Overview of the Cayman Islands Economic Substance Requirements

Legislation requiring a “relevant entity” conducting “relevant activity” to file notifications and, unless exempt, to report and maintain economic substance has been introduced in the Cayman Islands.

The International Tax Co-operation (Economic Substance) Law and International Tax Co-operation (Economic Substance) (Prescribed Date) Regulations, 2018 were first published on 27 December 2018. The International Tax Co-operation (Economic Substance) Law has subsequently been revised and amended on 22 February 2019, 14 January 2020 and 12 February 2020, and is supported by the International Tax Co-operation (Economic Substance) Regulations, 2020 and the International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2020 (together, the “ES Law”). ES Guidance on Economic Substance for Geographically Mobile Activities (“ES Guidance”) was published on 22 February 2019 with version 2 being published on 30 April 2019 and updated on 17 September 2019. Version 3 of the ES Guidance was published on 13 July 2020. This advisory provides an overview of key aspects only and we would be happy to advise in further detail if required.

The Cayman Islands is a member of the OECD Inclusive Framework on Base Erosion and Profit Shifting (“BEPS”) and enacted the ES Law in response to requirements for geographically mobile activities to have economic substance developed under BEPS Action 5, consistent with the European Union timeframe to have such requirements in place on 1 January 2019. The ES Law has applied to all entities established before 2019 since 1 July 2019. Similar legislation has been or is being enacted in all OECD-compliant jurisdictions with no or nominal tax, including Bermuda, the British Virgin Islands, Guernsey and Jersey. The ES Law and ES Guidance were published following consultation with the OECD, the EU and Cayman Islands stakeholders. International standards are continuing to develop and it is anticipated that the ES Law and ES Guidance will evolve and be subject to further clarification.

Scope

The ES Law requires Cayman Islands incorporated companies, limited liability companies, limited liability partnerships and registered foreign companies to file an economic substance notification. It also requires a “relevant entity” conducting “relevant activity” to report to the Tax Information Authority (“TIA”) and maintain economic substance in the Cayman Islands. A “relevant entity” which does not conduct “relevant activity” is not required to submit an economic substance report. A “relevant entity” which receives no “relevant income” is not required to maintain economic substance.

What is a “relevant entity”?

Cayman Islands incorporated companies (other than certain domestic companies which carry on business within the Cayman Islands), limited liability companies, limited liability partnerships and registered foreign companies, are “relevant entities” unless excluded as set out below.
Investment funds, as defined in the ES Law, are excluded from the definition of “relevant entity”. The definition of an investment fund includes entities through which an investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held).

An entity which is tax resident in another jurisdiction is also excluded from the definition of “relevant entity”. An entity will be regarded as tax resident in another jurisdiction if it is subject to corporate income tax on all 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. An entity that can evidence that it is a “disregarded entity” for US income tax purposes and has a US corporation as its parent will also be regarded as tax resident in another jurisdiction.

Limited partnerships and trusts are not “relevant entities”.

What is a “relevant activity”?

Each of the following activities, which have been identified by the OECD as “geographically mobile” is a “relevant activity” as defined further in the ES Law.

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

A “relevant entity” that conducts more than one “relevant activity” is required to satisfy the ES Test in relation to each relevant activity.

Please see the appended schedule for further details of the relevant activities (and the corresponding CIGA).

The ES Test

A relevant entity that conducts a relevant activity must satisfy an ES Test (“ES Test”) in relation to that relevant activity. A relevant entity satisfies the ES Test in relation to a relevant activity if the relevant entity:

(a) conducts its core income generating activities (“CIGA”) in relation to that relevant activity in the Cayman Islands;
(b) is directed and managed in an appropriate manner in the Cayman Islands in relation to that relevant activity; and
(c) having regard to the level of relevant income derived from the relevant activity carried out in the 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.

