



## November 2020

### The Cayman Islands International Tax Co-Operation (Economic Substance) Law

#### The Economic Substance Requirement

The International Tax Co-Operation (Economic Substance) Law (Revised) and its associated regulations and guidance (the “**Law**”) requires that certain entities ensure that where they receive income in respect of certain “**Relevant Activities**”<sup>1</sup> they satisfy an Economic Substance Test which requires that the following occur in the Cayman Islands in respect of those Relevant Activities:

- ▣ the conduct of core income generating activities;
- ▣ the direction and management of the entity;
- ▣ the maintenance of adequate staff and premises; and
- ▣ the incurring of adequate expenditure.

These requirements may require consideration of the following changes for affected entities:

- ▣ a change to the composition of their board of directors;
- ▣ the employment of staff or additional staff at premises in the Cayman Islands;
- ▣ the election for income tax residency in a jurisdiction outside the Cayman Islands;
- ▣ the amendment of services or fees provided for in current service provider agreements; and/or

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<sup>1</sup> Fund Management Business, Financing and Leasing Business and Holding Company Business, Headquarters Business, Insurance Business, Intellectual Property Business, Shipping Business, Banking Business and/or Distribution and Service Centre Business

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- ▣ the use of outsourcing of core income generating activities to service providers based in the Cayman Islands.

#### Who is Affected?

The Law imposes notification and reporting requirements on the following entities (each an “**Entity**” and collectively, “**Entities**”):

- ▣ all companies incorporated under the Companies Law (Revised);
- ▣ all LLCs registered under the Limited Liabilities Companies Law (Revised);
- ▣ all limited liability partnerships registered under the Limited Liability Partnership Law, 2017 as amended; and
- ▣ all companies incorporated outside the Cayman Islands and registered under the Companies Law (Revised) (for example a Delaware LLC acting as a general partner of a Cayman Exempted Limited Partnership).

The Law also imposes reporting requirements on all Entities that are Relevant Entities.

#### The Notification Requirement

An Annual Economic Substance Notification must be submitted by every Entity to the Cayman Tax Information Authority (the “**TIA**”) by 31 March each year beginning on 31 March 2020, where applicable, and will be a pre-condition to the filing of that Entity’s annual return. The notification will confirm whether the Entity is carrying on a Relevant Activity and if it is:

- ▣ whether it is a Relevant Entity (see below);
- ▣ its financial year end; and
- ▣ the name and address of its point of contact for the TIA.

Where the Entity is tax resident outside the Cayman Islands it will also be required to report details of its ownership structure, financial year end, the jurisdiction in which it is tax resident and any other information required by the TIA.

#### The Reporting Requirement

The Law also imposes a requirement on Relevant Entities carrying on Relevant Activities to submit an annual report to the TIA. Reports must generally be submitted within 12 months of the end of each financial year commencing on or after 1 January 2019<sup>2</sup>. However the first annual reporting deadline for all Relevant Entities other than those conducting Intellectual Property Business has been extended to 28 February 2021 if that date is later than the deadline otherwise applicable. For Relevant Entities conducting Intellectual Property Business their first annual reporting deadline has been extended to 31 January 2021 if that date is later than the deadline otherwise applicable to them. A “**Relevant Entity**” is

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<sup>2</sup> See below for fund management activities

any Entity that is not:

- ▣ an Investment Fund<sup>3</sup>;
- ▣ an Entity which is tax resident outside the Cayman Islands; or
- ▣ a Domestic Company.

The TIA will use the information provided in each report to determine whether or not a Relevant Entity has complied with an economic substance test. Relevant Entities formed on or after 1 January 2019 that conduct a Relevant Activity, are required to comply with the economic substance test from the date that they commence the Relevant Activity. Those carrying on a Relevant Activity that were in existence before 1 January 2019 are required to comply with the economic substance test from 1 July 2019.

The report will need to include the following information as at the end of the relevant financial year:

- ▣ Relevant Activities conducted;
- ▣ amount and type of gross income from each Relevant Activity recorded in accordance with applicable accounting standards;
- ▣ amount and type of expenses and assets in respect of each Relevant Activity;
- ▣ location of the place of business and other property used in the Cayman Islands for each Relevant Activity;
- ▣ number of personnel with appropriate qualifications responsible for carrying on each Relevant Activity;
- ▣ details of any other person who is conducting the Relevant Entity's core income generating activities in relation to each of its Relevant Activities in the Cayman Islands;
- ▣ the core income generating activity that have been conducted;
- ▣ a declaration whether the Relevant Entity satisfies the economic substance test;
- ▣ details of any MNE Group of which the Relevant Entity is a Constituent Entity;
- ▣ specific details in connection with intellectual and high-risk intellectual property business carried out by the Relevant Entity; and
- ▣ such further information or documents as may be required by the TIA.

