



## Legal Insights

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# Economic Substance in the Cayman Islands – tips to remain compliant

December 2022

### Introduction

The Cayman Islands introduced the International Tax Co-operation (Economic Substance) Act (as amended) (the “**Act**”) in 2018. As noted by the Tax Information Authority of the Cayman Islands (the “**TIA**”), the Act was introduced in response to the work carried out by the European Union and the OECD on ‘fair taxation’ and international tax practices.<sup>1</sup>

The Act requires all ‘relevant entities’ that carry on ‘relevant activities’ to satisfy the economic substance test that applies to that relevant activity. As we now approach the fourth anniversary of the Act coming into force, we thought we would share several tips for best practice in ensuring continued compliance with the requirements of the Act.

### Keeping the relevant entity’s business under constant review

What is required to comply with the applicable economic substance test varies greatly between businesses and there is certainly no ‘one size fits all’ approach to meeting the requirements, even for entities that carry on the same ‘relevant activity’.

For example, determining, as part of the relevant economic substance test, whether a business has adequate operating expenditure, an adequate physical presence and an adequate number of employees in the Cayman Islands is entirely dependent on the specific circumstances of that business, such as its size, number of customers, global footprint and income etc.

As businesses evolve and, hopefully, grow over time, what was ‘adequate’ in 2019 may no longer be adequate almost four years later. Indeed, given the (in some cases) material changes in business practices

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<sup>1</sup> Economic Substance for Geographically Mobile Activities Guidance, Version 3.1 issued on 30 June 2021, page 1 (the “**Guidance**”).

caused by the COVID-19 pandemic, it may be that the way some relevant entities carry on their relevant activities has changed beyond recognition since the Act came into force. Therefore, in most cases it will not be appropriate to simply maintain the same office space and number of employees year after year where the business has undergone material changes. To do so risks being found to be non-compliant with the economic substance test as it is by no means a 'box ticking' exercise.

Therefore, relevant entities that must comply with the economic substance test should periodically (at least annually) review whether its business footprint in the Cayman Islands adequately meets the true scale of its operations. To the extent any changes are required in order to ensure compliance with the Act, the business should take those steps well in advance of the next submission date for its economic substance notification so that it is compliant at the time of submission. Any shortcomings cannot be retrospectively corrected.

### **Regular board meetings**

One of the requirements of the economic substance test is that a relevant entity carrying on a relevant activity must be 'directed and managed in an appropriate manner' in the Cayman Islands. In determining whether this standard has been met, the TIA will have regard to the frequency with which board meetings are held in the Cayman Islands and whether a quorum of such meetings is present in the Cayman Islands.<sup>2</sup>

Relevant entities carrying on relevant activities must ensure that these board meetings are in fact held and that they are held in accordance with the quorum requirements of the Guidance. All too often it appears that relevant entities are leaving it later and later in the year to comply with these obligations and in so doing they risk being found to be non-compliant with the economic substance test if, for any reason, those meetings cannot be scheduled and properly held before the end of the reporting period.

Further, any such board meetings must not be tokenistic. They must fully consider the activities of the business and take such strategic and other decisions that a prudent board of directors would take in order to ensure the effective management of the business. Of course, the number of board meetings required to be held will vary from business to business depending on its specific line of trade and its other circumstances.

### **Ensure an accurate categorisation of the business in question**

Anyone who has reviewed the Act and the associated Guidance will agree that the requirements are, to say the least, nuanced and it can be tricky to work out exactly where a living, breathing business which is fraught with its own complexities and subtleties falls within the requirements.

Based on experiences we have had with our own clients, we would strongly advise any relevant entity to ensure that its advisers fully understand the precise nature of its business as the slightest misunderstanding

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<sup>2</sup> See page 26 of the Guidance.

or lack of information can result in an incorrect categorisation under the Act (with consequent incorrect advice on how compliance with the Act is to be achieved).

Further, to the extent that a relevant entity's business has evolved since the Act came into force, we would recommend that the relevant entity's advisers be advised of those changes so that a new economic substance analysis can be undertaken in the context of the business as it now stands, so that the next economic substance return can be prepared with this evolution in mind.

### **Income, not profit!**

We have advised a number of clients on compliance with their obligations under the Act and from time to time we have advised clients that, in our opinion, they were not meeting the requirements of the economic substance test. This was often on the basis that their physical presence, operating expenditure and/or number of employees was insufficient based on the income of the business.<sup>3</sup>

In these circumstances it has not been uncommon for our client to respond and point out that, based on their most recent accounts, the business had either traded at a loss or had made only negligible profits and that therefore they were only required to maintain a negligible presence in the Cayman Islands and that they were therefore compliant. However, per the precise wording of the Act and of the Guidance, it is very clearly the income of the business that is the relevant metric here.

### **Conclusion**

Whilst businesses and their advisers are undoubtedly more familiar with the expectations of the TIA as regards meeting the applicable economic substance test now that we have several years' experience, satisfying the economic test remains an exercise in trying to aim at a moving target as businesses evolve over time. If you are in any doubt as to your obligations (if any) under the Act or if it has been a while since this has been considered in the context of your business, we would be delighted to assist.

***This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice on Economic Substance, please contact your usual Loeb Smith attorney or any of the following:***

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<sup>3</sup> Per the requirements of the Guidance – see page

## About Loeb Smith Attorneys

Loeb Smith is an offshore corporate law firm, with offices in the British Virgin Islands, the Cayman Islands, and Hong Kong, whose Attorneys have an outstanding record of advising on the Cayman Islands' law aspects and BVI law aspects of international corporate, investment, and finance transactions. Our team delivers high quality Partner-led professional legal services at competitive rates and has an excellent track record of advising investment fund managers, in-house counsels, financial institutions, onshore counsels, banks, companies, and private clients to find successful outcomes and solutions to their day-to-day issues and complex, strategic matters