Further details of the relevant activities and the corresponding CIGA are set out at the end of this advisory.
Reduced ES Test for pure equity holding companies

A relevant entity that is only carrying on a relevant activity that is the business of a pure equity holding company is subject to a reduced ES Test which is satisfied if the relevant entity confirms that it has complied with all applicable filing requirements under the Companies Law, and has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities. The ES Guidance confirms that a pure equity holding company may engage its registered office service provider to satisfy these reduced substance requirements in the Cayman Islands.

Application of the ES Test to “high risk intellectual property business”

However, a “relevant entity” which conducts “high risk intellectual property 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 intellectual assets being carried out in the Cayman Islands, unless the relevant entity can demonstrate that there was a high degree of control over the development, exploitation, maintenance, protection and enhancement 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 Cayman Islands, and provides sufficient specified information to the TIA in relation to that financial year to rebut this presumption. We would be happy to advise on the meaning of “high risk intellectual property business” and the evidential threshold, if required.

CIGA

CIGA means the activities that are of central importance to a relevant entity in terms of generating relevant income and which, if conducted, must be conducted in the Cayman Islands. The examples of CIGA are not mandatory or exhaustive, so a “relevant entity” need not perform every element of CIGA listed for the “relevant activity”. The assessment of substance in the Cayman Islands will include consideration of what elements of CIGA the “relevant entity” is undertaking in the Cayman Islands.

Directed and managed

A relevant entity is directed and managed in an appropriate manner in the Cayman Islands in relation to a relevant activity if:

(a) its board of directors, as a whole, has appropriate knowledge and expertise to discharge its duties;
(b) meetings of the board of directors are held in the Cayman Islands, with a quorum of directors present in the Cayman Islands, at adequate frequencies given the level of decision making required;
(c) minutes of the above meetings record the making of strategic decisions of the relevant entity at the meeting; and
(d) the minutes of all meetings of the board of directors and appropriate records of the relevant entity are kept in the Cayman Islands.

 Relevant income

Relevant income means all of an entity’s gross income from its relevant activities and recorded in its books and records under applicable accounting standards. A relevant entity that carries on a relevant activity but which has no relevant income is not obliged to meet the requirements of the ES Test. The relevant entity will still, however, be required to satisfy its notification and reporting obligations under the ES Law (albeit the report filed will be a ‘nil’ return).

What is “adequate” and “appropriate”? 

The ES Guidance is intended to assist relevant entities carrying on relevant activities to understand how to satisfy the ES Test, including ES Guidance as to the meaning of “adequate” and “appropriate” for the purposes of the ES Law. The ES Guidance does not prescribe a minimum number of full time employees for a particular level of relevant income either generally or for or any particular type of relevant activity because that would be arbitrary and would prove uneconomical in many cases. What is adequate or appropriate for each relevant entity will be dependent on the particular facts of the relevant entity and its business activity. A relevant entity will have to ensure that it maintains and retains appropriate records to demonstrate the adequacy and appropriateness of the resources utilised and expenditures incurred.
Licensed entities

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 banking business, insurance business or 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 ES Law (and, as such, will need to comply with notification and reporting requirements and conduct any CIGA in relation to the relevant activity in the Cayman Islands).

Outsourcing

A relevant entity may satisfy the ES Test by outsourcing the conduct of its CIGA to another person in the Cayman Islands provided that the relevant entity is able to monitor and control the carrying out of the CIGA.

Timing

A relevant entity is subject to the ES Law from the date on which the relevant entity commences a relevant activity unless (i) the relevant entity was in existence prior to 1 January 2019, in which case it must comply with the ES Law by 1 July 2019; or (ii) the relevant entity is conducting fund management business, and was registered with CIMA as an “excluded person” before re-registering as a “registered person” prior to 15 January 2020, in which case it must comply with the ES Law from when it became a “registered person”.

