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Economic Substance Requirements in the Cayman Islands

The Economic Substance Law

This summary replaces our previous release of [21 December 2018](#) to provide an updated overview of the key aspects of the legislation by outlining steps to identify which Cayman entities are in scope and how to achieve compliance.

In response to the work of the OECD and the European Union on fair taxation, the Cayman Islands enacted new legislation requiring ‘relevant entities’ engaged in certain ‘relevant activities’ to demonstrate ‘adequate economic substance’ in the territory.

The International Tax Co-operation (Economic Substance) Law, 2018 (the **ES Law**) came into effect on 1 January 2019 and the Cayman Islands Government subsequently issued related [Guidance Notes](#) on 22 February 2019 and the International Tax Co-operation (Economic Substance) (Amendment of Schedule) Regulations, 2019 (the **Amended Schedule**) which came into force on the same date.

Step 1: Classification of a Relevant Entity

The ES Law applies to Relevant Entities. **Relevant Entities** are defined in the Amended Schedule as:

- (a) a company, other than a domestic company, that is:
 - (i) incorporated under the Companies Law (Revised); or
 - (ii) a limited liability company registered under the Limited Liability Companies Law (Revised);

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- (b) a limited liability partnership that is registered under the Limited Liability Partnership Law, 2017;
- (c) a company that is incorporated outside of the Islands and registered under the Companies Law (Revised);

but does not include:

- (i) investment funds (including any entity through which an investment fund directly or indirectly invests or operates); or
- (ii) an entity that is tax resident outside the Cayman Islands.

Step 2: Relevant Activities conducted by Relevant Entities

If an entity is deemed as a Relevant Entity as per Step 1 above, this Relevant Entity will be required to file a notice with the Tax Information Authority (the **Authority**) stating whether or not it has carried out any of the following activities (the **Relevant Activities**) in the previous financial year:

- Banking business
- Distribution and service centre business
- Finance and leasing business
- Fund management business
- Headquarters business
- Holding company business
- Insurance business
- Intellectual property holding business
- Shipping business

The [Guidance Notes](#) provide further information on the definition of each type of Relevant Activity.

Step 3: The Economic Substance Test

A Relevant Entity conducting any of the above Relevant Activities is required to satisfy a three-tiered economic substance test (the **ES Test**). To pass the ES Test, a Relevant Entity must:

- 1) conduct Cayman Islands core income generating activities in relation to that Relevant Activity;
- 2) be directed and managed in an appropriate manner in the Cayman Islands in relation to that Relevant Activity; and
- 3) taking into account the level of income generated from that Relevant Activity carried out in the Cayman Islands:
 - (i) have an adequate operating expenditure incurred in the Cayman Islands;
 - (ii) have an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and

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- (iii) have an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

Cayman Islands Core Income Generating Activities (Cayman Islands CIGA)

Core income generating activities are defined as activities that are being carried out in Cayman and are of central importance to a Relevant Entity in terms of generating income. A Relevant Entity must conduct an adequate amount of the appropriate elements under the Cayman Islands CIGA for the particular type of Relevant Activity that it is undertaking in order to show economic substance. Depending on the Relevant Activity, Cayman Islands CIGA will differ and Marbury advises to carefully decipher which of its activities constitute as the core income generating ones. The [Guidance Notes](#) include definitions of each type of Relevant Activity and the corresponding Cayman Islands CIGA.

Holding Companies

Holding companies are subject to exceptions to the above ES Test, either with a reduced test (for pure equity holding companies; see below), or with a more stringent test (in the case of higher risk intellectual property holding companies). Provisions for holding companies will need to be assessed on a case-by-case basis.

Pure equity holding company

A Relevant Entity that is *only* carrying on a Relevant Activity that is the business of a pure equity holding company is subject to a reduced ES Test which is satisfied if it confirms that:

- (a) it has complied with all applicable filing requirements under the Companies Law (2018 Revision); and
- (b) it has adequate human resources and adequate premises in the Cayman Islands for holding and managing equity participations in other entities.

The [Guidance Notes](#) confirm that a pure equity holding company may engage its registered office service provider to satisfy these reduced substance requirements in the Cayman Islands where the pure equity holding company is passively holding equity interests in other entities.

Notification and reporting

The ES Law dictates compliance of Relevant Entities as of 1 January 2019 and reporting as of the end of each financial year. Thus starting in 2020, all Relevant Entities must notify the Authority annually

- (a) whether or not they are carrying on a Relevant Activity;
- (b) 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, shall provide appropriate evidence to support that tax residence as may be required by the Authority; and
- (c) the date of the end of its financial year.

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Relevant Entities carrying on Relevant Activities that are required to satisfy the ES Test must also prepare and submit to the Authority a report for assessment detailing particulars including, but not limited to, income, expenses, assets, management, employees and physical presence.

The specific time, form and manner of such notification has yet to be finalised. The Authority expects to develop and launch a portal to enable to electronic notification and reporting and we will provide further updates when they become available.

Penalties for non-compliance

The penalty for not satisfying the ES Test is KYD10,000. In the event of failing the ES Test in the subsequent financial year, the penalty increases to KYD100,000. Such failure after two consecutive years may result in court involvement and ultimately the Cayman Islands entity being struck-off.

Achieving Compliance

A Relevant Entity is subject to the ES Law from the date on which it commences a Relevant Activity unless the Relevant Entity was in existence prior to 1 January 2019, in which case it must comply by 1 July 2019.

Marbury would advise that all existing entities undergo a review as per the steps laid out herein in order to decipher whether they are deemed as Relevant Entities, and if so, whether such Relevant Entities conduct Relevant Activities. From there, Relevant Entities are advised to take the necessary steps to ensure compliance by the deadline.

For further information on any aspect of this updaters please contact your usual Marbury adviser.

Disclaimer

This guide provides an overview of economic substance in the Cayman Islands and should not be read as legal advice. For more information please contact Marbury. Links to the Cayman Islands Economic Substance legislation and related Guidance Notes can be found here: http://www.tia.gov.ky/pdf/Economic_Substance.pdf.