



# Economic Substance

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Quick reference guide enabling side-by-side comparison of local insights into economic substance regimes in offshore and other jurisdictions, including affected entities and activities; tax residence considerations; criteria used by tax authorities to determine whether an organisation has sufficient economic substance within a given jurisdiction; enforcement regimes; reporting and compliance requirements; and recent trends.

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## Contributors

### Cayman Islands



**Richard Munden**  
richard.munden@careyolsen.com  
*Carey Olsen*

**CAREY OLSEN**



**Jasmine Amaria**  
jasmine.amaria@careyolsen.com  
*Carey Olsen*



**Michael Padarin**  
michael.padarin@careyolsen.com  
*Carey Olsen*



**Anthony McKenzie**  
anthony.mckenzie@careyolsen.com  
*Carey Olsen*



**Dylan Wiltermuth**  
dylan.wiltermuth@careyolsen.com  
*Carey Olsen*

## LEGAL FRAMEWORK

### Legislation

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

The economic substance requirements are set out in the International Tax Co-operation (Economic Substance) Act (as revised) (the ES Act) and certain regulations issued by the Cabinet of the Cayman Islands pursuant to the ES Act. The Tax Information Authority of the Cayman Islands has also issued guidance on understanding the scope of the ES Act and how to comply with the ES Act. The most recent version of the guidance was published in July 2022.

*Law stated - 31 January 2023*

### Relevant entities

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

The requirements of the ES Act apply to the following entities:

- Cayman Islands companies incorporated under the Companies Act (as revised) or the Limited Liability Companies Act (as revised);
- Cayman Islands limited liability partnerships registered under the Limited Liability Partnership Act, (as revised);
- General partnerships and limited partnerships under the Partnerships Act (as revised);
- Exempted Limited Partnerships and Foreign Limited Partnerships under the Exempted Limited Partnerships Act (as revised); and
- Non-Cayman Islands companies registered as foreign companies under the Companies Act (as revised).

The requirements that apply to a particular entity depend on whether that entity is a 'relevant entity' within the meaning of the ES Act. The following entities are not relevant entities:

- investment funds (including vehicles through which an investment fund invests);
- an entity that is tax resident outside the Cayman Islands; and
- a domestic company or local partnership (as defined in the ES Act).

All entities are required to submit annually an ES Notice (an ESN) to the Registrar of Companies that must be completed and submitted using an online portal. A relevant entity that carries on a 'relevant activity' is required to meet an economic substance test and submit an economic substance report to the Tax Information Authority.

*Law stated - 31 January 2023*

### Relevant activities

What activities trigger the economic substance requirements in your jurisdiction?

Relevant entities are required to satisfy an Economic Substance Test (an ES Test) if they carry on any of the following relevant activities:

- banking business;

- distribution and service centre business;
- financing and leasing business;
- fund management business;
- headquarters business;
- holding company business;
- insurance business;
- intellectual property business; and
- shipping business.

The scope of each of the above activities is defined in the ES Act. The Guidance in respect of the ES Act issued by the Tax Information Authority of the Cayman Islands contains further explanation of how those definitions should be construed, together with examples of relevant activity. If a relevant entity carries on more than one relevant activity then it is required to meet an ES Test in respect of each activity.

The Guidance provides that if a relevant entity carries on a relevant activity but does not generate any relevant income the entity is not obliged to meet the requirements of the ES Test in respect of that activity. However, the entity will still be required to satisfy its notification and reporting obligations.

*Law stated - 31 January 2023*

### **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 ?

The ES Act provides that entities that are tax resident outside the Cayman Islands are not considered to be relevant entities. The Guidance in respect of the ES Act issued by the Tax Information Authority of the Cayman Islands provides that an entity is tax resident outside the Cayman Islands if:

- it is subject to corporate income tax in another jurisdiction on all the income from the relevant activity; or
- it is a 'disregarded entity' for US income tax purposes and has a US corporation as its parent.

If the relevant activity is carried on by a branch of an entity then that branch will be considered to be tax resident outside the Cayman Islands if that branch is subject to corporate income tax in another jurisdiction on all of the income of that branch by reason of its domicile, residence or any other criteria of a similar nature.