Notification obligation (to be complied with by all entities)

Starting in 2020, every legal person that is registered with the General Registry must provide a notification to the TIA annually via the General Registry prior to the entity submitting its annual return. Such an entity is required to confirm whether the ES Law applies to it, and in some cases provide certain details such as its financial year end date. For example, if an entity is conducting a relevant activity but its gross income in relation to that activity is subject to tax in a jurisdiction outside of the Cayman Islands, the entity will be required to confirm this in the notification and may need to provide appropriate supporting evidence at a later date.

Reporting obligation (to be complied with only by relevant entities conducting relevant activities)

Relevant entities conducting relevant activities that are required to satisfy the ES Test must prepare and submit to the TIA an annual report containing prescribed information for the purpose of the TIA's determination whether the ES Test has been satisfied in relation to that relevant activity within twelve months after the last day of the end of each financial year commencing on or after 1 January 2019. For example, a relevant entity with a financial year of 1 January 2020 to 31 December 2020 would be required to submit the first annual report on or before 31 December 2021.

As mentioned above, entities that re-registered as “registered persons” with CIMA prior to 15 January 2020 have only been required to comply with the ES Law in respect of fund management business since the date of re-registration. Therefore, such entities will not be required to file a first annual report until 2021.

Where a relevant entity that is required to satisfy the ES Test fails to prepare and submit the annual report to the TIA by the deadline, the entity may be subject to a penalty of CI$5,000 (or US$6,250) and an additional penalty of CI$500 (or US$625) for each day during which the failure to comply continues.

Liquidation or otherwise ceasing to carry on relevant activities

A relevant entity will, so long as it exists, continue to have any obligations which the ES Law imposes on it (and which the liquidators or equivalent must ensure it satisfies). However, a relevant entity which is finally dissolved or completes winding up before it is possible to notify or report for the purposes of the ES Law will not be required to do so.
Determination of whether the ES Test is satisfied

The TIA shall have the power, in accordance with the ES Law and the ES Guidance, to make a determination as to whether a “relevant entity” satisfies the ES Test for any financial year. The TIA will take a principles-based approach to determining whether or not a “relevant entity” has satisfied the ES Test with respect to its “relevant activities”.

Failure to satisfy the 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 the relevant entity notifying the relevant entity of such determination, giving the reasons, directing any action to be taken to satisfy the ES Test and advising of the relevant entity’s right to appeal.

The TIA shall impose a penalty of CI$10,000 (or US$12,500) on a relevant entity for failing to satisfy such ES Test or CI$100,000 (or US$125,000) if it is not satisfied in the subsequent financial year after the initial notice of failure. Following failure after two consecutive years the Grand Court may make an order requiring the relevant entity to take specified action to satisfy the ES Test or an order that the relevant entity is defunct or to be struck off.

Offences

It is an offence for a person to knowingly or wilfully supply false or misleading information to the TIA under the ES Law. Such an offence is punishable on summary conviction by a fine of CI$10,000 or with imprisonment for a term of five years, or both. A person will also commit an offence if they fail to provide or make available to the TIA within the time specified, or knowingly or wilfully alter, destroy, mutilate, deface, hide or remove, any information requested by the TIA under the ES Law that is in that person’s possession or control. This offence is punishable on summary conviction by a fine of CI$10,000 or with imprisonment for a term of two years, or both.

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 CI$10,000 or to imprisonment for one year, or to both, and on conviction on indictment to a fine of CI$50,000 (or US$60,000), or to imprisonment for a term of three years, or to both.

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, such person 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.

Circumvention

When considering mitigating steps to ensure an entity’s compliance with, or exemption from, the ES Law, it is worth noting that 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 ES Law. This will be the case where an entity seeks to manipulate or artificially suppress its income to circumvent substance requirements.

Entities that are potentially in scope of the ES Law should consider the implications of restructuring (or similar) exercises which have the ultimate effect of seemingly removing or reducing economic substance requirements while not otherwise factually altering the activities carried on in the Cayman Islands.
Further developments and next steps

International standards are continuing to develop and it is anticipated that the ES Law and ES Guidance may also evolve and are subject to further clarification. The Cabinet may make regulations prescribing anything that may be prescribed under the ES Law and amending the ES Law, including to further define the scope of relevant entities that are required to satisfy the ES Test and the scope of relevant activities.

