

Economic substance in the Cayman Islands

The International Tax Co-operation (Economic Substance) Law (the **ES Law**) was introduced in the Cayman Islands on 1 January 2019 in response to 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 Law is supplemented by the Guidance Notes issued by the Cayman Islands Tax Information Authority (the **TIA**) on Economic Substance for Geographically Mobile Activities (the **ES Guidance**).

Under the ES Law 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 TIA.

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.

When is the ES Law applicable?

Relevant entities that existed *before 1 January 2019* and that were carrying on *relevant activities* on that date must comply with the ES Test from 1 July 2019.

Relevant entities established after *1 January 2019* must comply with the requirements from the date on which they start carrying on the *relevant activity*.

From January 2020, all entities registered or formed in the Cayman Islands will be required to include a statement in the annual return that is filed by their registered office service provider with the Registrar as to whether or not they are carrying on a *relevant activity*.

What is a relevant entity?

Under the ES Law all Cayman Islands companies incorporated under the Companies Law or the Limited

Liability Companies Law, all limited liability partnerships registered under the Limited Liability Partnerships Law, and all overseas companies which are registered in the Cayman Islands under the Companies Law are *relevant entities* except those entities which are:

- an *investment fund*;
- tax resident outside the Cayman Islands; or
- a *domestic company*.

Both 'investment fund' and 'domestic company' are clearly defined in the ES Law. The term 'investment fund' includes all funds registered with CIMA under the Mutual Funds Law, for example.

For tax residence, an entity must be subject to "corporate 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" in order for the TIA to consider it as being tax resident outside the Cayman Islands. For any entity that is claiming tax residence outside of the Cayman Islands, satisfactory evidence of this will be required.

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 Law 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. As this definition is taken from the Banks and Trust Companies Law, entities that conduct 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. As this definition is taken from the Insurance Law, entities that conduct 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 the Cayman Islands Monetary Authority or is 'otherwise authorised' to operate under the Securities Investment Business Law 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 Islands; • providing services to an entity in the same Group in connection with the business outside the 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 Islands or between the 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.
“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 Companies Law; and
- it has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations.

Where a *relevant entity* that is a pure equity holding company is **passively** holding equity participations in other entities it 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 Cayman Islands core income generating activities (**CIGA**) 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 Law sets out a non-exhaustive list of Cayman Islands CIGA for each *relevant activity* which are set out in the Schedule to this Guide.

Only the Cayman Islands 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, not all board meetings of a *relevant activity* must be held in the Cayman Islands but such meetings must be held at 'adequate' frequencies 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 TIA 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 Cayman Islands 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 a number of factors that will be taken into consideration by the TIA in this regard.

Outsourcing

A *relevant entity* may outsource some or all of its Cayman Islands 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.

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 TIA 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.

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

Enforcement action may be taken and financial penalties imposed for breaches of the ES Law. 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 TIA or a failure of an entity to comply with the ES Test, will constitute a breach of the ES Law. As well as potential fines, the ultimate consequence of failure to comply with the ES Law could result in the *relevant entity* being struck off for non-compliance and directors/managers being fined.

What are the reporting obligations?

A *relevant entity* must notify the TIA annually of the following:

- whether or not it is carrying on any *relevant activity*;
- the date of the end of its financial year; 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 appropriate evidence to support that tax residence as may be required by the TIA.

A *relevant entity* that is carrying on a *relevant activity* and which receives *relevant income* must also file a report with the TIA that contains certain prescribed information to allow the TIA to determine if the Company is satisfying the economic substance test. Such report must be filed no later than twelve months after the last day of the end of each financial year of the *relevant entity*.

What are the next steps?

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

- whether the entity is a relevant entity;
- whether it is conducting a relevant activity; and
- 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 reach out to your usual Harneys contact for further information about how Harneys can assist the *relevant entity* to confirm such classification and to satisfy the ES Test.

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SCHEDULE

CAYMAN ISLANDS CORE INCOME GENERATING ACTIVITIES

The CIGA examples given in the ES Law 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.

Banking business	<ul style="list-style-type: none"> (i) raising funds, managing risk including credit, currency and interest risk; (ii) taking hedging positions; (iii) providing loans, credit or other financial services to customers; (iv) managing capital and preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.
Insurance business	<ul style="list-style-type: none"> (i) predicting or calculating risk or oversight of prediction or calculation of risk; (ii) insuring or re-insuring against risk; (iii) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.
Fund management business	<ul style="list-style-type: none"> (i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking decisions on currency or interest fluctuations and hedging positions; (iv) preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.
Finance or leasing business	<ul style="list-style-type: none"> (i) negotiating or agreeing funding terms; (ii) identifying and acquiring assets to be leased; (iii) setting the terms and duration of financing or leasing; (iv) monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements.
Headquarters business	<ul style="list-style-type: none"> (i) taking relevant management decisions; (ii) incurring expenditures on behalf of other entities in the Group; (iii) co-ordinating activities of the Group.
Distribution and service centre business	<ul style="list-style-type: none"> (i) transporting and storing goods, components and materials; (ii) managing stocks; (iii) taking orders; (iv) providing consulting or other administrative services.
Shipping business	<ul style="list-style-type: none"> (i) managing crew (including hiring, paying and overseeing crew members); (ii) overhauling and maintaining ships; (iii) overseeing and tracking deliveries; (iv) determining what goods to order and when to deliver them, organising and overseeing voyages
Holding company business	All activities related to that business.