

# Cayman Islands Economic Substance Requirements for Certain Entities – Overview

## 1 Introduction

- 1.1 On 27 December 2018, the Cayman Islands published The International Tax Co-operation (Economic Substance) Law, 2018 and The International Tax Co-operation (Economic Substance) (Prescribed Dates) Regulations, 2018 (together, the "**Initial Law**"). The Initial Law was amended by several amendment regulations, which were subsequently consolidated into the International Tax Co-operation (Economic Substance) Law (2020 Revision) (the "**Economic Substance Law**"). The Economic Substance Law is supplemented by the issuance of related Guidance on Economic Substance for Geographically Mobile Activities (the "**Guidance**"), version 3.0 of which was issued on 13 July 2020.
- 1.2 The Economic Substance Law is responsive to global OECD Base Erosion and Profit Shifting ("**BEPS**") standards regarding geographically mobile activities. Requirements of this type are rapidly being implemented on a level playing field basis by all OECD-compliant "no or only nominal tax" jurisdictions.
- 1.3 Global standards in this field continue to develop. Accordingly, it is to be expected that the Economic Substance Law itself and the body of related Guidance will continue to evolve, with further amendments and updates to the Guidance likely to address important practical aspects of the economic substance requirements.
- 1.4 The Tax Information Authority (the "**Authority**") is the sole dedicated channel in the Cayman Islands for international cooperation on matters involving the provision of tax related information. The Authority is a function of the Department for International Tax Cooperation within the Cayman Islands Government's Ministry of Financial Services and Home Affairs. It is the Authority who will determine whether or not a relevant entity satisfies the economic substance test in respect of its relevant activities. The Authority also has statutory powers of monitoring compliance with the Economic Substance Law and sharing information with other competent authorities.

## 2 Implementing a Global Standard

The Economic Substance Law has had significant OECD, EU and industry input and reflects both:

- (a) the Cayman Islands' ongoing adherence to global standards as one of the 129 member countries committed to the OECD's BEPS Inclusive Framework; and

- (b) commitments made by the Cayman Islands to the EU as part of the EU's listing process.

### 3 Scope of the Economic Substance Law

- 3.1 The Economic Substance Law introduces certain reporting and economic substance requirements for "relevant entities" conducting "relevant activities".
- 3.2 All entities having separate legal personality and registered in the Cayman Islands (including where registered as a foreign entity) are required to make a determination as to whether or not they are a "relevant entity" and whether or not they conduct a "relevant activity" as each term is defined in the Economic Substance Law.
- 3.3 Entities without separate legal personality (such as certain forms of partnership or trust) are not within the classification of a relevant entity.
- 3.4 A "relevant entity" carrying on "relevant activity" will be required to satisfy the economic substance test with respect to any part of its "relevant income" that is not subject to corporate income tax imposed by a jurisdiction other than the Cayman Islands.

### 4 What is a Relevant Entity?

- 4.1 The definition of "relevant entity" set out in the Economic Substance Law is:
  - (a) a company, other than a domestic company, that is:
    - (i) incorporated under the Companies Law (2020 Revision) (the "**Companies Law**"); or
    - (ii) a limited liability company registered under the Limited Liability Companies Law (2018 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 Cayman Islands and registered under the Companies Law;
  - (d) but does not include:
    - (i) an investment fund; or
    - (ii) an entity that is tax resident outside the Cayman Islands.
- 4.2 "**Investment Fund**" means 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 licenced under the Banks and Trust Companies Law (2020 Revision) or the Insurance Law, 2010, or a person registered under the Building Societies Law (2020 Revision) or the Friendly Societies Law (1998 Revision).

#### 4.3 "Domestic Company"

- (a) This means a company that is not part of an MNE Group and that is:
  - (i) only carrying on business in the Islands and which 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); or
  - (ii) a company referred to in section 80 of the Companies Law.
- (b) For these purposes an "**MNE Group**" broadly means a collection of two or more enterprises that are required to prepare consolidated financial statements (or would be so required if equity interests in the enterprises were trading on a public securities exchange) 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.