Contacts

Walkers has a dedicated global Regulatory & Risk Advisory practice group of regulatory lawyers that can offer legal advice and guidance in connection with all aspects of the economic substance regime as it continues to evolve. Through its affiliate, Walkers Professional Services, Walkers is also committed to providing economic substance solutions that will enable all clients impacted by the regime to satisfy the necessary requirements for substance in the Cayman Islands, including notification and reporting.

For further information please speak with your usual Walkers contact:
Appendix
Economic Substance Requirements – Relevant Activities and Corresponding CIGA

The meaning of each “relevant activity” is set out below. Only a “relevant entity” which is conducting “relevant activity” as defined in the left hand column is required to satisfy the ES Test (which includes a requirement for the “relevant entity” to conduct CIGA. The examples of CIGA as set out in the right hand column are not mandatory or exhaustive, so a “relevant entity” may not need to perform every element of CIGA listed for the “relevant activity” to the extent they do not apply.

The term “group” where applicable, means a collection of enterprises related through ownership or control such that it is either required to prepare consolidated financial statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange.

<table>
<thead>
<tr>
<th>Definition</th>
<th>CIGA</th>
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<tbody>
<tr>
<td>Banking Business</td>
<td>The CIGA in the context of banking business include:</td>
</tr>
<tr>
<td>Banking business has the meaning given by section 2 of the Banks and</td>
<td>(a) raising funds, managing risk including credit, currency and</td>
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<tr>
<td>Trust Companies Law (2018 Revision), where banking business means the</td>
<td>interest risk;</td>
</tr>
<tr>
<td>business of receiving (other than from a bank or trust company) and</td>
<td>(b) taking hedging positions;</td>
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<tr>
<td>holding on current, savings, deposit or other similar account money which</td>
<td>(c) providing loans, credit or other financial services to customers;</td>
</tr>
<tr>
<td>is repayable by cheque or order and may be invested by way of advances to</td>
<td>(d) managing capital and preparing reports or returns, or both, to</td>
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<tr>
<td>customers or otherwise.</td>
<td>investors or the Cayman Islands Monetary Authority, or both.</td>
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</tbody>
</table>

Distribution and Service Centre Business

Distribution and service centre business means the business of either or both of the following:

(a) purchasing from an entity in the same group (i) component parts or materials for goods; or (ii) goods ready for sale, and reselling such component parts, materials or goods outside the Cayman Islands;

(b) providing services to an entity in the same group in connection with the business outside the Cayman Islands.

However, it does not include any activity included in any other relevant activity except holding company business.

The CIGA in the context of distribution and service centre business include:

(a) transporting and storing goods, components and materials;

(b) managing stocks;

