

Economic substance in the Cayman Islands

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Background

The International Tax Co-operation (Economic Substance) Law (2020 Revision) (as amended, the **Substance Law**) imposes economic substance requirements on companies and LLCs in the Cayman Islands. The Substance Law was introduced in response to concerns of the EU Code of Conduct Group regarding favourable tax regimes facilitating offshore structures that generate profits without real economic activity. The Substance Law also reflects Cayman's commitment as a member of the OECD's Inclusive Framework on Base Erosion and Profit Shifting (**BEPS**) and, in particular, BEPS Action 5¹. In February 2020, the International Tax Co-operation (Economic Substance) (Amendment) Law, 2020 further enhanced the provisions of the Substance Law and such enhancements are reflected in this guide.

The Cayman Islands Tax Information Authority (the **TIA**) has issued Guidance on Economic Substance for Geographically Mobile Activities² (the **Guidance**) which provides additional detail and depth to the framework introduced by the Substance Law.

Under the Substance Law, a relevant entity which carries on a relevant activity is required to satisfy the economic substance test in relation to that relevant activity. If a relevant entity carries on more than one relevant activity, it must comply with the economic substance test in relation to each relevant activity.

Which entities are in-scope?

The economic substance regime applies to the following **relevant entities**:

- Cayman Islands companies and limited liability companies (**LLCs**);
- foreign companies registered in the Cayman Islands; and
- Cayman Islands limited liability partnerships (**LLPs**),

but does not include:

- an investment fund;
- an entity that is tax resident outside the Cayman Islands³;
- Cayman Islands exempted limited partnerships and trust vehicles; and
- domestic companies⁴.

Investment funds – excluded entities

For the purposes of the Substance Law, an **investment fund** is an entity whose principal business is the issuing of investment interests⁵ to raise funds or pool investor funds, with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments, and includes any entity through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held).

The definition of investment fund:

- includes downstream investment vehicles; and

¹ The Inclusive Framework on BEPS decided to resume the application of BEPS Action 5 to no or only nominal tax jurisdictions in October 2018. BEPS Action 5 focuses on the requirement for substantial activities in preferential regimes, including intellectual property regimes, which attract geographically mobile business income.

² A copy of the Guidance can be found on the "Economic Substance" webpage of the Tax Information Authority [here](#).

³ The TIA may regard an entity as tax resident outside the Cayman Islands if the entity is subject to tax in another jurisdiction by reason of its domicile, residence or any other similar criteria, but will require the production of satisfactory evidence to substantiate that claim. Satisfactory evidence may include a Tax Identification Number, tax residence certificate and assessment or payment of a tax liability. The entity will also be required to provide details regarding ownership and tax residence of its parent company/ies and ultimate beneficial owners.

⁴ A **domestic company** is a company which is not part of an MNE Group and which is:

- (a) only carrying on business in the Cayman Islands and complies with section 4(1) of the Local Companies (Control) Law (2019 Revision) or section 3(a) of the Trade and Business Licensing Law (2019 Revision);
- (b) a company referred to in section 80 of the Companies Law (2020 Revision).

"MNE Group" means any Group that includes two or more enterprises for which the tax residence is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction.

⁵ **"Investment interests"** is defined as a share, trust unit, partnership interest or other right that carries an entitlement to participate in the profits or gains of the entity.

- excludes persons licensed under certain regulatory laws, including the Banks and Trust Companies Law (2020 Revision) and the Insurance Law, 2010.

The Guidance clarifies that the TIA will regard mutual and private funds registered with or licensed by the Cayman Islands Monetary Authority (**CIMA**), pursuant to the Mutual Funds Law (2020 Revision) or the Private Funds Law, 2020 respectively, as "investment funds" for the purposes of the Substance Law.

As noted above, investment funds do not fall within the definition of "relevant entity" for the economic substance regime and will not be required to meet any economic substance requirements. However, all Cayman companies, LLCs and LLPs are required to make an annual notification for economic substance purposes as a prerequisite to filing the annual return, which is discussed in more detail below.