#### 4.4 "Resident outside the Cayman Islands"

- (a) Pursuant to the Guidance, entities will be regarded 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.
- (b) In the event that the entity is a "disregarded entity" for US income tax purposes, and has a US corporation or US individual as its parent, such entity will be considered as tax resident outside of the Cayman Islands if satisfactory evidence is provided to the Authority.
- (c) An entity claiming to be tax resident outside the Cayman Islands will be required to produce satisfactory evidence to substantiate the same. The evidence may include a Tax Identification Number, tax residence certificate and assessment or payment of a corporate income tax liability on all of that entity's income in the Islands from a relevant activity, or, in the case of a disregarded entity for US income tax purposes, a signed statement under penalty of perjury from an external tax advisor or 'C' level officer stating that all of that entity's income has been included on the corporate tax return of the US parent company. In the absence of such evidence the entity will be regarded as a relevant entity that is subject to the requirements of the Economic Substance Law.
- (d) The Authority has issued a "Form for Entity Tax Resident in another Jurisdiction", which is required to be submitted for each financial year that an entity is claiming to be tax resident outside the Cayman Islands

### 5 What is a Relevant Activity?

5.1 The Economic Substance Law applies economic substance requirements to the following categories of geographically mobile relevant activities previously identified by the OECD (and adopted by the EU):

- (a) banking;

- (b) insurance;
- (c) shipping;
- (d) fund management;
- (e) financing and leasing;
- (f) headquarters;
- (g) distribution and service centres;
- (h) holding company; and
- (i) intellectual property.

- 5.2 Where a "relevant entity" conducts a "relevant activity", the economic substance test will apply.
- 5.3 Where a "relevant entity" conducts more than one "relevant activity", the economic substance test will need to be satisfied in respect of each relevant activity conducted.
- 5.4 What constitutes the relevant activities of each of the above categories of business is set out in the Economic Substance Law and Guidance, and each category is required to be analysed separately.

## 6 Economic Substance Test

- 6.1 A relevant entity conducting a relevant activity is required to satisfy the economic substance test (the "**ES Test**") in respect of that relevant activity. The ES Test has three main components, which are satisfied if the relevant entity:
- (a) conducts core income generating activities ("**Cayman Islands CIGA Component**") in relation to that relevant activity;
  - (b) is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity ("**Management Component**"); and
  - (c) having regard to the level of relevant income derived from the relevant activity carried out in the Cayman Islands ("**Adequacy Component**"):
    - (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.
- 6.2 **Cayman Islands CIGA Component** - is specifically driven by the category of relevant activity being conducted. Cayman Islands CIGA means activities that are of central importance to a

relevant entity in terms of generating relevant income and which, if carried on by a relevant entity in terms of generating relevant income, must be carried on in the Cayman Islands.

**6.3 Management Component** – requires:

- (a) the board of directors, as a whole, must have the appropriate knowledge and expertise to discharge its duties as a board of directors;
- (b) meetings of the board of directors are held in the Cayman Islands at adequate frequencies given the level of decision making required;
- (c) that there is a quorum of directors present in the Cayman Islands during the meetings described in (b) above;
- (d) the minutes of those meetings record the making of strategic decisions of the relevant entity at the meeting; and
- (e) director meeting minutes and appropriate records are kept in the Cayman Islands.

**6.4 Adequacy Component** – the Guidance states that "adequate" shall mean "'as much or as good as necessary for the relevant requirement or purpose", and that what is adequate or appropriate for each relevant entity will be dependent on the particular facts of the relevant entity and its business activity. As such, the directors (or equivalent) of each relevant entity should address their minds to these questions and make their determination in good faith. A relevant entity must ensure that it maintains and retains appropriate records to demonstrate the adequacy and appropriateness of the resources utilised and expenditures incurred.

**6.5 Reduced ES Test for "Holding Company Business"** – which is the business of a "pure equity holding company". A pure equity holding company is defined as "a company that only holds equity participations in other entities and only earns dividends and capital gains". Such entities are subject to a reduced ES Test, which will be satisfied if the entity: (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 such equity participations.

With respect to limb (b), the Guidance provides that: *"A pure equity holding company maintaining a registered office in the Islands engaging its registered office service provider in accordance with the Companies Law may be able to satisfy the reduced ES Test, depending on the level and complexity of activity required to operate its business. For the avoidance of doubt, a pure equity holding company is not required to be directed and managed in the Islands."*

**6.6 Outsourcing**<sup>1</sup> - A relevant entity conducting a relevant activity may satisfy the ES Test by outsourcing the conduct of its Cayman Islands CIGA to another person in the Cayman Islands. A relevant entity that outsources its Cayman Islands CIGA must be able to monitor and control the carrying out of the Cayman Islands CIGA. The Authority has issued a "Form for Outsource Service Providers" which must be filed by the outsource service provider before an ES report is made by the relevant entity relying on such outsourcing.