(c) taking orders; and

(d) providing consulting or other administrative services.
<table>
<thead>
<tr>
<th>Definition</th>
<th>CIGA</th>
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<tbody>
<tr>
<td><strong>Financing and Leasing Business</strong></td>
<td>The CIGA in the context of financing and leasing business include:</td>
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<tr>
<td>Financing and leasing business means the business of providing credit</td>
<td>(a) negotiating or agreeing funding terms;</td>
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<tr>
<td>facilities for any kind of consideration to another person but does not</td>
<td>(b) identifying and acquiring assets to be leased;</td>
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<tr>
<td>include financial leasing of land or an interest in land, banking</td>
<td>(c) setting the terms and duration of financing or leasing;</td>
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<tr>
<td>business, fund management business or insurance business.</td>
<td>(d) monitoring and revising financing or leasing agreements and</td>
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<td></td>
<td>managing risks associated with such financing or leasing agreements.</td>
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<tr>
<td><strong>Fund Management Business</strong></td>
<td>The CIGA in the context of fund management business include:</td>
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<tr>
<td>Fund management business means the business of managing securities as</td>
<td>(a) taking decisions on the holding and selling of investments;</td>
</tr>
<tr>
<td>set out in paragraph 3 of Schedule 2 to the Securities Investment</td>
<td>(b) calculating risk and reserves;</td>
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<tr>
<td>Business Law (2020 Revision) carried on by a relevant entity licensed or</td>
<td>(c) taking decisions on currency or interest fluctuations and</td>
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<tr>
<td>otherwise authorised to conduct business thereunder for an investment</td>
<td>hedging positions;</td>
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<tr>
<td>fund (where “managing securities” means managing securities belonging to</td>
<td>(d) preparing reports or returns, or both, to investors or the</td>
</tr>
<tr>
<td>another person in circumstances involving the exercise of discretion).</td>
<td>Cayman Islands Monetary Authority, or both.</td>
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<tr>
<td><strong>Headquarters Business</strong></td>
<td>The CIGA in the context of headquarters business include:</td>
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<tr>
<td>Headquarters business means the business of providing any of the following</td>
<td>(a) taking relevant management decisions;</td>
</tr>
<tr>
<td>services to an entity in the same group:</td>
<td>(b) incurring expenditures on behalf of other entities in the group;</td>
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<tr>
<td>(a) the provision of senior management;</td>
<td>(c) co-ordinating activities of the group.</td>
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<tr>
<td>(b) the assumption or control of material risk for activities carried</td>
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<td>out by any of those entities in the same group; or</td>
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<tr>
<td>(c) the provision of substantive advice in connection with the</td>
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<tr>
<td>assumption or control of risk referred to in paragraph (b).</td>
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<tr>
<td>However, it does not include banking business, financing and leasing</td>
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<tr>
<td>business, fund management business, intellectual property business,</td>
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<tr>
<td>holding company business or insurance business.</td>
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<tr>
<td><strong>Holding Company Business</strong></td>
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</table>


### Definition

Holding company business means the business of a “pure equity holding company”, with “pure equity holding company” meaning a company that only holds equity participations in other entities and only earns dividends and capital gains.

### CIGA

The CIGA in the context of holding company business include all activities related to that business.

#### Insurance Business

Insurance business has the meaning given by section 2 of the Insurance Law, 2010 where “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.

The CIGA in the context of insurance business include:

- (a) predicting or calculating risk or oversight of prediction or calculation of risk;
- (b) insuring or re-insuring against risk;
- (c) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.

#### Intellectual Property Business

Intellectual property business means the business of holding, exploiting or receiving income from intellectual property assets. An "intellectual property asset" means an intellectual property right including a copyright, design right, patent and trademark.

The term “intellectual property asset” includes any such right from which identifiable income accrues to the business but does not apply to a business which owns intellectual property merely as an adjunct to its business.

The CIGA in the context of intellectual property business include:

- (a) where the intellectual property asset is a:
  - (i) patent or an asset that is similar to a patent, research and development; or
  - (ii) non-trade intangible (including a trademark), branding, marketing and distribution.
- (b) in exceptional cases, except if the relevant activity is a high risk intellectual property business, other core income generating activities relevant to the business and the intellectual property assets, which may include:
  - (i) taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income;
  - (ii) 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;
  - (iii) carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties.

#### Shipping Business
Shipping business 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:

(a) the business of transporting by sea, passengers or animals, goods or mail for a fee;

(b) renting or chartering of ships for the purpose described in paragraph (a);

(c) the sale of travel tickets and ancillary ticket related services connected with the operation of a ship;

(d) 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 functioning as a private seafarer recruitment and placement service.

However, it does not include a holding company business or the owning, operating or chartering of a pleasure yacht.

The CIGA in the context of shipping business include:

(a) managing crew (including hiring, paying and overseeing crew members);

(b) overhauling and maintaining ships;

(c) overseeing and tracking deliveries;

(d) determining what goods to order and when to deliver them, organising and overseeing voyages.