What are the relevant activities?

The term **relevant activity**, captures regulated activities such as banking business, fund management business and insurance business, together with distribution and service centre business, financing and leasing business, headquarters business, holding company business, intellectual property business and shipping business. The **Schedule** to this guide sets out the definitions for each relevant activity. The TIA's Guidance contains sector specific guidance for the relevant activities.

The definition of relevant activity excludes investment fund business, meaning the business of operating as an investment fund.

If a mutual or private fund's investment manager is a Cayman Islands entity (or is registered in the Cayman Islands) and carries on securities investment business, the investment manager must be licensed or registered as a 'registered person' under the Securities Investment Business Law (2020 Revision) and its activities will fall within the definition of "fund management business". Please see our guide on [Registered persons under the Securities Investment Business Law](#) for further information.

What is the economic substance test?

The economic substance test has three limbs, and a relevant entity complies with the economic substance requirements if the relevant entity:

- conducts core income generating activity (**CIGA**) in relation to that relevant activity; and
- is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity; and
- having regard to the level of relevant income derived from the relevant activity carried out in the Cayman Islands:
 - incurs an adequate amount of operating expenditure in the Cayman Islands;
 - has an adequate physical presence (including maintaining business premises or equipment) in the Cayman Islands; and
 - has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

The Substance Law lists certain core activities which are considered to be CIGA for the purposes of each relevant activity which are set out in the Schedule to this Guide. The elements of CIGA listed in the Schedule for each relevant activity are neither exhaustive nor mandatory. It is a question of fact in each case which elements are undertaken to generate the relevant income.

Appropriate direction and management

The Substance Law clarifies that a relevant entity will comply with the requirement to be directed and managed in an appropriate manner if, in relation to a relevant activity:

- the relevant entity's board of directors⁶, as a whole, has the appropriate knowledge and expertise to discharge its duties as a board of directors;

⁶ For the purposes of the Substance Law, "director", in relation to an entity, means any director, member or other person in whom the management of the entity is vested.

- meetings of the board of directors are held in the Cayman Islands at adequate frequencies given the level of decision making required;
- there is a quorum of directors present in the Cayman Islands during such meetings;
- the minutes of board meetings held in the Cayman Islands record the making of strategic decisions at the meeting; and
- the minutes of all meetings of the board of directors and appropriate records of the relevant entity are kept in the Cayman Islands.

The Guidance states that this limb of the economic substance test is designed to ensure adequate frequency of meetings held and attended in the Cayman Islands, although it is not necessary for all meetings to be held in the Cayman Islands. What constitutes adequate frequency of meetings in the Cayman Islands will depend upon the relevant activities of each company. Where there are corporate directors, the requirements will apply to the individual officers or employees of the corporate director actually performing the duties.

Meaning of "adequate" and "appropriate"

The Guidance states that:

- **adequate** shall mean "as much or as good as necessary for the relevant requirement or purpose"; and
- **appropriate** shall mean "suitable or fitting for a particular purpose, person, occasion".

Accordingly, what is adequate or appropriate for a particular relevant entity will depend upon the facts, circumstances and business activities applicable in each case. Every relevant entity will need to maintain and retain books and records demonstrating the adequacy and appropriateness of the resources utilised and expenditure incurred in order to reflect its compliance with the substance requirements.

Pure equity holding companies – reduced requirements

Pure equity holding companies are subject to a reduced economic substance test, requiring confirmation that:

- the relevant entity has complied with all applicable filing requirements under the Companies Law (2020 Revision) (as amended, the **Companies Law**); and
- has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity interests in other entities.

A **pure equity holding company** is a company that only holds equity participations in other entities and only earns dividends and capital gains. The Guidance states that a pure equity holding company may engage its registered office service provider in the Cayman Islands to satisfy this reduced economic substance test depending on the level and complexity of activity required to operate its business.

