

Bermuda Economic Substance Guide 2023 (Lexology Getting the Deal Through)

Briefing Summary: In this guide, lawyers from our Bermuda office outline the latest economic substance requirements for businesses carrying on relevant activities in Bermuda, including the legal framework, enforcement and demonstrating compliance.

Service Area: Bermuda Legal Services, Corporate, Corporate Regulation and Compliance, Taxation and Economic Substance Requirements

Sector: Trust and Company Business

Location: Bermuda

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Legal Framework

Legislation

What legislation sets out the economic substance requirements in your jurisdiction?

The Economic Substance Act 2018 and Economic Substance Regulations 2018 set out the economic substance requirements for Bermuda. The Bermuda Registrar of Companies, as the regulator responsible for administering and monitoring the economic substance requirements, has also issued formal guidance in relation to the legislation, in the Economic Substance Requirements for Bermuda – Guidance Notes (General Principles).

Law stated – 31 January 2023

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Relevant Entities

What types of entity are subject to the economic substance requirements in your jurisdiction?

All Bermuda registered companies, limited liability companies (LLCs) and partnerships are in scope of the economic substance requirements in Bermuda. This also extends to overseas entities that have a registered branch in Bermuda.

Those local entities that are carrying on business only in Bermuda, which are subject to the requirement to be at least 60 per cent owned and controlled by Bermudians (or, in respect of partnerships, have no non-Bermudian partners), and which are not part of a group of entities with affiliates tax resident outside of Bermuda, are in scope of the legislation but are not required to demonstrate compliance with the economic substance requirements.

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Relevant Activities

What activities trigger the economic substance requirements in your jurisdiction?

The purpose of the economic substance legislation is to address the principle (as set out by the OECD Forum on Harmful Tax Practices and the EU Code of Conduct Group on Business Taxation) that jurisdictions should not facilitate the use of structures that attract profits but do not reflect real economic activity that is being undertaken in that jurisdiction. In that regard, nine business sectors were identified as being at greater risk of generating geographically mobile income, and it is those business sectors – referred to in Bermuda as ‘relevant activities’ – that are subject to the economic substance requirements. Any entity that is in scope of the requirements that carries on any one or more of these relevant activities (and earns any gross revenue from that relevant activity) will be required to satisfy the economic substance requirements.

The nine relevant activities subject to the economic substance requirements are:

- banking;
- insurance;
- fund management;
- financing and leasing;
- headquarters;
- shipping;
- distribution & service centre;
- intellectual property; and
- holding entity.

Each of these activities is specifically defined in the economic substance legislation, and carrying on any one or more of them will trigger the economic substance requirements. Notably, there is no de minimis exception. In other words, any gross revenue earned from a relevant activity, however small, will result in an entity being in scope of the economic substance requirements. However, the assessment of compliance with those requirements will be applied on a proportionate basis, based on the nature, scale and complexity of the entity's particular business.

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Tax Residence Requirements

Must entities be tax resident (or deemed tax resident) in your jurisdiction to be subject to the economic substance requirements? If yes, what are the tax residence rules and requirements? If not, do the economic substance requirements in your jurisdiction differ with respect to non-resident entities?

All Bermuda companies, LLCs and partnerships, and all Bermuda-registered branches of overseas companies, LLCs and partnerships, are in scope of the economic substance requirements. There is no requirement that such entities be tax resident or deemed tax resident in Bermuda to be in scope.

However, those entities that can demonstrate that they are tax resident outside of Bermuda will not be in scope of the Bermuda economic substance requirements, and for these purposes will be deemed 'non-resident entities'. To be deemed a non-resident entity (and therefore be taken out of scope of the Bermuda economic substance requirements), the jurisdiction of tax residency must not be a jurisdiction that is on Annex 1 to the EU list of non-cooperative jurisdictions for tax purposes and must not be a jurisdiction that does not have a corporate tax regime or in which tax residency does not result in the entity being subject to the equivalent economic substance requirements in that jurisdiction (such jurisdictions may include: Anguilla, Bahamas, Bahrain, Barbados, British Virgin Islands, Cayman Islands, Turks and Caicos Islands and the United Arab Emirates)

An entity seeking to be deemed a non-resident entity must provide evidence to the Bermuda Registrar of Companies that all of its income from its relevant activity or activities is liable to tax in the overseas jurisdiction. This evidence must include a letter, certificate or other document issued by the relevant taxing authority in that jurisdiction confirming that the entity is liable to tax in that jurisdiction.

