partial tax year in which they own the trust (including tax years in which they do not create the trust or transfer property to the trust). For foreign trusts with U.S. beneficiaries, any portion of a trust attributable to a gratuitous transfer by a U.S. taxpayer is considered to be owned by the taxpayer. 26 U.S.C. §§ 671, 679. One purpose of this rule is to prevent U.S. taxpayer from deferring income tax through foreign trusts.

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