

# GUIDANCE NOTE

ECONOMIC SUBSTANCE IN THE CAYMAN ISLANDS



World



Class



Responsiveness

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## ECONOMIC SUBSTANCE IN THE CAYMAN ISLANDS

### INTRODUCTION

On 1 January 2019, the Cayman Islands introduced The International Tax Co-operation (Economic Substance) Law, 2018 and on 12 February 2020 The International Tax Co-operation (Economic Substance) (Amendment) Law, 2020 came into force together with The International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2020 (altogether, the “**Law**”). The Law has been issued in response to the Cayman Islands’ commitment to the global initiative to combat base erosion and profit shifting.

### OVERVIEW

The Law requires all Cayman Islands entities (and foreign entities registered in the Cayman Islands) which, in summary, includes all legal persons that are registered with the Cayman Islands Register of Companies to make an annual notification to the Cayman Islands Tax Information Authority (“**TIA**”). In addition, entities (known as ‘**Relevant Entities**’ as further defined below) who carry on certain activities (known as ‘**Relevant Activities**’ as further detailed below) must report on such activities to the TIA on an annual basis. Entities which are tax resident outside the Cayman Islands must also make an annual filing with the TIA. A Relevant Entity that is carrying on a Relevant Activity will generally be required to have substantial activities in the Cayman Islands, also known as “economic substance” and satisfy the applicable economic substance test (the “**ES Test**”). Where a Relevant Entity carries on more than one Relevant Activity then it will be required to satisfy the ES Test in respect of each activity.

### RELEVANT ENTITY

A “Relevant Entity” means –

- (a) a company that is –
  - (i) incorporated under the Companies Law (2020 Revision); or
  - (ii) a limited liability company registered under the Limited Liability Companies Law (2020 Revision);
- (b) a limited liability partnership that is registered in accordance with the Limited Liability Partnership Law, 2017;
- (c) a company that is incorporated outside of the Islands and registered under the Companies Law (2020 Revision);

but does not include –

- (a) an investment fund; or
- (b) a domestic company; or
- (c) an entity that is tax resident outside the Cayman Islands.

### RELEVANT ACTIVITY

“Relevant Activities” includes the following businesses:

1. “**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;);
2. “**distribution and service centre business**” which means the business of either or both of the following -
  - (a) purchasing from an entity in the same group of entities –



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- (i) component parts or materials for goods; or
  - (ii) goods ready for sale, and reselling such component parts, materials or goods outside the Islands;
- (b) providing services to an entity in the same group of entities in connection with the business outside the Islands, but does not include any activity included in any other relevant activity except holding company business;
- 3. **“financing and leasing business”** which 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;
- 4. **“fund management business”** which means the business of managing securities as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (2020 Revision) (**“SIBL”**) carried on by a relevant entity licensed or otherwise authorised to conduct business under that Law for an investment fund;
- 5. **“headquarters business”** means the business of providing any of the following services to an entity in the same group of entities –
  - (a) the provision of senior management;
  - (b) the assumption or control of material risk for activities carried out by any of those entities in the same group of entities; or
  - (c) the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b),but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business;
- 6. **“holding company business”** which means the business of a pure equity holding company, and **“pure equity holding company”** means a company that only holds equity participations in other entities and only earns dividends and capital gains;
- 7. **“insurance business”** which has the meaning given to that expression by section 2 of the Insurance Law, 2010;
- 8. **“intellectual property business”** which means the business of holding, exploiting or receiving income from intellectual property assets;
- 9. **“shipping business”** which means any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Islands or between the Islands –
  - (a) the business of transporting, by sea, passengers or animals, goods or mail for a charge;
  - (b) the renting or chartering of ships for the purpose described in paragraph (a);
  - (c) the sale of travel tickets and ancillary services connected with the operation of a ship;
  - (d) 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
  - (e) the management of the crew of a ship.

### ES TEST - GENERAL

The ES Test varies depending on the Relevant Activity being conducted. Generally speaking, in order to satisfy the ES Test, a Relevant Entity will need to show that it: (a) conducts core income-generating activities in relation to that Relevant Activity in the Cayman Islands (**“CIGA”**); (b) is directed or managed in an appropriate manner in or from the Cayman Islands in relation to that Relevant Activity (c) having regard to the level of relevant income derived from the Relevant Activity carried out in the



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Cayman Islands – (i) has an adequate amount of operating expenditure incurred in the Cayman Islands, (ii) has an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and (iii) has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands. CIGA means activities that are of central importance to a Relevant Entity in terms of generating relevant income and must be carried on in the Cayman Islands. Sector-Specific Guidance has been issued for each Relevant Activity.

### ES TEST – REDUCED FOR HOLDING COMPANIES

Entities which perform “holding company” business are subject to a ‘*reduced*’ ES Test. As noted above, holding company business is the business of a pure equity holding company and pure equity holding company means a company that only holds equity participations in other entities and only earns dividends and capital gains. As part of the functions of a pure equity holding company, activities may include, for example, ownership of a bank account, governance decisions, entering into contractual arrangements with professional or other service providers, and the payment of fees and expenses.