Entities that are tax resident outside the Cayman Islands must confirm those details in an economic substance notice but are not required to satisfy an ES Test in respect of any relevant activity. In addition, the entity will be required to file an annual verification form on the Tax Information Authority's website and must produce evidence to the Authority substantiating the exemption claimed, such as a tax ID number or a tax residence certificate.

*Law stated - 31 January 2023*

### **Guidance**

## Has the government published guidance on the economic substance requirements?

The government has published four versions of guidance in relation to the requirements under the ES Act. The most recent, Version 3.2 (the Guidance), was issued in July 2022.

*Law stated - 31 January 2023*

## ECONOMIC SUBSTANCE REQUIREMENTS

### General requirements

#### What general economic substance requirements apply in your jurisdiction?

All entities are required to submit annually an economic substance notice to the Registrar of Companies that must be completed and submitted using an online portal. A relevant entity that carries on a 'relevant activity' is required to meet an economic substance test and submit an economic substance report to the Tax Information Authority. A relevant entity that carries on the relevant activity of high-risk intellectual property business is required to submit certain additional information in its economic substance report.

If a relevant entity carries on a relevant activity it is required to satisfy an economic substance test (an ES Test). A reduced ES Test applies to a relevant entity that carries on holding company business.

A relevant entity that carries on a relevant activity other than holding company business will satisfy the ES Test if:

- it conducts in the Cayman Islands all core income-generating activities in relation to the relevant activity;
- it is directed and managed in an appropriate manner in the Cayman Islands in relation to the relevant activity; and
- having regard to the level of relevant income derived from the relevant activity carried out in the Cayman Islands it:
  - has incurred adequate operating expenditure in the Cayman Islands;
  - has adequate physical presence (including maintaining a place of business, or plant, property and equipment) in the Cayman Islands; and
  - has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

'Relevant income' is defined as 'all of that 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 holding company business will satisfy the ES Test if:

- it has complied with all applicable filing requirements under the Companies Law (as revised); and
- it has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities.

*Law stated - 31 January 2023*

### 'Directed and managed'

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

If a relevant entity is required to satisfy an ES Test in respect of a relevant activity other than holding company business then that relevant entity must be directed and managed in an appropriate manner in the Cayman Islands in relation to that activity.

The Guidance provides that a relevant entity satisfies this part of the ES Test if:

- its board of directors has the appropriate knowledge and expertise to discharge its duties;
- meetings are held in the Cayman Islands at adequate frequencies given the level of decision-making required with respect to the activity;
- such directors' meetings are always quorate;
- the minutes of those meetings record the strategic decisions that the entity takes; and
- all such directors' meeting minutes and other appropriate records are kept in the Cayman Islands.

The number of board meetings held in the Cayman Islands is required to be included in the economic substance report filed by a relevant entity that carries on a relevant activity.

*Law stated - 31 January 2023*

## **Core income-generating activities**

### **What requirements apply in relation to core income-generating activities?**

Core income-generating activities (CIGA) are defined in the International Tax Co-operation (Economic Substance) Act (as revised) (ES Act) as activities that are of central importance to a relevant entity in terms of generating income from the relevant activities carried on by that entity that must be carried on in the Cayman Islands. Other than in respect of holding company business, a relevant entity that carries on a relevant activity must conduct CIGA to satisfy the ES Test.

The ES Act provides examples of CIGA but the nature of CIGA for any entity will depend on how that entity conducts its business and the Guidance confirms that the CIGA examples are not exhaustive or mandatory. The examples of CIGA set out in the ES Act for each relevant activity are as follows.

For banking business:

- raising funds, managing risk including credit, currency and interest risk;
- taking hedging positions;
- providing loans, credit or other financial services to customers; and
- managing capital and preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.

For distribution and service centre business:

- transporting and storing goods, components and materials;
- managing stocks;
- taking orders; and
- providing consulting or other administrative services.

For financing and leasing business:

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- negotiating or agreeing funding terms;
- identifying and acquiring assets to be leased;
- setting the terms and duration of financing or leasing; and
- monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements.

### For fund management business:

- taking decisions on the holding and selling of investments;
- calculating risk and reserves;
- taking decisions on currency or interest fluctuations and hedging positions; and
- preparing reports or returns, or both, to investors or the Cayman Islands Monetary Authority, or both.