IP businesses

As the risk of artificial profit shifting is considered to be greater, the Substance Law contains a rebuttable presumption that a relevant entity which conducts high risk intellectual property (**IP**) business has not met the economic substance test for a financial year.

Relevant entities in liquidation

The economic substance test applies to relevant entities for so long as they are in existence. If a relevant entity is in liquidation, it must satisfy the economic substance test in respect of any period in which it carries on a relevant activity. However, the economic substance test will not apply once the entity ceases to carry on a relevant activity and reporting will not be required for any period in which relevant activities were not carried out.

Is outsourcing permitted?

The Substance Law recognises that relevant entities may use service providers located in the Cayman Islands to carry out activities on their behalf. Outsourced activities may be taken into account to satisfy the economic substance test in relation to a relevant activity provided that any outsourced CIGA is monitored and controlled by the relevant entity. However, a relevant entity must not use outsourcing to circumvent

the economic substance test. Outsourcing in this context includes outsourcing, contracting or delegating to third parties or to entities within the same group.

The resources of the Cayman service provider will be taken into consideration when determining whether the people and premises test is met. Only the portion of employee time directly used in the service of the relevant entity is counted. There must be no double counting if services are provided to more than one relevant entity carrying out relevant activities.

The relevant entity remains responsible for ensuring accurate information is reported on its return including precise details of the resources employed by its service providers. The TIA will require service providers to verify the information on outsourcing within thirty days after the relevant entity provided such information. The TIA may not accept a relevant entity's claim to have satisfied the ES Test by means of domestic outsourcing unless that information is verified by the service provider within that timeframe.

What are the filing requirements?

Every entity incorporated or registered in the Cayman Islands will be required to make an annual economic substance notification (**ESN**) as detailed below. Relevant entities carrying on a relevant activity will also be required to make an economic substance return (**ES return**) which must be prepared and submitted to TIA annually, within 12 months of the relevant entity's financial year end. Initial ES returns will be due with respect to the financial year commencing on or after 1 January 2019. The TIA is currently developing an economic substance portal to facilitate electronic reporting which is expected to launch in the third quarter of 2020.

Relevant entities will also be obliged to provide the TIA with such other information as may be required in order to make an assessment or determination regarding economic substance. Entities engaged in more than one relevant activity will need to pass the economic substance test for each relevant activity. However, only one notification will be required.

Annual economic substance notification

Every entity⁷ will be required to make an ESN to the TIA by 31 March each year, via the General Registry as a prerequisite to filing the annual return⁸. The ESN must state:

- whether or not it is carrying on a relevant activity;
- if it is carrying on a relevant activity, whether or not it is a relevant entity;
- in the case of an entity with overseas tax residency which is carrying on a relevant activity:
 - the name and address of the immediate parent, ultimate parent and ultimate beneficial owner of the entity and any other information reasonably required to identify them;
 - the date of the end of its financial year; and
 - the jurisdiction in which the entity is claiming to be tax resident and any other information as may be reasonably required to support that claim; and
- in the case of a relevant entity which is carrying on a relevant activity:
 - the date of the end of its financial year; and
 - the name and address of the officer responsible for providing that information to the TIA.

ES return

Relevant entities carrying on a relevant activity and, therefore, required to meet the economic substance test must make an ES return providing details of:

- the type of relevant activity conducted;
- the amount and type of relevant income in respect of the relevant activity;
- the amount and type of expenses and assets in respect of the relevant activity;

⁷ For these purposes "entity" is defined to cover companies, limited liability companies and limited liability partnerships incorporated or registered in the Cayman Islands.

⁸ Foreign Companies are required to file an ESN despite not being required to file an annual return. All foreign companies should file their ESN by 31 March each year, which would be the corresponding deadline for Cayman entities to file their annual returns.