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<sup>1</sup> Relevant entities conducting IP Business which is high-risk IP business are not able to outsource their CIGA (per section 4(7) of the Economic Substance Law).

The Authority has the power, in accordance with the Economic Substance Law, the Economic Substance Regulations and the Guidance, to make a determination as to whether a relevant entity has satisfied the Economic Substance Test for any financial year in respect of which a report is required under the Economic Substance Law. The relevant entity must be able to demonstrate that it has adequate supervision of the outsourced activities and, to satisfy the ES Test, that both the supervision and those CIGA are undertaken in the Cayman Islands.

## 7 Notification and Reporting

7.1 **Notification:** Having conducted the required initial analysis, all companies, limited liability companies, limited liability partnerships and foreign registered companies are required to make a simple notification confirming whether or not they are a "relevant entity" and whether or not they conduct a "relevant activity", such notification to be made online, via the General Registry's Corporate Administration Platform (CAP). Every "relevant entity" is required to disclose on its annual return to the Registrar of Companies what type of relevant activities, if any, it is carrying on. The notification is required to be completed prior to the filing of the annual return with the Registrar of Companies.

7.2 **Reporting:** "Relevant entities" conducting "relevant activities" are required to report certain information on their relevant activities on an annual basis to the Authority (an "**ES Return**"), the first such annual ES Return being due no later than 12 months after the last day of the relevant entity's financial year commencing on or after 1 January in the year it commences a relevant activity. The ES Return, when submitted, will provide certain information as at the end of the relevant financial year (see Schedule 2 for a list of the ES Return information requirements).

For example, if a "relevant entity", which is subject to the ES Test, commences a "relevant activity" on or after 1 January 2020 and has a financial year end of 31 December, the first annual ES Return would:

- (a) be due on or before 31 December 2021; and
- (b) would speak to the relevant entity's economic substance as of 31 December 2020.

For a relevant entity formed on or after 1 January 2019 that will conduct a "relevant activity", the economic substance requirements apply from the date that the relevant entity commences the relevant activity. For relevant entities conducting relevant activities that were in existence before 1 January 2019, the economic substance requirements apply from 1 July 2019.

The reporting deadlines for relevant entities that were due to file an ES Return by 31 December 2020 have been extended for the first year only. The deadlines are:

- (i) For relevant entities carrying on IP business: **31 January 2021**; and
- (ii) For all other ES Returns (including the Form of Entity Tax Resident in Another Jurisdiction): **28 February 2021** unless the reporting deadline falls after 28 February 2021, in which case the deadline remains at 12 months after the end of the financial year.

## **8 Failure to Comply with the ES Test**

- 8.1 If the Authority determines that a relevant entity that is required to satisfy the ES Test has failed to satisfy such ES Test for a financial year, it shall issue a notice to the relevant entity notifying the relevant entity of such determination, giving the reasons, details regarding any penalty, directing any action to be taken to satisfy the ES Test and advising of the relevant entity's right to appeal.
- 8.2 The Authority shall also impose a penalty of US\$12,195 on a relevant entity for failing to satisfy such ES Test or US\$121,951 if it is not satisfied in the subsequent financial year after the initial notice of failure.
- 8.3 After two consecutive years of non-compliance, the Registrar of Companies can apply to the Grand Court for an order:
- (a) requiring the relevant entity to take a specified action, including for the purpose of satisfying such ES Test; or
  - (b) that a relevant entity be struck off as a defunct company or struck off as a limited liability partnership on the basis that the Registrar has reasonable cause to believe is not carrying on business or is not in operation.