This principle also extends to tax transparent entities. A transparent entity may be deemed a non-resident entity if it can demonstrate that the entirety of its income from a relevant activity is treated as attributable to and taxable on some or all of its members or partners.

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Guidance

Has the government published guidance on the economic

Economic Substance Requirements

General Requirements

What general economic substance requirements apply in your jurisdiction?

An entity that is in scope (being a Bermuda company, limited liability company (LLC) or partnership, or a Bermuda- registered branch of an overseas company, LLC or partnership), and which carries on one or more relevant activities, must satisfy the economic substance requirements. Such an entity will comply with the economic substance requirements if:

- it is managed and directed in Bermuda;
- its core income-generating activities are undertaken in Bermuda with respect to its relevant activity;
- it maintains adequate physical presence in Bermuda;
- it has adequate full-time employees in Bermuda with suitable qualifications; and
- it incurs adequate operating expenditure in Bermuda in relation to its relevant activity.

The full economic substance requirements apply to an entity carrying on any relevant activity other than the relevant activity of 'holding entity'. An entity that is carrying on the relevant activity of holding entity, and which carries on no other relevant activity, is not subject to the economic substance requirements detailed above, and must instead comply with the 'minimum economic substance requirements'. These minimum requirements are that it must:

- comply with the corporate governance requirements applicable to it pursuant to its governing legislation (eg, the Companies Act 1981 in respect of companies);
- have adequate people in Bermuda for holding and managing its equity participations; and
- have adequate premises in Bermuda.

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'Directed and Managed'

What requirements apply in relation to board meetings and the location where entities are directed and managed?

An entity that is in scope of the economic substance requirements must be managed and directed in Bermuda. There are no prescriptive rules as to what will be deemed to be 'managed and directed in Bermuda', and no specific requirements in relation to the number or frequency of board or other meetings in Bermuda. The Registrar will assess compliance by an entity with this requirement in the context of the nature, scale and complexity of that entity's particular business. In that assessment, the Registrar will have regard to whether the entity in question:

- holds an adequate number of meetings in Bermuda where strategic decisions are made;
- has an adequate number of senior executives, employees and other persons

For each of the assessment criteria described above, the entity should maintain careful records in Bermuda of the meetings held and the details of the discussions and decisions held and taken at such meetings. Records should also be maintained of the employees in Bermuda, to demonstrate that they are suitably qualified to hold the responsibilities that they do.

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Core Income-Generating Activities

What Requirements apply in relation to core income-generating activities?

An entity that is in scope of the economic substance requirements must undertake its CIGA in Bermuda.

The CIGA applicable to each relevant activity are set out in the economic substance legislation, and where an entity carries on a relevant activity the CIGA applicable to that relevant activity must be undertaken in Bermuda. It is important to note that it is possible that an entity may not undertake a particular CIGA at all, because that CIGA is not applicable to that entity's business. However, if a CIGA is being undertaken by that entity, it must be undertaken in Bermuda.

An entity may generally outsource the performance of one or more of its CIGA to a third party or an affiliate, provided that the outsourced CIGA is undertaken in Bermuda by that third party or affiliate.

For those activities undertaken by an entity that are not one of the defined CIGA (eg, back office functions, IT, payroll, legal services or other expert advice or specialist services), these may generally be performed outside of Bermuda provided they are not of central importance to the entity in terms of generating gross revenue from the relevant activity. In respect of such activities, the Registrar may also take into account evidence regarding normal business practice for a particular relevant activity, such as commercial (ie, non-tax-related) factors requiring a particular activity to be performed cross-border. This would include scenarios in which it is necessary to acquire or utilise specialist services exclusively available in a particular jurisdiction or to serve clients or deal with counterparties necessarily located outside of Bermuda (eg, the master of a ship performing certain functions ancillary to crew management; a loss adjuster performing certain functions ancillary to client services in the jurisdiction where the client or insured property is located; or a fund manager appointing and overseeing sub-managers to execute jurisdiction-specific investments or advise on jurisdiction-specific risks).

