

STUARTS WALKER HERSANT HUMPHRIES

# Guidance Note

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Economic Substance Requirements  
Fund Managers

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## Economic Substance Requirements Fund Managers

### Introduction

On 1 January 2019, the Cayman Islands introduced The International Tax Co-operation (Economic Substance) Act, 2018 and on 12 February 2020 The International Tax Co-operation (Economic Substance) (Amendment) Act, 2020 came into force together with The International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2020 and on 30 June 2021 the International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations 2021, came into force (altogether, the “ESA”). The ESA has been issued in response to the Cayman Islands’ commitment to the global initiative to combat base erosion and profit shifting.

This Guidance Note summarises the main elements of the ESA as it relates to investment funds, fund managers and other entities registered as registered persons under the Securities Investment Business Act (2020 Revision) (the “SIBA”). The ESA as it relates to SIBA registered persons (previously exempted persons) as it relates to fund managers only relates to companies which are “*managing securities belonging to another person in circumstances involving the exercise of discretion*” (i.e. entities carrying on discretionary fund management under the SIBA).

### Overview

The ESA defines which Cayman Islands entities are regulated by the ESA (“**Relevant Entities**”). Relevant Entities must report annually as to whether or not they are carrying on one or more of a defined list of activities (“**Relevant Activities**”). These entities must satisfy an economic substance test in the Cayman Islands in respect of such Relevant Activities.

### Relevant Entities

Entities that are not Relevant Entities fall outside the scope of the ESA, therefore the first step is to determine whether an entity is considered a Relevant Entity. The following are not Relevant Entities:

- “investment funds” (as defined – see below);
- entities that are authorised to carry on business in the Cayman Islands as domestic companies; and
- entities that are tax resident outside the Cayman Islands.

Any entity claiming to be tax resident outside the Cayman Islands will be required to produce satisfactory evidence to substantiate the same, such as a tax ID number, tax residence certificate together with an income tax return, assessment or payment of a corporate income tax liability on its gross income arising in the Cayman Islands from a Relevant Activity.



## Investment Funds

The ESA excludes investment funds altogether. The ESA defines an "investment fund" as "*an entity whose principal business is the issuing of investment interests 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), but does not include a person licensed under the Banks and Trust Companies Act (2018 Revision) or the Insurance Act, 2010, or a person registered under the Building Societies Act (2014 Revision) or the Friendly Societies Act (1998 Revision).*"

Guidance issued by the Cayman Islands Tax Information Authority ("**Guidance**") confirms that mutual funds licensed or registered with the Cayman Islands Monetary Authority are considered investment funds for the purpose of the ESA.

For entities not registered or licensed as mutual funds it will be necessary to assess the individual circumstances of each entity to determine if it is out of scope as an investment fund. In the absence of additional guidance, and subject to such a case by case analysis:

- both open-ended and closed-ended vehicles may be investment funds;
- a master fund, intermediary fund or trading subsidiary of an investment fund would generally be treated as an investment fund by virtue of being "*an entity through which an investment fund directly or indirectly invests*";
- an underlying portfolio company owned directly or indirectly by an investment fund would not itself be an investment fund for these purposes, and
- where a corporate general partner of an investment fund does not undertake business activities separate from its General Partner role within an investment fund structure, the corporate general partner will generally itself be an investment fund, by virtue of being an "*entity through which an investment fund directly or indirectly invests or operates*".

It is crucial to consider all the circumstances, particularly where an entity has only one investment; has only one investor; has no third-party investors; or does not instruct a fund manager.

## Fund Managers

For entities that carry on any form of fund management, the first step is to assess if the entity is a Relevant Entity. Of the entities that are most commonly used for fund management activities, most exempted companies, Cayman LLCs and foreign entities registered in Cayman as foreign companies will be Relevant Entities, unless in each case they are tax resident outside Cayman.

The Guidance provides that "*The principles are that (a) those individuals who in fact conduct a relevant entity's Cayman Islands CIGA that generates the relevant income must do so in the Islands, not elsewhere, and (b) the relevant entity must be directed and managed in the Islands*".