A holding company will satisfy the ES Test if it (a) has complied with all applicable filing requirements under the Companies Law and (b) has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities. What is required for compliance with limb (b) of the reduced ES Test will be dependent on how the pure equity holding company business is being conducted. A holding company that maintains its registered office in the Cayman Islands and engages its registered office service provider in accordance with the Companies Law may be able to satisfy the reduced ES Test where such entity is passively holding equity interests in other entities depending on the level and complexity of activity required to operate its business.

### ES TEST – INCREASED FOR HIGH RISK INTELLECTUAL PROPERTY COMPANIES

For the purposes of the Law, the TIA regards the term IP asset as including any such right from which identifiable income accrues to the business (i.e. such income being separately identifiable from any income generated from any tangible asset in which the right subsists). That is, the term does not apply to a business which owns IP assets merely as an adjunct to its business or sells a product or services having aspects derived from IP assets. This interpretation applies to IP business generally (i.e. including high risk IP business). Typical sources of separately identifiable income in respect of an IP asset include income from licensing the IP asset, such as royalties or licence fees, and income from the assignment/sale of IP assets. A Relevant Entity that is not the legal or economic owner of the IP asset will not be within the scope of the definition of IP business.

The Law contains more rigorous requirements for 'high risk intellectual property' businesses. These include entities that hold intellectual property they did not create and acquired either from an entity in the same group or another entity outside of the Cayman Islands, and then license the intellectual property to related entities. A Relevant Entity that is carrying on high risk IP business is presumed not to have met the ES Test for a financial year, even if there are CIGA relevant to the business and the IP assets being carried out in the Cayman Islands. A Relevant Entity may rebut this presumption if it can produce materials to the TIA which demonstrate that there is, and historically has been, a high degree of control over the development, exploitation, maintenance, protection and enhancement (also referred to as



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“DEMPE”) of the IP asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and/or perform their activities within the Cayman Islands.

### ES TEST - OUTSOURCING

A Relevant Entity conducting a Relevant Activity may satisfy the ES Test by outsourcing the conduct of its CIGA to another person in the Cayman Islands. A Relevant Entity that outsources its CIGA must be able to monitor and control the carrying out of the CIGA. Stuarts Corporate Services Ltd. (“SCS”) can provide various services to assist Relevant Entities with meeting their respective economic substance requirements.

### NOTIFICATION AND REPORTING

All Cayman entities with legal personality are required to make an economic substance notification (“ESN”) to the TIA prior to making its annual return in each year. SCS will provide all its registered office clients who have Relevant Entities with a declaration on an annual basis in order to make such annual filing.

In addition, a Relevant Entity that is carrying on a Relevant Activity must provide an annual return to the TIA (the “ESR”) in each year which must confirm –

- (a) the type of relevant activity conducted by it;
- (b) the amount and type of relevant income in respect of the relevant activity;
- (c) the amount and type of expenses and assets in respect of the relevant activity;
- (d) the location of the place of business or plant, property or equipment used for the relevant activity of the relevant entity in the Cayman Islands;
- (e) the number of full-time employees or other personnel with appropriate qualifications who are responsible for carrying on the relevant entity’s relevant activity;
- (f) the name and address of any person other than the relevant entity who is conducting the relevant entity’s core income generating activities in relation to its relevant activity;
- (g) information showing the CIGA in respect of the relevant activity that have been conducted;
- (h) a declaration as to whether or not the relevant entity satisfies the ES Test in accordance with the Law;
- (i) in the case of a relevant activity that is an intellectual property business, a declaration as to whether or not it is a high risk intellectual property business and, if it is, whether or not the relevant entity will provide information under paragraph (k) to rebut the presumption that it has not met the ES Test within the specified time;
- (j) details of any MNE Group in respect of which the relevant entity is a Constituent Entity for the purposes of the Tax Information Authority (International Tax Compliance) (Country-By-Country Reporting) Regulations, 2017<sup>1</sup>;
- (k) in the case of a relevant entity that is carrying on a high-risk intellectual property business:
  - (i) detailed business plans which demonstrate the commercial rational for holding the intellectual property assets in the Islands;

<sup>1</sup> “MNE Group” is defined under the Tax Information Authority (International Tax Compliance) (Country-By-Country Reporting) Regulations, 2017 and applies to Groups with a total consolidated revenue of at least US\$850 million.



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- (ii) employee information, including level of experience, type of contracts, qualifications and duration of employment;
- (iii) evidence that decision making is taking place within the Cayman Islands, and
- (iv) any other information as may be reasonably required by the Authority to determine whether the relevant entity meets the ES Test; and
- (l) such other information as may be prescribed.

Regulations will prescribe other information which the TIA requires to determine whether a relevant entity has satisfied the ES Test. A Relevant Entity must provide the TIA with appropriate evidence to support the above-mentioned information as the TIA may reasonably require.

