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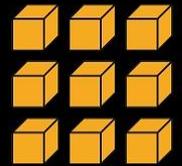
# **Economic Substance 3.0 for the Digital Space**

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**JupiterBlock**

# What is economic substance?

Economic substance is the sum of requirements, which may be imposed by the Cayman Islands under The International Tax Co-operation (Economic Substance) Law (2020 Revision), as amended, or by another jurisdiction, requiring a business to have a local presence, including staff and premises, expenditures, as well as management, in the jurisdiction of its tax residency. At a global level, framework legislation is being pushed through in over 135 jurisdictions through the OECD BEPS Inclusive Framework and the OECD Forum on Harmful Tax Practices, so that profits from an economic activity are taxed in the country where the economic activity actually takes place.

In the new digital and remote-working economy, the application of economic substance requirements is problematic to say the least. At the international level, this issue has been recognized and heavily debated, and the OECD countries have been working on a new international tax framework which was initially announced for 2020, including digital taxes. However, at this point there is no international consensus and it is also unclear if the arrival of such taxes would remove economic substance requirements.

# Does it concern me?

In the Cayman Islands, only certain entities carrying out certain relevant activities are required to comply with the economic substance requirements. Recent guidance has been published by the Cayman Islands Tax Information Authority (TIA) on 13 July 2020 further detailing and explaining economic substance requirements.

Overall, the relevant activities which trigger economic substance requirements in the Cayman Islands are:

- (a) banking business;
- (b) distribution and service centre business;
- (c) financing and leasing business;
- (d) fund management business;
- (e) headquarters business;
- (f) holding company business;
- (g) insurance business;
- (h) intellectual property business; or
- (i) shipping business.

Digital assets & blockchain businesses could fall under fund management, headquarters, holding company, or intellectual property business, but other relevant activities cannot be excluded. This is a growing space!

# What if I have a holding company?

For economic substance purposes, a holding company is an entity which only holds equity participations for itself and in its own name; the only income should be dividends, or incidental (such as interest paid on the bank account balance).

Holding companies have an easier-to-meet threshold. Basically, the economic substance needs of a holding company could even be met by the Cayman Islands registered office.



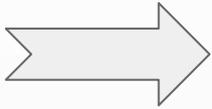
Talk to your Cayman counsel and/or your Cayman registered office.

But be mindful that:

- (i) if your holding company also provides services to other companies in your group, then you are moving into headquarters business territory; and
- (ii) if your intellectual property is owned and managed at the level of the holding company, then you are moving into intellectual property business territory.

# What if I just buy and sell digital assets?

Buying and selling digital assets, other than done for your own account, could put you in the category of fund management business.



This may not be true in all cases; it very much depends on the digital assets in question, and on how the business is structured and managed. If you are not certain which rules may apply, you should talk to your Cayman counsel.

You should in all cases reach out to your Cayman counsel if:

- (i) you don't know if you are required to be registered or licensed under the Securities Investment Business Law (2020 Revision) - there is a high chance you should;
- (ii) you are managing virtual assets belonging to another person in circumstances involving the exercise of discretion.

**Please be mindful that simply reading any information and publications about Cayman laws and regulations does not equal obtaining proper legal advice. This is simply meant to point you in the right direction.**

# What if I have a fund?

Funds trading in digital assets or investing in blockchain projects are increasingly numerous as the industry grows and institutional investors come in larger numbers.

Investment funds are required to be registered with the Cayman Islands Monetary Authority (CIMA), either as mutual or as private funds. Economic substance requirements would not apply to an entity which is an investment fund, or a vehicle through which a fund invests.

**This does not mean that fund directors can be oblivious to economic substance.**

First, if the fund's investment manager is subject to economic substance requirements and does not comply with them, this is a major source of risk and liability for the fund's directors.

Second, there is no history of implementation of the economic substance requirements and therefore there is always a risk that the TIA could consider that the requirements have not been met by the investment manager. This risk factor should be disclosed to investors.



# I develop and license software. What next?

In some cases, products sold may be virtually indistinguishable from the rights to use the IP held by the company. The TIA expressly warned that disguising IP income as embedded sales may be deemed a circumvention of economic substance requirements.



**Specific tax guidance is necessary to determine the exact scope of economic substance requirements.**

Same is true if:

(i) an entity is not the legal owner of the IP but holds a licence which gives full and exclusive rights including to sub-licence (in such cases the TIA may consider that the entity would fall in scope of economic substance requirements); or

(ii) an entity has acquired the IP from a company located in a different jurisdiction and is now licensing and earning income within a multinational group (this is called “**high risk intellectual property business**” and is subject to additional economic substance requirements as well as reporting).

# What about the Covid-19 shelter in place?

Sadly, Guidance 3.0 is silent on the difficulty of meeting economic substance requirements for the duration of the shelter-in-place regulations, and also due to the Cayman Islands borders being closed during the pandemic. However, it is likely that the TIA will publish additional guidance with respect to economic substance requirements for 2020.

We would hope that such additional guidance would include allowances with respect to Board of Directors meetings held via Zoom or other video/teleconference technologies, delays in the acquisition of premises in the Cayman Islands, and/or the hiring of local staff, for the companies that were planning to do that. In the meantime, our recommendation would be to carefully document efforts to comply with economic substance requirements, and to reach out to your Cayman counsel or Cayman tax advisory firm.

Don't wait until the end of 2020 to take stock of where you are with respect to economic substance requirements, and reach out to your Cayman counsel or Cayman tax advisory firm to ask about any updates.