- the location of the place of business or plant, property or equipment used for the relevant activity in the Cayman Islands;
- the number of full-time employees or other personnel with appropriate qualifications who are responsible for carrying on the relevant activity;
- the name and address of any other person to whom CIGA are outsourced;
- information showing the CIGA in respect of the relevant activity that have been conducted;
- a declaration as to whether or not the relevant entity satisfies the economic substance test;
- details of any MNE Group in respect of which the relevant entity is a part;
- in the case of a relevant activity that is an IP business, a declaration as to whether or not it is a high risk IP business and, if it is, whether or not the relevant entity will provide the information to rebut the presumption that it has not met the economic substance test within the time specified;
- in the case of a relevant entity that is carrying on a high risk IP business:
 - detailed business plans which demonstrate the commercial rationale for holding the IP assets in the Cayman Islands;
 - employee information, including level of experience, type of contracts, qualifications and duration of employment; and
 - evidence that decision making is taking place within the Cayman Islands; and
 - any other information as may be reasonably required to determine whether the relevant entity meets the economic substance test; and
- such other information as may be prescribed.

What are the penalty provisions?

Failure to meet the economic substance test in respect of a financial year may lead to a fine of up to CI\$10,000 (US\$12,195). Continued failure to meet the test in the following year could lead to an additional penalty of up to CI\$100,000 (US\$121,951), and possibly being struck from the Register. Failure by a relevant entity to submit an ES return may result in a penalty of CI\$5,000 (US\$6,098) with an additional CI\$500 (US\$610) for each day failure continues thereafter.

It is an offence to fail to provide information requested by the TIA without reasonable excuse, or to knowingly or wilfully alter, destroy, hide or remove any such information, punishable by a fine of up to CI\$10,000 (US\$12,195) and/or up to two years' imprisonment. It is also an offence to knowingly or wilfully supply false or misleading information to the TIA, punishable by a fine of up to CI\$10,000 (US\$12,195) and/or up to five years' imprisonment.

The Substance Law also contains vicarious liability provisions relating to offences committed by bodies corporate with the consent or connivance of, or due to any neglect on the part of, any director, member, manager, secretary or other officer. In such circumstances, the relevant director, member, manager, secretary or officer commits the same offence as the body corporate and is liable to be proceeded against and punished accordingly.

Are there any anti-avoidance provisions?

Whilst the Substance Law does not contain any anti-avoidance provisions, the Guidance makes clear that the TIA will both monitor arrangements that appear to be circumvention mechanisms and investigate cases where a person has entered into any arrangement to circumvent any obligation under the Substance Law. The Guidance provides the example of an entity which seeks to manipulate or artificially suppress its income to avoid substance requirements.

How will information be shared?

In accordance with international standards and scheduled arrangements, the TIA may share the information provided to it under the Substance Law as appropriate. Where a relevant entity fails the economic substance test, the TIA will systematically provide the economic substance information filed with it to:

- the competent authority in the jurisdiction in which the immediate parent, ultimate parent and ultimate beneficial owner of the relevant entity resides; and

- in the case of a relevant entity incorporated or formed outside the Cayman Islands, the competent authority in the jurisdiction of incorporation/formation.

In the case of any entity with tax residency overseas, the TIA will share the information provided to it with the competent authority in:

- the jurisdiction in which that entity is tax resident;
- the jurisdiction in which the immediate parent, ultimate parent and ultimate beneficial owner of the entity resides; and
- if the relevant entity is incorporated outside the Cayman Islands, the competent authority of the relevant jurisdiction in which the entity is incorporated.

Economic substance information will also be shared in relation to relevant entities which conduct high risk IP business.

Contacts

A full list of contacts specialising in the economic substance legislation in the Cayman Islands can be found [here](#).