The ESR must be filed with the TIA by way of an online portal (the “**ES Portal**”) in each year with the first filing due in 2020 and it is currently expected the new ES Portal will be available in Q3 2020. The TIA will issue user guidance in respect of the ES Portal prior to its release. Such ESR on the ES Portal can be made either by SCS as the registered office provider or by an authorised director (or equivalent) of the Relevant Entity.

### TAX RESIDENT REPORTING

A company, limited liability company or limited liability partnership incorporated or established in the Islands is not regarded as a Relevant Entity for the purposes of the Law if it is tax resident outside the Cayman Islands. The TIA will regard an entity as tax resident in a jurisdiction other than the Cayman Islands if the entity is subject to corporate income tax on all of its income from a relevant activity by virtue of its tax residence, domicile or any other criteria of a similar nature in that other jurisdiction. Additionally, in the event that the entity is a “disregarded entity” for U.S. income tax purposes, and has a U.S. corporation or U.S. individual as its parent, the TIA will consider the entity as tax resident outside of the Cayman Islands if satisfactory evidence is provided.

Entities which claim the tax resident exemption under the Law are required to file an annual ESR with the TIA. An entity that is carrying on a Relevant Activity and is tax resident in a jurisdiction outside the Cayman Islands is required to provide the TIA with —

- (a) the name and address of its immediate parent, ultimate parent and ultimate beneficial owner and any other information reasonably required to identify its immediate parent, ultimate parent and ultimate beneficial owner<sup>2</sup>;
- (b) the date of the end of its financial year; and
- (c) the jurisdiction in which the entity is claiming to be tax resident and any other information as may reasonably be required to support that claim.

### CIRCUMVENTION

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

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<sup>2</sup> These details are only required where the entity’s owners meet these defined terms under the Law.



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## SHARING OF INFORMATION WITH COMPETENT AUTHORITIES

The TIA will exchange information provided to it under the Law in accordance with relevant international standards and scheduled agreements under the Tax Information Authority Law (Revised) with other competent authorities in respect of Relevant Entities that fail to satisfy the ES Test in relation to Relevant Activities and in relation to high risk IP business. Information will also be shared with the competent authority of the jurisdiction where an entity claims to be tax resident or subject to income tax on its relevant income.

Recipient competent authorities could be in the jurisdiction of residence of the Relevant Entity's immediate parent, ultimate parent, and ultimate beneficial owner and could also be in the jurisdiction where the Relevant Entity (or the entity claiming not to be a relevant entity by reason of its tax residence) itself is incorporated or claims to be tax resident, if that is outside the Cayman Islands.

## FINES AND PENALTIES

**Failure to Satisfy ES Test** - If the TIA determines that a Relevant Entity has failed to satisfy the ES Test for a financial year it shall issue a notice to that entity notifying it of such determination, giving the reasons, directing any action to be taken to satisfy the ES Test and advising it of its right to appeal. The TIA shall impose a penalty of approx. US\$12,500 on a Relevant Entity for failing to satisfy the ES Test or approx. US\$125,000 if it is not satisfied in the subsequent financial year after the initial notice of failure. After two consecutive years of failure the Grand Court in the Cayman Islands may make an order requiring the Relevant Entity to take specified action to satisfy the ES Test or an order that it is defunct or to be struck off.

**False or Misleading Information** - In addition, under the Law it is an offence for a person to knowingly or wilfully supply false or misleading information to the TIA. Such an offence is punishable on summary conviction by a fine of approx. US\$12,500 or with imprisonment for a term of five years, or both. It is also an offence to disclose information relating to the affairs of the TIA, a Relevant Entity or any officer, customer, investor, member, client or policyholder of a Relevant Entity. Such an offence is punishable with a fine and/or imprisonment.

**Failure to Submit the ESR** - Where a Relevant Entity that is required to satisfy the ES Test fails to prepare and submit to the TIA the ESR within the specified time, the TIA will by notice in writing impose a penalty of US\$6,098 and an additional penalty of US\$610 for each day during which the failure to comply continues. The penalty must be paid within 30 days, subject to the permitted appeal process.

**Document Retention** - A relevant entity that is required to satisfy the ES Test in relation to a relevant activity must retain for six years after the end of a financial year a book, document or other record, including any information stored by electronic means that relates to the information required to be provided to the Authority.

**Failure to Provide Information** - A person who fails to provide or make certain information available to the Authority without lawful excuse within the specified time or who knowingly or wilfully alters, destroys, mutilates, defaces, hides or removes any such information may be criminally liable.

## FURTHER INFORMATION

Please contact your usual attorney at Stuarts should you require any specific on economic substance in the Cayman Islands.



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This publication is for general guidance and is not intended to be a substitute for specific legal advice. Specialist advice should be sought about specific circumstances. If you would like further information, please contact:

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Stuarts Walker Hersant Humphries is a leading Cayman Islands legal practice with international reach. Offering a full range of corporate and commercial legal advice together with a constant client focus, our experienced attorneys assist our clients on their most significant and challenging commercial transactions, structures, liabilities and obligations.

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