

Economic substance in the Cayman Islands

The International Tax Co-operation (Economic Substance) Act (**ES Act**) was introduced in the Cayman Islands in response to the OECD's Base Erosion and Profit Shifting framework and related EU initiatives in relation to what are known as "Geographically Mobile Activities".

Overview

The ES Act is supplemented by the Guidance Notes issued by the Cayman Islands Department for International Tax Cooperation (**DITC**) on Economic Substance for Geographically Mobile Activities (**ES Guidance**) which can be found on the DITC's website – www.ditc.ky

Under the ES Act any *relevant entity* which carries on a *relevant activity* and receives *relevant income* in a financial period must satisfy the economic substance test in relation to that activity (**ES Test**) and make an annual filing with the DITC.

Aside from the basic filing requirements, a *relevant entity* which does not carry on any *relevant activity* is not required to satisfy the ES Test.

What is a relevant entity?

Under the ES Act all Cayman Islands companies and partnerships, and all such entities which are registered in the Cayman Islands are *relevant entities* except those entities which are:

- A local partnership
- An investment fund
- Tax resident outside the Cayman Islands
- A domestic company

The ES Act clearly defines "investment fund", "local partnership" and "domestic company". The term "investment fund" includes all funds registered with the Cayman Islands Monetary Authority (**CIMA**) under the Mutual Funds Act and Private Funds Act, but is broad enough to cover other entities in fund structures. "Local partnerships" and "domestic companies" are vehicles which only operate domestic businesses in the Cayman Islands pursuant to domestic trade and business legislation and will not be relevant to most of our clients.

For tax residence, an entity must be 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" for the DITC to consider it as being tax resident outside the Cayman Islands. For any entity claiming tax residence outside of the Cayman Islands, satisfactory evidence of this will be required to be provided to the DITC in the entity's annual filings.

What is relevant income?

Relevant income is "all of an entity's gross income from its *relevant activities* and recorded in its books and records under applicable accounting standards". Any income that is not generated from *relevant activities* is not to be considered when determining adequate substance in the Cayman Islands.

What is a relevant activity?

The ES Act specifies nine categories of *relevant activity*:

Relevant activity	Definition
“Banking business”	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. This definition is taken from the Banks and Trust Companies Act so entities conducting banking business should already hold a banking licence.
“Insurance business”	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. This definition is taken from the Insurance Act so entities conducting insurance business should already hold an insurance licence.
“Fund management business”	The business of managing securities belonging to another person in circumstances involving the exercise of discretion carried on by a <i>relevant entity</i> that has been issued a licence by CIMA or is 'otherwise authorised' to operate under the Securities Investment Business Act and which does so for an investment fund.
“Finance and leasing business”	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.
“Headquarters business”	The business of providing any of the following services to an entity in the same group: <ul style="list-style-type: none"> ▪ The provision of senior management ▪ The assumption or control of material risk for activities carried out by any of those entities in the same group or ▪ The provision of substantive advice in connection with such assumption or control of risk, but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business
“Distribution and service centre business”	The business of either or both of the following: <ul style="list-style-type: none"> ▪ Purchasing from an entity in the same group component parts or materials for goods, or goods ready for sale, and reselling such component parts, materials or goods outside the Cayman Islands ▪ Providing services to an entity in the same group in connection with the business outside the Cayman Islands, but does not include any activity included in any other <i>relevant activity</i> except holding company business
“Shipping business”	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: <ul 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 the previous paragraph ▪ 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, but does not include a holding company business or the owning, operating or chartering of a pleasure yacht

Relevant activity	Definition
“Holding company business”	The business of being a “pure equity holding company”, being a company that only holds equity participations in other entities and only earns dividends and capital gains.
“Intellectual property business”	The business of holding, exploiting or receiving income from “intellectual property assets”, being any intellectual property right including a copyright, design right, patent or trademark.

What is the ES Test?

There are three different ES Tests depending on the nature of the *relevant activity*.