An Entity that is able to establish to the TIA that it is tax resident outside the Cayman Islands and is subject to corporate income tax on all its income from a Relevant Activity will not be considered to be a Relevant Entity. An Entity that is a disregarded entity for US income tax purposes and that has a US corporation as its parent will be considered to be tax resident outside the Cayman Islands if satisfactory evidence is provided. Satisfactory evidence of tax residence outside the Cayman Islands might comprise copies of annual tax filings, proof of payment of income tax, a tax identification number, tax residence certificate or in the case of a disregarded entity a signed statement from an external tax advisor that all of the Entity's income has been included on the corporate tax return of its US parent. Information provided

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<sup>3</sup> An Investment Fund is widely defined as an Entity whose principal business is the issuing of shares, trust units, partnership interests or other rights that carry an entitlement to participate in the profits or gains of that Entity to raise funds or pool investor funds with the aim of enabling a holder of such 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 does not include licensees under the Banks and Trust Companies Law (Revised) or the Insurance Law, 2010 or persons registered under the Building Societies Law (Revised) or the Friendly Societies Law (Revised).

to evidence tax residency outside the Cayman Islands will be exchanged with the tax authorities of the jurisdiction in which the Entity claims tax residency, the jurisdiction in which its immediate parent, ultimate parent and ultimate beneficial owner reside and if the Entity is resident outside the Cayman Islands, that jurisdiction.

#### Relevant Activities and Core Income Generating Activities

The table below sets out each of the Relevant Activities of Fund Management Business, Financing and Leasing Business and Holding Company Business, their definition under the Law and the core income generating activity associated with each such activity. For information on the Relevant Activities of Headquarters Business, Insurance Business, Intellectual Property Business, Shipping Business, Banking Business and/or Distribution and Service Centre Business please get in touch with your usual Dillon Eustace contact.

**Table**

<b>Relevant Activity</b>	<b>Definition</b>	<b>Core Income Generating Activity</b>
Fund Management Business	Managing securities <sup>4</sup> belonging to another person in circumstances involving the exercise of discretion carried on by a Relevant Entity licensed or otherwise authorised to conduct business under the Securities Investment Business Law (Revised) for an investment fund	(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
Financing and Leasing Business	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	(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
Holding Company Business	A company that only holds equity participations in other entities and only earns dividends and capital gains	all activities related to holding company business

<sup>4</sup> Shares, instruments creating or acknowledging indebtedness, warrants and similar instruments entitling the holder to subscribe for such shares or debt securities, certificates representing certain securities, options, futures, contracts for differences and tradable virtual assets that represent or are convertible into, or into a derivative of, any of the foregoing.

Core income generating activities are those that are of central importance to the Relevant Entity in terms of generating gross income from a Relevant Activity and they must be carried on in the Cayman Islands. The core income generating activities listed above are not exhaustive and it will be a question of fact in each case as to what activities actually generate income from Relevant Activities. A Relevant Entity is not required to carry on all core income generating activities listed in respect of a Relevant Activity but those it does carry on should be carried on in the Cayman Islands. Where more than one Relevant Activity is carried on the economic substance test should be complied with in relation to each such activity. An Entity does not need to be actively engaged in a Relevant Activity to be carrying on that activity and passive collection of income from one or more of these businesses would constitute a Relevant Activity.

#### Specific Guidance on Certain Relevant Activities

Set out below are certain specific points of guidance issued by the TIA which will be of use to our clients who carry on Fund Management Business, Financing and Leasing Business or Holding Company Business, for specific guidance on other Relevant Activities please get in touch with your usual Dillon Eustace contact.

#### Fund Management

For those Entities which were excluded persons under the Securities Investment Business Law who provide discretionary investment management services and who have registered with CIMA as Registered Persons, they will not be considered to be carrying on Fund Management Business until 15 January 2020 and will need to submit their first return for the period from that date to the end of their then current financial year.

Guidance has been issued by the TIA on each element of the core income generating activities making up fund management business:

Taking decisions on the holding and selling of investments. The actual taking of decisions regarding the acquisition, disposal or trading of investments need to be taken in the Islands by an investment committee, board of directors or equivalent. It is necessary for a quorum of directors to be physically present in the Islands in order to treat their decisions as being made in the Islands.

Calculating risks and reserves. A fund manager can satisfy this head of core income generating activity by assessing its client investment fund's risk as a whole, and calculating the overall risk across the investment fund and the reserves required on a strategic basis. An investment fund's risks typically include market risk, credit risk (where applicable), liquidity risk as well as operational risks. A fund manager is unlikely to satisfy this head of core income generating activity if calculations are limited to a marginal calculation for one area of applicable risk and do not encompass other areas of applicable risk or if the fund manager routinely accepts the calculations made by other entities.

Taking decisions on currency or interest fluctuations and hedging positions. A fund manager can satisfy this head of core income generating activity by taking a strategic approach on risk management of its client investment fund's overall position arising from currency or interest rate fluctuations. For example,

the fund manager's core income generating activity could include conducting FX, interest rate or other hedging functions, or similar, with a view to controlling risks or optimising exposures of the client investment fund. A fund manager is unlikely to satisfy this head of core income generating activity by taking isolated decisions involving specific investments of its client investment fund.