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As a result, each discretionary fund manager's circumstances will need to be considered on a case by case basis to determine how in practice the manager takes decisions on the holding and selling of investments

## Relevant Activities

Entities that are Relevant Entities will then need to determine if their activities are Relevant Activities. A Relevant Entity carrying on more than one Relevant Activity is required to satisfy the economic substance test in relation to each Relevant Activity.

In relation to funds, it is likely that the Relevant Activities of greatest relevance will be "*fund management business*" and "*holding company business*". Again, a fact-specific analysis will be required and each of the Relevant Activities must be considered.

Particular care will need to be taken if a Relevant Entity holds, exploits or receives income from intellectual property assets.

## Fund Management Business

The ESA defines fund management business as "*the business of managing securities as set out in paragraph 3 of Schedule 2 to the SIBA carried on by a relevant entity licensed or otherwise authorised to conduct business under that Law for an investment fund*". Three elements of this definition should be noted:

- paragraph 3 of Schedule 2 to the SIBA covers "*managing securities belonging to another person in circumstances involving the exercise of discretion*". It does not extend to other activities such as arranging deals in securities or providing non-binding discretionary advice.
- the word "licensed" covers only the small minority of entities that are fully licensed under the SIBA and does not extend to entities registered as registered persons under the SIBA.
- the words "*authorised to conduct business*" will cover Relevant Entities performing discretionary investment management registered as registered persons under the SIBA.

Under the ESA then neither entities whose activities are limited to providing non-binding investment advice nor investment management entities currently registered as SIBA excluded persons are conducting the Relevant Activity of fund management business. The latter category will, however, need to comply with substance requirements in the Cayman Islands.

## Economic Substance Test

The economic substance test ("ES Test") can be satisfied in relation to a Relevant Entity carrying on a Relevant Activity if it (i) conducts Cayman Islands core income generating activities ("CIGAs"); (ii) is directed and managed in an appropriate manner in the Cayman Islands; and (iii) has adequate operating expenditure, physical presence and personnel in the Cayman Islands.



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## Core Income Generating Activities

Fund management business CIGAs include:

- 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.

In respect of licensed fund management business (not registered/exempted persons), the Guidance provides that:

*“Given the stringent regulatory requirements in the Cayman Islands, which result in significant overlap with the substance requirements, it is expected that relevant entities licensed to carry on... licensed fund management business will already generally be operating in the Islands with adequate resources and expenditure. However, those relevant entities will still be subject to the ESA (i.e. filing requirements, Cayman Islands CIGA performed in the Islands and monitoring by the Authority)”*

## Reporting

All corporate entities required to file an annual return with the General Registry will be required to file a declaration as to whether or not they are Relevant Entities and if so, what type of Relevant Activities, if any, they are carrying on; and if not, the basis of the exemption they are claiming (e.g. investment fund or foreign tax residence). Relevant Entities that do carry on a Relevant Activity shall, no later than 12 months after the date of their financial year end, prepare and submit an annual return to the Tax Information Authority (the “ESR”) in each year. The ESR must be filed for any relevant entity that carried on a relevant activity for a given reporting period regardless of whether that entity has been terminated or continued out of the jurisdiction subsequently.

## 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 ESA. An example could include an entity which seeks to manipulate or artificially suppress its income to circumvent substance requirements.

## Sharing of Information with Competent Authorities

The TIA will exchange information provided to it under the ESA in accordance with relevant international standards and scheduled agreements under the Tax Information Authority Act (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.



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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.

**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.

**False or Misleading Information** - In addition, under the ESA it is an offence for a person to knowingly or willfully 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.

**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 TIA.

**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 willfully alters, destroys, mutilates, defaces, hides or removes any such information may be criminally liable.

## Key Dates

The ESA and accompanying Regulations provide a timetable for compliance, notification and reporting:

- **Compliance:** Relevant Entities in existence prior to 1 January 2019 must satisfy the economic substance test in relation to a Relevant Activity from 1 July 2019.