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Premises

What requirements apply in relation to the physical premises of relevant entities?

An entity that is in scope of the economic substance requirements must have an adequate physical presence in Bermuda. There are no prescriptive rules as to what will be deemed to be an 'adequate physical presence in Bermuda' and

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Employees and Personnel

What requirements apply in relation to the employees and personnel of relevant entities?

An entity that is in scope of the economic substance requirements must have adequate full-time employees in Bermuda with suitable qualifications in relation to that entity's relevant activity. There are no prescriptive rules as to what may be deemed 'adequate' for these purposes. The Registrar will assess compliance by an entity with this requirement in the context of the nature, scale and complexity of that entity's business. Provided that an entity can demonstrate that it has, either itself or through appropriately monitored outsourcing arrangements, adequate employees with suitable qualifications in Bermuda to carry out its CIGA, the requirement may be met.

In calculating the number of employees, an entity should base this on 'full-time equivalent' units (FTEs). This is a calculation based on the total number of hours worked divided by the average annual hours worked in a full-time job. For these purposes, the Registrar deems a full-time job to constitute 1,540 hours worked per year (applying a 35-hour work week, and allowing for standard public holidays and leave entitlements). Using the FTE calculation, the hours worked by employees, as well as appropriately monitored contractors and outsourced service providers, may be included in an entity's total. Directors and officers of an entity may also spend time performing certain CIGA on behalf of an entity, and this time may similarly be included in the FTE total for that entity. A person's hours may also be divided between entities or between relevant activities, provided that his or her hours are not double-counted.

Entities should maintain records of hours spent by each person on each relevant activity (whether an employee or outsourced service provider), and should also have records of the qualifications and experience held by such persons, to demonstrate that this requirement has been met.

Law stated – 31 January 2023

Expenditure

What requirements apply in relation to expenditure?

An entity that is in scope of the economic substance requirements must incur adequate expenditure in Bermuda in relation to that entity's relevant activity. There are no prescriptive rules as to what may be deemed 'adequate' for these purposes. The Registrar will assess compliance by an entity with this requirement in the context of the nature, scale and complexity of that entity's business. There is also no exhaustive definition of what constitutes expenditure in this context, although it would generally be expected to constitute business and employment expenses and fees for goods and services paid to persons or entities located in Bermuda.

Where more than one relevant activity is being carried on by an entity, its expenses in relation to each relevant activity will be assessed separately.

Law stated – 31 January 2023

Where an entity that is in scope of the economic substance requirements is carrying on the relevant activity of 'intellectual property', in certain circumstances there may be enhanced requirements applicable to that entity, in addition to the economic substance requirements applicable generally.

In particular, where an entity carrying on intellectual property business holds an intellectual property asset that was developed or created by that entity or acquired from another non-affiliated entity, and that asset is licensed to another non-affiliated person, that entity will be presumed not to comply with the economic substance requirements unless it is either conducting research and development in relation to intellectual property assets such as patents or is carrying on marketing, branding and distribution of non-trade intangible assets such as trademarks. This presumption is rebuttable, but only in exceptional circumstances, and only if it can be demonstrated that the entity is taking the strategic decisions and bearing the principal risks related to the development and subsequent exploitation of that asset (whether itself or by a third party) and it is carrying on the underlying trading activity through which the assets are exploited and which lead to the generation of income from third parties. In such circumstances, particular focus will also be given to assessing whether or not the entity has adequate employees and premises in Bermuda to carry on such activities.