Preparing reports to investors or to CIMA. A fund manager can satisfy this head of core income generating activity by ensuring that there are systems and processes in place so that the fund manager is able to provide its client investment fund with accurate information on the investment fund's financial position on a timely basis. It is acceptable for the investment fund's administrator or other person to perform the administrative task of compiling the various routine reports and returns for the investment fund to its investors and any regulatory returns to CIMA, however the fund manager should ensure that such contractual arrangements are in place so as to allow for appropriate reporting to be available in a timely manner.

A fund manager might outsource some or all of its core income generating activity to another entity within the Cayman Islands but where outsourcing is to an entity outside the Cayman Islands fee income allocated to that activity should not be routed through the fund manager.

#### Financing and Leasing

Guidance has been issued by the TIA that the essence of financing and leasing activity is the provision of credit facilities as a business activity in its own right and as a core part of an Entity's business for the purposes of profit. An Entity that provides credit as an incidental part (meaning an occasional, minor activity with no profit making purpose) of a different sort of business will not be treated as carrying on financing and leasing business. Where credit is offered and there is no expectation of consideration from the credit this will not fall within the scope of this activity and for this purpose the grant of security in favour of a lender would not constitute consideration. The purchase of debt securities as an investment is not within the scope of this activity.

#### Holding Company

This activity is defined as the business of a pure equity holding company and guidance from the TIA has clarified that this definition applies to a company that only holds equity participations in other entities and only earns dividends and capital gains from those holdings. The ownership of any other form of investment or asset, the undertaking of any other non-incidental activity or the earning of any other non-incidental income will bring a company outside of this definition. A pure equity holding company is not required to be directed and managed in the Cayman Islands, is not required to undertake any core income generating activities or have any expenditure in the Cayman Islands and depending on the level and complexity of activity required to operate its business such a company might satisfy the economic substance test by maintaining a registered office in the Cayman Islands and complying with all its filing obligations under the Companies Law (Revised).

### How to ensure that a Relevant Entity is Directed and Managed in the Cayman Islands

An Entity will need:

- ▣ a board of directors that collectively has the appropriate knowledge and expertise to discharge its duties in relation to the Relevant Activity;
- ▣ to hold board meetings in the Cayman Islands at adequate frequencies for the level of decision making required in relation to the Relevant Activity, (although not all board meetings need to be held in the Cayman Islands);
- ▣ to have a quorum of directors present in the Cayman Islands in person for those meetings held in the Cayman Islands;
- ▣ to have its board minutes record all strategic decision making in relation to the Relevant Activity and be kept in the Cayman Islands along with other appropriate records.

### How to ensure that a Relevant Entity has adequate staff, premises and expenditure in the Cayman Islands

This part of the economic substance test is assessed by reference to relevant income derived from Relevant Activities, where no income is earned from Relevant Activities carried out by a Relevant Entity it will not be obliged to meet the economic substance test and will only be required to submit an Economic Substance Notification and file a nil return.

What is required in terms of adequate staff, premises and expenditure for those Relevant Entities receiving income from Relevant Activities is intentionally left vague with an obligation being placed on the directors of Relevant Entities to make a determination in good faith on these questions and to maintain appropriate records to demonstrate the adequacy of the resources utilized in the Cayman Islands in performing their Relevant Activities.

A Relevant Entity carrying on a Relevant Activity can outsource some or all of the core income generating activities related to that Relevant Activity provided that it is able to demonstrate that the outsourced activities are undertaken in the Cayman Islands and it is able to monitor and control those activities. In these circumstances both the outsourced activity and its supervision by the Relevant Entity must take place in the Cayman Islands. Where outsourcing arrangements are entered into the TIA may require the provider of the outsourced services to verify information provided to the TIA by the Relevant Entity within 30 days of its submission and the TIA may not accept a claim to have satisfied the economic substance test via domestic outsourcing if that verification is not given. It will be important therefore to include provision requiring such verification to be given in any outsourcing arrangements entered into by a Relevant Entity.

Care should be taken in any arrangements entered into to limit the impact of the Law as its anti-avoidance provisions mean that such arrangements will be deemed to never have been in existence where one or more of the main purposes for which they were entered into was to avoid any obligation under the Law. Guidance published by the TIA highlights that manipulation or artificial suppression of an Entity's income to circumvent substance requirements as an example of what it would consider to be an avoidance mechanism.

## Liquidation Procedures

Where a Relevant Entity is in liquidation or being wound up it must continue to satisfy the economic substance test for any period during which it carries on a Relevant Activity but need not do so after it has ceased to carry on such activity. The liquidator of a Relevant Entity will have a duty to maintain its records and respond to information requests from the TIA under the Law for six years after the final dissolution of that entity.

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