### For headquarters business:

- taking relevant management decisions;
- incurring expenditures on behalf of group entities; and
- coordinating group activities.

### For insurance business:

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

### For intellectual property business:

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

### For shipping business:

- managing crew (including hiring, paying and overseeing crew members);
- overhauling and maintaining ships;
- overseeing and tracking deliveries; and

- determining what goods to order and when to deliver them, and organising and overseeing voyages.

*Law stated - 31 January 2023*

## **Premises**

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

For a relevant entity to satisfy an ES Test in respect of a relevant activity other than holding company business, that relevant entity must have an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands having regard to the level of relevant income derived from the relevant activity.

For a relevant entity to satisfy an ES Test in respect of a holding company business, that relevant entity must have adequate premises in the Cayman Islands for holding and managing equity participations in other entities.

The Guidance in respect of the ES Act issued by the Tax Information Authority of the Cayman Islands clarifies that 'adequate' means 'as much or as good as necessary for the relevant requirement or purpose'. What is adequate for each relevant entity will depend on its activity as well as the particular facts of its business. The Guidance notes that the directors (or equivalent) of each relevant entity must address their minds to the question and in good faith determine what is adequate. Every entity should also maintain records of this decision-making process sufficient to demonstrate compliance.

*Law stated - 31 January 2023*

## **Employees and personnel**

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

For a relevant entity to satisfy an ES Test in respect of a relevant activity other than holding company business, that relevant entity must have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands having regard to the level of relevant income derived from the relevant activity.

For a relevant entity to satisfy an ES Test in respect of a holding company business, that relevant entity must have adequate human resources in the Cayman Islands for holding and managing equity participations in other entities.

The Guidance in respect of the ES Act issued by the Tax Information Authority of the Cayman Islands clarifies that 'adequate' means 'as much or as good as necessary for the relevant requirement or purpose'. What is adequate for each relevant entity will depend on its activity as well as the particular facts of its business. The Guidance notes that the directors (or equivalent) of each relevant entity must address their minds to the question and in good faith determine what is adequate. Every entity should also maintain records of this decision-making process sufficient to demonstrate compliance.

*Law stated - 31 January 2023*

## **Expenditure**

### **What requirements apply in relation to expenditure?**

For a relevant entity to satisfy an ES Test in respect of a relevant activity other than holding company business, that relevant entity must have an adequate amount of operating expenditure incurred in the Cayman Islands having regard to the level of relevant income derived from the relevant activity.

The Guidance in respect of the ES Act issued by the Tax Information Authority of the Cayman Islands clarifies that

'adequate' means 'as much or as good as necessary for the relevant requirement or purpose'. What is adequate for each relevant entity will depend on its activity as well as the particular facts of its business. The Guidance notes that the directors (or equivalent) of each relevant entity must address their minds to the question and in good faith determine what is adequate. Every entity should also maintain records of this decision-making process sufficient to demonstrate compliance.

*Law stated - 31 January 2023*

## Enhanced requirements

### Are there any instances where enhanced substance requirements apply?

The ES Act treats high-risk intellectual property business differently from other types of relevant activity. High-risk intellectual property business is defined as intellectual property business carried on by an entity that:

- did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business;
- acquired the intellectual property asset:
  - from an entity in the same group; or
  - in consideration for funding research and development by another person situated in a country or territory other than the Cayman Islands;
- licenses the intellectual property asset to one or more entities in the same group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same group.

The ES Act states that if a relevant entity is carrying on high-risk intellectual property business then such entity will be presumed not to meet the ES Test even if there is CIGA in the Cayman Islands unless the entity can demonstrate that a high degree of control over the development, exploitation, maintenance, protection and enhancement of the IP asset, has been exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside or perform their activities within the Cayman Islands and provides sufficient information in the economic substance report for the relevant period to rebut that presumption.

The economic substance report for an entity that carries on high-risk intellectual property business must include:

- detailed business plans that demonstrate the commercial rationale for holding the IP assets in the Cayman Islands;
- employee information, including level of experience, type of contracts, qualifications and duration of employment;
- evidence that decision-making is taking place within the Cayman Islands; and
- any other information as may be reasonably required by the Authority to determine whether the relevant entity meets the ES Test.