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- Relevant Entities formed on or after 1 January 2019 must satisfy the economic substance test in relation to a Relevant Activity from the date on which the Relevant Entity commences the Relevant Activity.
- Relevant Entities performing discretionary investment management registered as registered persons under the SIBA must satisfy the economic substance test in relation to fund management business from the date of their registration or re-registration under the amended SIBA.
- Notification: starting in 2020, all Relevant Entities must notify the Tax Information Authority whether or not they are conducting a Relevant Activity and provide certain additional details including as to the date of their financial year.
- Reporting: within 12 months of the end of their financial year, Relevant Entities carrying on a Relevant Activity must submit to the Tax Information Authority a report setting forth prescribed details as to their compliance with the economic substance test.

## Next Steps

Although some issues remain to be further refined in the Guidance, the deadlines for compliance with the ESA require that clients with Cayman Islands entities (or non-Cayman entities registered in Cayman as foreign companies) address the new requirements now. All Relevant Entities conducting fund management business will need to undertake their own internal review and analysis to determine what measures, if any, they might need to take in order to demonstrate substance in the Cayman Islands and achieve compliance with the ESA. Clients should therefore consult Stuarts to determine:

- are their entities "investment funds" if so, they should confirm this classification and document this determination in board resolutions;
- if they are not investment funds, are they Relevant Entities?
- if they are Relevant Entities, are they carrying on Relevant Activities?
- if they are Relevant Entities carrying on Relevant Activities:
  - when were they incorporated or registered in Cayman?
  - do those Relevant Activities include holding, exploiting or receiving income from intellectual property assets?
  - does the Relevant Entity only hold equity participations in other entities and only earn dividends and capital gains?
  - is the entity registered under the SIBA as a registered person?

## Framework Services

In order to facilitate our clients to meet the ESA requirements, Stuarts is able to offer the following services as a framework upon which our clients can build a physical presence in the Cayman Islands:



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- a dedicated office of approximately 120 ft.<sup>2</sup>;
- a resident administrative officer;
- a company secretary;
- registered office services; and
- receptionist services, voice mail and answering services, dedicated file storage, telephone number with local telecom provider, mail processing, mailing address, business meeting space, on site amenities – fax, copier & printing, internet access and conference call facilities, and boardroom services.

Additional Services Include:

- accounting services (as required);
- authorised signatories;
- server hosting;
- hard drive to maintain books and records;
- email and website hosting;
- board support services, nominated staff to carry out services with a client email; and
- legal services.

As a minimum, we would suggest that fund managers put in place the following:

- rent some dedicated office space;
- obtain one Cayman Islands work permit for an employee; and
- quarterly board meetings should be held in the Cayman Islands; and
- books and records should be maintained in the Cayman Islands, such records can be kept on a hard drive.

The services set out above are not intended to be a comprehensive solution to the economic substance requirements in the Cayman Islands but are instead intended to offer a framework upon which our clients can build, to meet the requirements of the ES Test. A quote or any services can be provided on request. Fees for legal services, if required, would be charged on a time spent basis.



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# Guidance Note

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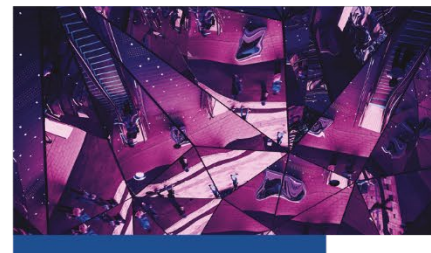
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Stuarts Walker Hersant Humphries is a leading Cayman Islands legal practice with international reach. Offering a full range of corporate and commercial legal advice together with a constant client focus, our experienced attorneys assist our clients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

Our proven track record in advising leading international Law Firms, Investment Managers, Investment Companies and High-Net-Worth individuals is a result of the deep understanding of our markets.

At Stuarts, we strive to build and maintain lasting relationships with our clients through the combined legal expertise and business acumen of our practice groups and by providing outstanding service.



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