This guide is only intended to give a summary and general overview of the subject matter. It is not intended to be comprehensive and does not constitute, and should not be taken to be, legal advice. If you would like legal advice or further information on any issue raised by this guide, please get in touch with one of your usual contacts. © 2019 MOURANT OZANNES ALL RIGHTS RESERVED

Schedule

Relevant activity	Definition	Core income generating activities
Banking business	means the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise	<ul style="list-style-type: none"> raising funds, managing risk including credit, currency and interest risk taking hedging positions providing loans, credit or other financial services to customers managing capital and preparing reports or returns, or both, to investors or CIMA, or both
Distribution and service centre business	<p>means the business of either or both of the following:</p> <p>(a) purchasing from an entity in the same group:</p> <p>(i) component parts or materials for goods; or</p> <p>(ii) goods ready for sale, and reselling such component parts, materials or goods outside the Islands;</p> <p>(b) providing services to an entity in the same group in connection with the business outside the Islands</p> <p>but does not include any activity included in any other relevant activity except holding company business</p>	<ul style="list-style-type: none"> transporting and storing goods, components and materials managing stocks taking orders providing consulting or other administrative services
Financing and leasing business	means the business of providing credit facilities for any kind of consideration to another person but does not include financial leasing of land or an interest in land, banking business, fund management business or insurance business	<ul style="list-style-type: none"> negotiating or agreeing funding terms identifying and acquiring assets to be leased setting the terms and duration of financing or leasing monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements
Fund management business	means the business of managing securities belonging to another person in circumstances involving the exercise of discretion which is carried on by a relevant entity licensed or otherwise authorised to conduct business under the Securities Investment Business Law (2020 Revision) for an investment fund	<ul style="list-style-type: none"> 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 or returns, or both, to investors or CIMA, or both
Headquarters business	<p>means the business of providing any of the following services to an entity in the same group:</p> <p>(a) the provision of senior management;</p> <p>(b) the assumption or control of material risk for activities carried out by any of those entities in the same group; or</p> <p>(c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b),</p> <p>but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business</p>	<ul style="list-style-type: none"> taking relevant management decisions incurring expenditures on behalf of group entities co-ordinating group activities
Holding company business	means the business of a pure equity holding company	all activities related to that business

Relevant activity	Definition	Core income generating activities
Insurance business	means the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims	<ul style="list-style-type: none"> • predicting or calculating risk or oversight of prediction or calculation of risk • insuring or re-insuring against risk • preparing reports or returns, or both, to investors or the CIMA, or both
IP business	<p>intellectual property business means the business of holding, exploiting or receiving income from intellectual property assets</p> <p>high risk intellectual property business means an intellectual property business carried on by an entity that:</p> <ol style="list-style-type: none"> did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business acquired the intellectual property asset: <ol style="list-style-type: none"> from an entity in the same group; or in consideration for funding research and development by another person situated in a country or territory other than the Islands; and licences the intellectual property asset to one or more entities in the same group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same group 	<ul style="list-style-type: none"> • where the IP asset is a: <ul style="list-style-type: none"> ◦ patent or an asset that is similar to a patent, research and development; or ◦ non-trade intangible (including a trademark), branding, marketing and distribution • in exceptional cases, except if the relevant activity is a high risk IP business, other CIGA relevant to the business and the IP assets, which may include: <ul style="list-style-type: none"> ◦ taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income; ◦ taking the strategic decisions and managing (as well as bearing) the principal risks relating to acquisition by third parties and subsequent exploitation and protection of the intangible asset; ◦ carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties
Shipping business	<p>means any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Cayman Islands or between the Cayman Islands:</p> <ol style="list-style-type: none"> the business of transporting, by sea, passengers or animals, goods or mail for a charge; the renting or chartering of ships for the purpose described in paragraph (a); the sale of travel tickets and ancillary ticket related services connected with the operation of a ship; the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea; or the functioning as a private seafarer recruitment and placement service, <p>but does not include a holding company business or the owning, operating or chartering of a pleasure yacht</p>	<ul style="list-style-type: none"> • managing crew (including hiring, paying and overseeing crew members); • overhauling and maintaining ships; • overseeing and tracking deliveries; • determining what goods to order and when to deliver them, organising and overseeing voyages

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