## **9 Offences Under the Economic Substance Law**

- 9.1 It is an offence for a person to knowingly or wilfully supply false or misleading information to the Authority under the Economic Substance Law. Such an offence is punishable on summary conviction by a fine of US\$12,195 or with imprisonment for a term of five years, or both.
- 9.2 It is also an offence to disclose information relating to the affairs of a relevant entity or any officer, customer, investor, member, client or policyholder of a relevant entity. Such an offence is punishable on summary conviction to a fine of US\$12,195 or to imprisonment for one year, or to both, and on conviction on indictment to a fine of US\$60,976, or to imprisonment for a term of three years, or to both.
- 9.3 Where an offence under the ES Law that has been committed by a body corporate is proved to have been committed with the consent or connivance of, or to be attributable to any neglect on the part of any director, manager, secretary or other officer of the body corporate, or any person who was purporting to act in such a capacity, the officer or any person purporting to act in that capacity, as well as the body corporate, commits that offence and is liable to be proceeded against and punished accordingly. Where the affairs of a body corporate are managed by its members, the foregoing shall apply in relation to defaults of a member in connection with the member's functions of management as if the member were a director of the body corporate.

## **10 Conclusion**

The extent to which an entity is affected by the Economic Substance Law will depend upon a number of factors including the entity type, where the entity is tax resident, the type of business the particular entity is engaged in and the way in which it operates. The application of the Economic Substance Law needs to be monitored on an ongoing basis as any change in an entity's business activities may impact whether or not it is subject to the Economic Substance Law. We encourage you to speak with your usual Maples contact.

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**ScheduleES Return Information Requirements**

- 1 The type of relevant activity conducted by the relevant entity.
- 2 The amount and type of relevant income in respect of the relevant activity.
- 3 The amount and type of expenses and assets in respect of the relevant activity.
- 4 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.
- 5 The number of full-time employees or other personnel with appropriate qualifications who are responsible for carrying on the relevant entity's relevant activity.
- 6 Information showing the Cayman Islands CIGA in respect of the relevant activity that have been conducted.
- 7 A declaration as to whether or not the relevant entity satisfies the ES Test in accordance with the Economic Substance Law.
- 8 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 the information under paragraph 10 below to rebut the presumption (see "*High Risk Intellectual Property Business*" below) within the ES Return reporting period.
- 9 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.
- 10 In the case of a relevant entity that is carrying on a high risk intellectual property business:
  - 10.1 detailed business plans which demonstrate the commercial rationale for holding the intellectual property assets in the Islands;
  - 10.2 employee information, including level of experience, type of contracts, qualifications and duration of employment;
  - 10.3 evidence that decision making is taking place within the Islands; and
  - 10.4 any other information as may be reasonably required by the Authority to determine whether the relevant entity meets the substance test.
- 11 The name and address of the relevant entity's immediate parent, ultimate parent and ultimate beneficial owner and any other information as may reasonably be required by the Authority to identify the relevant entity's immediate parent, ultimate parent and ultimate beneficial owner.
- 12 The jurisdiction of tax residence of the relevant entity's immediate parent, ultimate parent and ultimate beneficial owner.

- 13 Information as may reasonably be required by the Authority in respect of expenditure incurred in respect of a person other than the relevant entity who is conducting Cayman Islands CIGA for relevant activities on behalf of the relevant entity.
- 14 Information as may reasonably be required by the Authority to confirm that the relevant entity monitors and controls in the Cayman Islands the carrying out of its Cayman Islands CIGA by another person.
- 15 A copy of the relevant entity's financial statements or books of account for the relevant entity's financial year.
- 16 Information as may reasonably be required by the Authority in respect of employees who are conducting Cayman Islands CIGA for relevant activities including the number of employees and appropriate qualifications of such employees.
- 17 Confirmation of —
  - 17.1 compliance with the Management Component requirements (see paragraph 6.3 above);
  - 17.2 the number of board meetings held in the Cayman Islands; and
  - 17.3 the number of board meetings held outside the Cayman Islands.
- 18 Confirmation of compliance with the reduced ES Test for a "pure equity holding company" (see paragraph 6.5 above)

## High Risk Intellectual Property Business

A relevant entity that is carrying on a high risk intellectual property business is presumed<sup>2</sup> not to have met the ES Test for a financial year, even if there are Cayman Islands CIGA relevant to the business and the intellectual property assets being carried out in the Cayman Islands, unless the relevant entity:

- 1 can demonstrate that there was a high degree of control over the development, exploitation, maintenance, enhancement and protection of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Islands; and
- 2 provides sufficient information under paragraph 10 above in relation to that financial year to rebut this presumption.

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<sup>2</sup> Section 4(7) of the Economic Substance Law.