The holding company business test

A *relevant entity* that carries on holding company business meets the ES Test if:

- It complies with its statutory obligations under the relevant governing statute (for companies the Companies Act, limited liability companies the Limited Liability Companies Act, limited liability partnerships the Limited Liability Partnerships Act, partnerships the Partnership Act, and exempted limited partnerships and foreign limited partnerships the Exempted Limited Partnership Act), and
- It has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations

A *relevant entity* that is a pure equity holding company may engage its registered office provider to satisfy this reduced substance test in the Cayman Islands.

The general test

An entity conducting a *relevant activity* (other than holding company business or high risk intellectual property business) meets the ES Test if the *relevant entity*:

- Conducts core income generating activities (**CIGA**) in the Cayman Islands in relation to that *relevant activity*
- Is directed and managed in an appropriate manner in the Cayman Islands in relation to that *relevant activity*
- Having regard to the level of *relevant income* derived from the *relevant activity* carried out in the Cayman Islands, has an adequate amount of operating expenditure, physical presence and number of full-time employees or other personnel with appropriate qualifications, in the Cayman Islands

Identifying the activities to address the above will be a matter of fact and will need to be assessed on a case-by-case basis for each *relevant entity*.

The ES Act sets out a non-exhaustive list of CIGA for each *relevant activity* which are set out in further below.

Only the CIGA of a *relevant entity* must be conducted in the Cayman Islands, its other activities may be conducted anywhere in the world.

In order for a *relevant entity* to be able to show that it is directed and managed in an “appropriate” manner (defined as “suitable or fitting for a particular purpose, person, occasion”). Not all board meetings of a *relevant entity* (or its general partner in the case of a partnership) must be held in the Cayman Islands but such meetings must be held at “adequate” frequencies (meaning “as much or as good as necessary for the relevant requirement or purpose”) having regard to the nature of the *relevant activity* and the level of decision making required. For a meeting to be treated as being held in the Cayman Islands there must be a quorum of directors physically present in the Cayman Islands. Minutes of such meetings must be recorded and kept in the Cayman Islands. In relation to determining what is adequate in terms of expenditure, premises or employees, the DITC makes it clear in the ES Guidance that they will employ a principles-based approach and specifically will want to ensure that those individuals who in fact do conduct the CIGA for the *relevant activity*, do so in the Cayman Islands and not elsewhere and by extension that will dictate expenditure and premises. The ES Guidance sets out factors that will be taken into consideration by the DITC in this regard. Best practice

would be for *relevant entities* to conduct internal reviews of its *relevant activities* and ensure records are maintained to demonstrate the adequacy and appropriateness of resources utilised and expenditures incurred.

The high risk intellectual property business test

As income derived from intellectual property assets are considered to be at higher risk of profit shifting from higher to lower (or zero) tax jurisdictions, a more rigorous requirement applies to certain entities which carry on intellectual property business. Please contact us to discuss these requirements.

It can be noted that the DITC regards the term “intellectual property asset” as only including intellectual property assets that generate separately identifiable income for a business 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 intellectual property merely as an adjunct to its business or which does not generate separately identifiable income for a business. That said, businesses must be careful where an intellectual property asset is held for long term gain. The law relating to intellectual property business is more complex and we would be happy to discuss this with you if this applies to your business.

Outsourcing

A *relevant entity* may outsource some or all of its CIGA to an entity in the Cayman Islands provided that it has adequate supervision of the outsourced activities, they are performed in the Cayman Islands and the third party service provider has adequate resources to fulfil the outsourced activities. Outsourcing cannot be done to circumvent compliance with the ES Test.

Core income generating activities

The CIGA examples given in the ES Act for each *relevant activity* are detailed below. It should be noted that these are not exhaustive lists and there is no requirement for a *relevant entity* to conduct all CIGA for the *relevant activity* if it does not do so as part of its business.

