MAPLES GROUP

UPDATE

Cayman Islands Economic Substance Requirements – 'Relevant Activity' of 'Intellectual Property Business'

For general background on The International Tax Co-operation (Economic Substance) Law, 2018 (as amended by relevant regulations, the "Economic Substance Law"), the related Guidance on Economic Substance for Geographically Mobile Activities (the "Guidance") and for the meaning of 'relevant entity', please click here.

This update assumes that an entity has already been determined to be a 'relevant entity' under the Economic Substance Law and that the 'relevant entity' is now considering whether it is carrying on one of the nine categories of geographically mobile 'relevant activities' - in particular, under the 'intellectual property business' category.

What is 'intellectual property business'?

In the Economic Substance Law:

1. 'intellectual property business' means the business of holding, exploiting or receiving income from intellectual property assets;

2. 'intellectual property asset' means an intellectual property right including a copyright, design right, patent and trademark; and

3. 'high risk intellectual property business' means an intellectual property business carried on by an entity that:

   (i) did not create the intellectual property in an intellectual property asset that it holds for the purposes of its business;

   (ii) acquired the intellectual property asset:

      A. from an entity in the same Group; or
      B. in consideration for funding research and development by another person situated in a country or territory other than the Islands; and

   (iii) licences the intellectual property asset to one or more entities in the same Group or otherwise generates income from the asset in consequence of the activities (such as facilitating sale agreements) performed by entities in the same Group.

Economic Substance Test

If a 'relevant entity' carries on the 'relevant activity' of 'intellectual property business' it will be subject to the economic substance test (the "ES Test") set out in the Economic Substance Law (unless it has no relevant income in respect of that relevant activity, in which case only notification and reporting obligations will apply). The economic substance test can be satisfied in relation to that 'intellectual property business' if the 'relevant entity':

(a) conducts 'Cayman Islands core income generating activities' ("Cayman Islands CIGA");

(b) is directed and managed in an appropriate manner in the Cayman Islands; and

(c) has adequate operating expenditure, physical presence and personnel in the Cayman Islands.

Cayman Islands Core Income Generating Activities

The relevant 'Cayman Islands core income generating activities' in the context of 'intellectual property business' include:

(a) where the intellectual property asset is a:

(i) patent or an asset that is similar to a patent, research and development; or

(ii) non-trade intangible (including a trademark), branding, marketing and distribution

(b) in exceptional cases, except if the relevant activity is a high risk intellectual property business, other core income generating activities relevant to the business and the intellectual property assets, which may include:

(i) taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income;

(ii) 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;

(iii) carrying on the underlying trading activities through which the intangible assets are exploited leading to the generation of income from third parties.

High Risk Intellectual Property Business

In addition, section 4(7) of the Economic Substance Law provides that:

'A relevant entity that is carrying on a relevant activity that is a high risk intellectual property business is presumed not to have met the economic substance test for a financial year, even if there are core income generating activities relevant to the business and the intellectual property assets being carried out in the Islands, unless the relevant entity:

(a) can demonstrate that there was a high degree of control over the development, exploitation, maintenance, enhancement and protection of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Islands; and

(b) provides sufficient information under section 7(4)(j) to the Authority in relation to that financial year to rebut this presumption.'

Intellectual property business, in the form of 'high risk intellectual property ("IP") business', has sector-specific guidance applicable to it included in the Guidance, which provides that:

'A relevant entity that is carrying on high risk IP business is presumed not to have met the ES Test for a financial year, even if there are Cayman Islands CIGA relevant to the business and the IP assets being carried out in the Islands. A relevant entity may rebut this presumption if it can produce materials to the Authority which demonstrate that there is, and historically has been, a high degree of control over the development, exploitation, maintenance, protection and enhancement (also referred to as "DEMPPE") of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities within the Islands.

The Authority's approach regarding the rebuttable presumption will be aligned with the policy articulated by the FHTP in the following document in paragraphs 32 to 39 under the heading **"IP**

income – exceptional cases and rebuttable presumption":

- OECD (2018, Resumption of application of substantial activities for no or nominal tax jurisdictions – BEPS Action 5, OECD, Paris. http://www.oecd.org/tax/beps/resumption-of-application-of-substantial-activities-factor.pdf

This high risk IP company evidential threshold requires:

(a) detailed business plans which demonstrate the commercial rationale for holding the IP assets in the Islands;

(b) employee information, including level of experience, type of contracts, qualifications and duration of employment; and

(c) evidence that decision making is taking place within the Islands,

and any other information as may be reasonably required by the Authority to determine whether the relevant entity meets the ES Test.

Periodic decisions by non-resident directors or board members, or local staff passively holding intangible assets would not be sufficient to satisfy the ES Test in respect of any IP business and therefore cannot rebut the presumption in the case of high risk IP business.'

What to do if a Relevant Entity is Carrying on the Relevant Activity of Intellectual Property Business

It is worth noting that there are a range of consequences for breaches of the Economic Substance Law (including financial penalties and potential striking-off).

If you suspect that you have a relevant entity conducting intellectual property business or have any specific questions on this Update please speak to your usual Maples Group contact or to:

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