*Law stated - 31 January 2023*

## Reduced requirements

### Are there any instances where reduced economic substance requirements apply?

The ES Act treats holding company business differently from other types of relevant activity and a reduced ES Test

applies to a relevant entity that carries on holding company business.

Holding company business is defined as the business of an entity that only holds equity participations in other entities and only earns dividends and capital gains. The Guidance provides that other incidental activities, such as owning a bank account, entering into contracts with professional or other service providers, and the payment of fees and expenses, will not cause an entity to fall outside the definition.

An entity carrying on holding company business satisfies the ES Test if:

- it has complied with all applicable filing requirements under the Companies Law (as revised); and
- it has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities.

Within the ES Act, in all circumstances 'adequate' is defined as 'as much or as good as necessary for the relevant requirement or purpose'. What is adequate for each relevant entity will depend on its activity as well as the particular facts of its business. The Guidance notes that the directors (or equivalent) of each relevant entity must address their minds to the question and in good faith determine what is adequate. Every entity should also maintain records of this decision-making process sufficient to demonstrate compliance.

*Law stated - 31 January 2023*

## Outsourcing

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

The ES Act expressly provides that a relevant entity may outsource its CIGA with respect to a relevant activity to any person in the Cayman Islands provided that the entity is able to monitor and control that person carrying out such CIGA so as to ensure the CIGA is in fact being carried out in the Cayman Islands. Other activities that are not CIGA, such as payroll or HR, may be outsourced to service providers outside the Cayman Islands with no restrictions of any kind under the ES Act.

For the purposes of satisfying the ES Test the activities of the service provider (the person taking on the outsourced activity) will be taken into account and further, the resources of that service provider will be taken into account to satisfy the people and premises part of the ES Test as well. This means that the service provider's employees can be considered to be employees of the relevant entity but only while they are providing services for that relevant entity and this must be evidenced by the relevant entity (via timesheets or the like). In addition, the Authority requires service providers to verify the information on outsourcing within 30 days of the date on which the relevant entity submits its economic substance report.

Relevant entities carrying on banking business, insurance business and or fund management business must also comply with additional requirements in respect of outsourcing CIGA that are set out in the Authority's 'Statement of Guidance: Outsourcing Regulated Entities'.

*Law stated - 31 January 2023*

## 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 authority responsible for the enforcement of the economic substance requirements under the International Tax Co-operation (Economic Substance) Act (the ES Act) is the Tax Information Authority. The ES Act contains several provisions that require entities to provide information to the Tax Information Authority.

With respect to economic substance notices, section 7(1) states that in addition to the information required to be disclosed in the notice an entity shall provide appropriate evidence to support that information as may be reasonably required by the Tax Information Authority.

With respect to the economic substance reports, section 7(4)(k) provides that the Tax Information Authority may prescribe additional information that is required to be provided beyond what is set out in the ES Act. The Authority also has the power under section 7(7) to serve notice on any person it reasonably believes to have relevant information that the Tax Information Authority reasonably requires to discharge its obligations under the ES Act and require that person to either provide the document or other information to them or make such information available to the Authority for inspection.

*Law stated - 31 January 2023*

## Reporting formalities

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

All entities are required to submit annually an ES Notice (an ESN) to the Registrar of Companies that must be completed and submitted using an online portal. In the ESN the entity must state whether it is carrying on any 'relevant activity'. If an entity is not carrying on a relevant activity then it must also confirm if it is an investment fund. If an entity is carrying on a relevant activity then the entity must also identify the type of relevant activity and confirm whether it is a 'relevant entity'. Certain additional information will be required depending on the answers the relevant entity selects in the online form. Subject to any extensions that may be granted, the deadline for submitting an ESN is 31 March each year.

If a relevant entity is carrying on a relevant activity it is required to prepare and submit an economic substance report in respect of the relevant activity using an online portal. The ES Act requires the report to contain the information that is listed in section 7(4) of the ES Act and in the Schedule to the International Tax Co-operation (Economic Substance) Regulations 2020. Subject to any extensions that may be granted, the report is required to be filed with the Authority within 12 months of the end of the relevant financial year of the relevant entity.

*Law stated - 31 January 2023*

## Demonstrating compliance

### How does an entity in practice demonstrate its compliance with the economic substance requirements? How do the enforcement authorities assess compliance?