Further, where an entity holds an intellectual property asset that has been acquired from an affiliate or obtained through the funding of overseas research and development and that asset is licensed to a foreign affiliate or used to generate intellectual property income through activities performed by a foreign affiliate, that entity will be deemed to be carrying on 'high-risk IP business' and will be subject to significantly enhanced monitoring and compliance requirements. Such an entity will be presumed not to comply with the economic substance requirements (irrespective of the CIGA being performed in Bermuda) unless it can demonstrate that it is taking the strategic decisions and bearing the principal risks related to the development and subsequent exploitation of that asset (whether itself or by a third party) and it is carrying on the underlying trading activity through which the assets are exploited and which lead to the generation of income from third parties, and that it has adequate employees and premises in Bermuda to carry on such activities. In addition, the entity must demonstrate that it does not merely passively hold the asset and generate income from it, but that it also exercises – and has historically exercised – a high degree of control over the development, exploitation, maintenance, enhancement and protection (the DEMPE functions) of that asset.

Every entity that is carrying on high-risk IP business as described above will be required to file a detailed business plan with the Registrar, demonstrating how the additional requirements in relation to such business are met. This detailed business plan is filed in addition to the economic substance declaration that is completed and filed by all entities in scope of the economic substance requirements, and must clearly lay out the commercial rationale for the assets in question to be held in Bermuda, provide concrete evidence that decision making takes place in Bermuda and not elsewhere, and provide detailed evidence of employees' experience, qualifications, contractual terms and length of service with the entity.

It should be noted that the Registrar will not consider that the above presumptions are rebutted only through periodic decisions taken in Bermuda.

Of those entities that are in scope of the economic substance requirements, there are two categories of entities to which reduced requirements apply.

The first category of entities that are subject to reduced requirements is purely local entities. These are entities that are carrying on business only in Bermuda, which are subject to the requirement to be at least 60 per cent owned and controlled by Bermudians (or, in respect of partnerships, have no non-Bermudian partners), and which are not part of a group of entities that includes affiliates tax resident outside of Bermuda. Such entities, to the extent that they are carrying on a relevant activity, are in scope of the legislation but are not required to demonstrate compliance with the economic substance requirements. They must simply comply with the corporate governance requirements applicable to them pursuant to their governing legislation (eg, companies must comply with the corporate governance requirements set out in the Companies Act 1981).

The second category of entities subject to reduced requirements is those entities that are carrying on the relevant activity of 'holding entity'. Referred to as 'pure equity holding entities', these are entities that have as their sole function the acquisition and holding of shares or other equitable interests in one or more other entities, with such interest being a controlling stake. They must carry on no other commercial activity, and therefore will conduct no other relevant activity. Such entities are not subject to the full economic substance requirements, and must instead comply with the minimum economic substance requirements. These minimum requirements are met if the entity:

- complies with the corporate governance requirements applicable to it pursuant to its governing legislation (eg, the Companies Act 1981 in respect of companies);
- has adequate people in Bermuda for holding and managing its equity participations; and
- as adequate premises in Bermuda.

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Outsourcing

What requirements apply in relation to outsourcing activities to entities located in your jurisdiction and entities located outside your jurisdiction?

Entities that are in scope of the economic substance requirements may generally outsource some or all of their CIGA to third-party service providers or to affiliated entities, provided that the outsourced activity is nonetheless performed in Bermuda. CIGA may not be outsourced if the outsourced activity in question is to be performed outside of Bermuda.

Where CIGA is outsourced by an entity, the entity must demonstrate that it has suitably qualified employees or other persons (eg, directors) in that entity who are responsible for the oversight and assessment of the implementation and execution of the outsourced activities. The entity must also demonstrate that the outsourced service provider or affiliate has adequate suitably qualified employees and premises in Bermuda to implement and execute the outsourced activities. Time taken by outsourced service providers or affiliates in performing the activity in question may not be double-counted.

Other activities that are not CIGA (eg, back office functions, IT, payroll, legal services or other expert advice or specialist services) may be outsourced either within or outside of Bermuda, provided that they are not of central importance to the entity in terms of generating gross revenue in respect of a relevant activity. The Registrar may also take into account commercial (ie, non-tax-related) factors requiring a particular non-CIGA activity to be performed cross-border.