# How can I be sure to meet the requirements?

1. Check with your Cayman Islands registered agent to make certain that your economic substance filing and annual return for 2020 have been done properly.
2. Check if you are carrying out any of the relevant activities, and if this has been properly reported by the registered agent. If not, make certain your registered agent understands what activities you are carrying out (they are not being nosy, they have a legal requirement to understand your business). The filing can be corrected.
3. Take stock of what income is attached to the relevant activities, and what expenses. The two principles to keep in mind are that:
  - a. those individuals who in fact conduct certain **core income generating activities (CIGA)** which are specific to a relevant activity and are described in the Guidance 3.0 must do so **in the Cayman Islands, not elsewhere**, and
  - b. the entity must be directed and managed in the Cayman Islands.

# Core Income Generating Activities (CIGA)

CIGA depend on the relevant activity. For **headquarters business**, for example:

- (i) taking relevant management decisions (strategic planning, marketing strategies, information technology, acquiring premises, etc.);
- (ii) incurring expenditures on behalf of group entities (specialist advice, procurement functions, marketing, IT and HR); and
- (iii) coordinating group activities for synergies and cost savings.

For **IP businesses**, CIGA depend on the type of intellectual property, how it is developed and also on the business model. For example:

- (i) for an entity relying on patents and other IP assets which are functionally equivalent, R&D activities with the adequate number of employees and operating expenditures;
- (ii) for an entity relying on income from trademarks, branding, marketing and distribution, the CIGA are the branding, marketing and distribution activities with the adequate number of employees and operating expenditures and the adequate degree of control.

# Outsourcing during Covid-19 and after?

Yes, for activities which are not CIGA or otherwise income-generating (back office functions, IT, payroll, legal services, etc.), including to service providers outside the Cayman Islands.

Yes, for core income generating activities (CIGA) but only to another person/ entity in the Cayman Islands and subject to the following requirements:

- (1) the entity must be able to effectively monitor and control the carrying out of the activities;
- (2) the activities are carried out in the Cayman Islands;
- (3) the resources of the service provider are sufficient to meet the people and premises test, with no double counting;
- (4) the entity remains responsible for ensuring accurate information is reported to the TIA including precise details of the resources employed by its service providers (timesheets); and
- (5) the information provided must be verified by the local service provider within 30 days.

# Management Principles

1. The Board of Directors, as a whole, has the appropriate knowledge and expertise to discharge its duties in relation to a relevant activity carried out.
2. Meetings are held in the Cayman Islands at adequate frequencies given the level of decision-making required in relation to a relevant activity.
3. At such meetings, a quorum of directors is present in the Cayman Islands.
4. The minutes of the Board meetings record the making of strategic decisions.
5. The company keeps all such minutes and appropriate records in the Cayman Islands.

The closure of borders due to the Covid-19 pandemic will likely offer some leeway with respect to requirements #2 and #3, and it is likely that the TIA as well as tax authorities from other jurisdictions will take into account the impossibility to travel. However, there is a risk that the TIA may still require a quorum of directors to be present in the Cayman Islands.

# The Income / Expenditure Test

Entities falling in scope for economic substance requirements will have to provide to the TIA, and the TIA will review, documents and information on income and expenditures for each relevant activity, so that the TIA determines if, having regard to the level of income derived from the relevant activity, the following seem adequate:

- (i) operating expenditure incurred in the Cayman Islands;
- (ii) physical presence in the Cayman Islands; and
- (iii) number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

**The mid-year point is a good moment to take stock of income / expenditures.**

Exempted companies in the Cayman Islands are not required by law to have an auditor or file financial statements, but they are required to keep proper books and records, including contracts and invoices, and under section 59 of the Cayman Islands Companies Law (2020 Revision), as amended, to make available electronic records of such books and records to the TIA at the registered office.

# When should I get help?

1. If you are not certain the economic substance and the annual return filings have been done prior to the 30 June 2020 extended deadline.
2. If you believe you may be in scope of economic substance, but are not certain if yes, and what to do about it.
3. If you have a Cayman exempted company and this is the first you've heard of economic substance.
4. If you haven't held any Board meetings this year.
5. If you are not certain to have proper books and records ready.
6. If you have an intellectual property business that falls in scope of economic substance requirements.

# About the Author

## RAMONA TUDORANCEA

### Regulatory and Compliance Expert M&A/ Investment Funds/ Corporate/ Digital Assets

Broad legal background in U.S. and E.U. business law

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Experienced in E.U./U.S. regulations, AML, FCPA and OFAC compliance, Cayman Islands investment funds and corporate structures and related regulatory compliance and digital assets / virtual assets service providers (VASPs). Admitted as an attorney in New York (2008) and Paris (2009), England and Wales (2019) and in BVI (2020).



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# About JB Advisory Services SEZC



JupiterBlock

**JB Advisory Services SEZC** is part of Cayman Enterprise City (CEC) and actively supports the growing blockchain, FinTech and digital ecosystem in the Cayman Islands. JB stands for **JupiterBlock**, in relation to our affiliate **JupiterBlock LLC**, which is incorporated in Wyoming and active in the United States.

**We are just at the beginning of an extraordinary journey which will see blockchain technology completely revamp the existing financial systems all over the world.**

We consult and advise clients in connection with:

- early-stage feasibility investigations, product design and development (including embedded corporate governance and compliance features and smart contract specifications);
- how to integrate blockchain and digital assets into existing business models;
- commercialisation and IP protection strategies; and
- how to manage regulatory and compliance challenges.

We also provide the bridge with venture capital and private equity funds, their expectations and requirements, and assist with drafting and conducting due diligence of prospective strategic acquisitions/investment opportunities and accessing potential sources of capital.