A relevant entity carrying on a relevant activity is required to submit an economic substance report. The Authority's assessment of whether that relevant entity satisfies the applicable ES Test will be based upon the information contained in the report. Subject to any extensions that may be granted, the report is required to be filed with the Authority within 12 months of the end of the relevant financial year of the relevant entity.

The information that must be included in the ES return is set out in section 7(4) of the ES Act and Schedule 2 of the ES Regulations (2020). That information includes:

- the type of relevant activity;
- the amount and type of relevant income;
- the amount and type of expenses and assets in respect of the relevant activity;
- the number of full-time employees or other personnel with appropriate qualifications who are responsible for carrying on the relevant entity's relevant activity;
- the name and address of any person other than the relevant entity who is conducting CIGA for that relevant entity (ie, outsourced CIGA);
- that CIGA that has been conducted;
- for intellectual property business a declaration as to whether it is high-risk intellectual property business;
- details of any MNE Group (as defined in the Tax Information Authority (International Tax Compliance) (Country-By-Country Reporting) Regulations, 2017) for which the relevant entity is a constituent entity;
- the jurisdiction of tax residence of the relevant entity's immediate parent, ultimate parent and ultimate beneficial owner; and
- a copy of the relevant entity's financial statements or books of account for the relevant financial year.

The Authority has the power to determine if a relevant entity has satisfied the applicable ES Test. The Guidance explains that the assessment will be undertaken using a principles-based approach. Specific requirements as to, for example, employee numbers for a particular level of relevant income are not prescribed, as all businesses will be treated as unique and the requirements for any entity will depend on how that entity conducts its business.

In assessing an entity's satisfaction of the ES Test the Authority will consider a variety of factors, including:

- the fluctuation of activities from year to year and the impact that fluctuation may have on what constitutes an adequate level of employees or personnel;
- the ability of directors to perform CIGA in addition to their fiduciary duties and the potential to eliminate the need for full-time employees or outsourced work; and
- the Authority will on request, take into consideration normal business practices for a relevant activity that are permitted in other jurisdictions subject to the Forum on Harmful Tax Practices' substantial activities requirements.

*Law stated - 31 January 2023*

## Penalties

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

Failure to submit an ES report when required shall result in a penalty of CI\$5,000 plus an additional penalty of CI\$500 per day that the report is not filed.

Any relevant entity that fails to satisfy the ES Test for a financial year shall be subject to a penalty of CI\$10,000. If a relevant entity fails again to satisfy the ES Test in the financial year that follows the financial year in which the Authority gave notice of the initial failure then the ES Act provides for a penalty of CI\$100,000.

*Law stated - 31 January 2023*

## UPDATE AND TRENDS

### Recent developments

What have been the most significant recent developments in the law on economic substance in your jurisdiction, including any notable regulatory actions or legislative changes?

The International Tax Co-operation (Economic Substance) Act (as revised) and the Guidance were subject to certain amendments in 2021. The 2021 amendments include expanding the definition of 'relevant entity' to include partnerships, bringing them into the scope of the Economic Substance regime. Due to the covid-19 pandemic, it is likely that some entities may be unable to hold meetings in the Islands, or may be temporarily prevented from carrying on core income-generating activities within the Islands. In these instances, the authority has requested an explanation so that these mitigating circumstances can be taken into account in considering whether an entity has satisfied the ES Test. The Guidance version 3.1 (issued on 30 June 2021) was updated in July 2022 with version 3.2.

*Law stated - 31 January 2023*

## Jurisdictions

	<b>Bahamas</b>	McKinney Bancroft & Hughes
	<b>Belize</b>	Quijano & Associates
	<b>Bermuda</b>	Carey Olsen
	<b>British Virgin Islands</b>	Carey Olsen
	<b>Cayman Islands</b>	Carey Olsen
	<b>Germany</b>	Freshfields Bruckhaus Deringer
	<b>Guernsey</b>	Carey Olsen
	<b>Jersey</b>	Carey Olsen
	<b>Mauritius</b>	Venture Law llc
	<b>Turkey</b>	Nazali Tax & Legal Services
	<b>Turks &amp; Caicos Islands</b>	Griffiths & Partners