This would include scenarios in which it is necessary to acquire or utilise specialist services exclusively available in a particular jurisdiction or to serve clients or to deal with counterparties necessarily located outside of Bermuda (eg, the master of a ship performing certain functions ancillary to crew management; a loss adjuster performing certain functions ancillary to client services in the jurisdiction where the client or insured property is located; or a fund manager appointing and overseeing sub-managers to execute jurisdiction-specific investments or advise on jurisdiction-specific risks).

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Enforcement and Compliance

Enforcement Authorities

Which government authorities are responsible for the enforcement of economic substance requirements? What is the extent of their information-gathering powers?

The Bermuda Registrar of Companies is the authority responsible for the monitoring and enforcement of the economic substance requirements in Bermuda. Entities in scope of the economic substance requirements must file an economic substance declaration with the Registrar each year, the information in which forms the primary basis for the Registrar's assessment of compliance. The Registrar also has very broad powers to request additional information, and to conduct on-site inspections of entities' books and records, to further support its monitoring and enforcement efforts. This includes the power to 'police the perimeter' by requesting information and inspecting records of entities that believe themselves not to be in scope of the economic substance requirements (eg, because the entity believes that it is not carrying on a relevant activity).

Law stated – 31 January 2023

Reporting Formalities

What reporting formalities apply with respect to the economic substance requirements?

Every entity that is in scope of the economic substance requirements must complete and file a detailed economic substance declaration with the Registrar of Companies in respect of each relevant financial period (being each financial year of that entity in which any relevant activity has been carried on). The declaration must be filed by each entity within six months of the end of that entity's financial year. The information to be provided in the declaration will include key financial data (eg, gross revenue and expenses per relevant activity), details of the nature and frequency of meetings, residency of employees and directors, location of premises, details of any outsourced core income-generating activities (CIGA) and details of the ownership and beneficial ownership of the entity.

An entity that is making a claim that it is a non-resident entity in respect of any particular relevant financial period (ie, resident for tax purposes in a jurisdiction outside of Bermuda, and therefore not subject to the economic substance requirements for that period) must file its evidence of such tax residency status

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The Registrar also has very broad powers to request additional information, and to conduct on-site inspections of entities' books and records, to further support its monitoring and enforcement efforts. This includes the power to 'police the perimeter' by requesting information and inspecting records of entities that believe themselves not to be in scope of the economic substance requirements (eg, because the entity believes that it is not carrying on a relevant activity). Entities are therefore required to maintain, in Bermuda, records of their activity, and in particular those records most relevant to assessments of compliance (eg, additional detail on employees' qualifications and time records, detailed financial records, details of business conducted, etc).

Law stated – 31 January 2023

Penalties

What are the potential penalties for failure to comply with the economic substance requirements?

Where the Registrar determines that an entity has not complied with the economic substance requirements, the entity in question will be issued with a notice to comply. This triggers the spontaneous exchange of information (being the information filed by that entity in respect of its economic substance compliance) with each jurisdiction in which that entity's immediate parent, ultimate parent and beneficial owners are located. It may also trigger the imposition of a civil penalty payable by that entity. On the issuance of the first notice to comply, the civil penalty can range from a minimum of BD\$7,500, to a maximum of BD\$50,000. On the second notice to comply (ie, if the non-compliance is not remedied within the timeframe specified by the Registrar) the civil penalty increases to a minimum of BD\$25,000 up to a maximum of BD\$100,000. On the issuance of a third notice to comply, this increases further, from a minimum BD

\$50,000 to a maximum of BD\$250,000. If the third notice to comply is not complied with, the Registrar may then apply to the Bermuda courts for an order to regulate the conduct of the entity's business, restrict the entity's ability to conduct business, or have the entity struck off the register altogether.

In addition to these civil penalties for non-compliance, the economic substance legislation makes it an offence for any person to knowingly provide false information to the Registrar, the penalty for which, on summary conviction, is a fine of up to BD\$10,000 or up to two years' imprisonment or both. Where the

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