Relevant activity	CIGA examples
Banking business	<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
Insurance business	<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 CIMA, or both
Fund management business	<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
Finance or leasing 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

Relevant activity	CIGA examples
Headquarters business	<ul style="list-style-type: none"> ▪ Taking relevant management decisions ▪ Incurring expenditures on behalf of other entities in the Group ▪ Co-ordinating activities of the Group
Distribution and service centre business	<ul style="list-style-type: none"> ▪ Transporting and storing goods, components and materials ▪ Managing stocks ▪ Taking orders ▪ Providing consulting or other administrative services
Shipping business	<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
Holding company business	<ul style="list-style-type: none"> ▪ All activities related to that business
IP holding business	<p>For IP assets that are patents or assets similar to patents (eg copyrighted software) this is research and development.</p> <p>For IP assets which are non-trade intangibles (eg trademarks) this is branding, marketing and distribution.</p> <p>In exceptional cases a <i>relevant entity</i> may be able to prove that it is conducting substantial activities even if this does not involve research and development or branding, marketing and distribution (as the case may be) provided that the activity is not high risk IP business, if the entity is:</p> <ul style="list-style-type: none"> ▪ Taking strategic decisions as well as bearing the principal risks of the development and 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

What happens if an entity does not comply with the ES Act?

Enforcement action may be taken and financial penalties up to C\$100,000 (or US\$121,950) imposed for breaches of the ES Act. Broadly, a failure by any person (which potentially includes directors or partners) to provide information or the provision of inaccurate or misleading information to the DITC, late filing of an economic substance report, or a failure of an entity to comply with the ES Test, will constitute a breach of the ES Act. As well as potential fines, the ultimate consequence of failure to comply with the ES Act could result in the *relevant entity* being struck off following non-compliance for two consecutive years and directors/managers being fined.

The DITC has issued detailed enforcement guidelines which provide guiding principles for the application of the administrative penalty regime to persons that are potentially subject to enforcement action.

What are the reporting obligations?

Economic substance notification

All entities must annually file an economic substance notification form with the General Registrar for any period in which they are registered in the Cayman Islands. The notification form must be filed by the registered office and is a pre-requisite to being able to file the annual return for the entity. Accordingly, failure to file the notification form in January of each year will mean the entity is not in good standing with the Registrar until both forms are filed.

The notification form must include the following:

- Whether or not the entity is carrying on a *relevant activity*
- If so, whether or not it is a *relevant entity*
- If so, the date of the end of its financial year
- If so, the name and address of the officer responsible for providing information to the DITC
- If not, whether it is an investment fund or a domestic/local entity, and
- If the *relevant entity* is carrying on a *relevant activity*, whether or not all or any part of the *relevant entity's* gross income in relation to the *relevant activity* is subject to tax in a jurisdiction outside of the Cayman Islands and if so, provide:
 - 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, and
 - Appropriate evidence to support that tax residence as may be required

Economic substance return

A *relevant entity* that is carrying on a *relevant activity* must also file a report with the DITC that contains certain prescribed information to allow the DITC to determine if the company is satisfying the ES Test. Such report must be filed no later than 12 months after the last day of the end of each financial year of the *relevant entity*. As noted above, fines apply for any late filing of an economic substance report.

We have already classified our entity but its activities have changed. Do we need to do anything?

The short answer is yes. If the activities of an entity change at any time, or if the tax residency situation of an entity changes, then the entity must reassess its position under the economic substance regime and determine if an updated or amended annual filing is required.

What does an entity need to do if it is transferring out of the Cayman Islands or dissolving?

A *relevant entity* must ensure it is up to date with its economic substance notification and, if applicable, its economic substance returns, before transferring out or completing the dissolution process. For entities that are dissolving by way of liquidation or strike-off, this means that economic substance filings are required for any period until the date on the entity's certificate of dissolution. This is part of the termination process.

What are the compliance obligations?

All companies or partnerships that are incorporated or registered in the Cayman Islands should:

- Determine whether or not the entity is a *relevant entity*
- Determine whether or not it is conducting a *relevant activity* for any current or previous financial year

- Make an annual economic substance notification filing with the Cayman Islands government directly to the General Registrar or through the vehicle's registered office services provider
- Determine what steps (if any) it needs to take in order to meet the ES Test and related reporting requirements

In order to determine if an entity is a *relevant entity*, or if you believe that a *relevant entity* is conducting a *relevant activity* please contact your usual Harneys representative for further information about how Harneys can assist the *relevant entity* to confirm such classification and to satisfy the ES Test.

Further Reading

The DITC publishes all of the relevant legislation and guidance on its website and we recommend this as a resource. Full details can be found here: <https://www.ditc.ky/es/es-legislation-resources/>.



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