

Intellectual Property Business

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Relevant Activity – What is an “intellectual property business”?

An entity engages in ‘intellectual property business’ where it conducts the business of holding, exploiting or receiving income from intellectual property (“IP”) assets.

An ‘intellectual property asset’ is an IP right including a copyright, design right, patent and trademark.

An entity engaging in a ‘high risk intellectual property business’ is automatically presumed not to meet the economic substance requirements. Please see more information regarding ‘high risk intellectual property business’ under **High Risk IP** below.

Source: Cayman Islands Economic Substance Guidance Notes v3.1, pages 21-22

Economic Substance Test

A ‘relevant entity’ that conducts one or more ‘relevant activity’, will need to satisfy the Economic Substance Test (“**ES Test**”) in respect of each relevant activity conducted.

An entity satisfies the ES Test with respect to an IP business if it:

- (a) conducts core income generating activities (“**CIGA**”) in the Islands in relation to its IP business;
- (b) is directed and managed in an appropriate manner in the Islands in relation to its IP business; and
- (c) having regard to the level of relevant income derived from the IP business;
 - (i) has an adequate amount of operating expenditure incurred in the Islands;
 - (ii) has an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Islands; and
 - (iii) has an adequate number of full-time employees or other personnel with appropriate qualifications in the Islands.

As outlined below, high risk IP has a more onerous ES test.

CIGA for Intellectual Property Business

CIGA with respect to every type of relevant activity means activities that are of central importance to a relevant entity in terms of generating relevant income and must be carried on in the Islands.

Income derived from IP assets can pose a higher risk of artificial profit attribution or profit shifting than non-IP assets and as such the CIGA for IP business are specific in nature. The legislation sets out the 'primary' CIGA for IP business which is outlined below.

(a) Patent or an asset that is similar to a patent:

(i) Where the IP asset is a –

A. Patent or an asset that is similar to a patent, research and development (“**R&D**”)

This CIGA refers to a relevant entity earning income from exploiting a patent or other IP assets that are functionally equivalent to patents. IP assets that are functionally equivalent to patents are (i) patents defined broadly, (ii) copyrighted software, and (iii) other IP assets that are nonobvious, useful, and novel. Such IP assets must be subject to a similar approval and registration process (where such processes are relevant) as patents and must be legally protected. Legal protection includes exclusive rights to use the IP asset, legal remedies against infringement, trade secret law, and contractual and criminal protections against use of the IP asset or unauthorised disclosure of information related to the IP asset. For further information on IP assets that are functionally equivalent to patents, see paragraphs 34 – 37 under Chapter 4.II.B. of the [Action 5 Report \(OECD, 2015\)](#).

In line with the general ES Test, the relevant entity will be required to demonstrate that it has conducted the R&D activities with the adequate number of employees and operating expenditures. A relevant entity will not satisfy this requirement where it simply acquires or outsources (outside the Islands) R&D. Provided that the IP business is not in the high risk category, ‘exceptional case’ CIGA may be of application to IP business founded on acquired IP asset(s).

(b) Non-trade intangible:

(ii) Where the IP asset is a –

B. Non-trade intangible (including a trademark), branding, marketing and distribution

This CIGA refers to a relevant entity earning income from exploiting IP assets in the trademark category. In line with the general ES Test, the relevant entity will be required to demonstrate that it has conducted the branding, marketing and distribution activities with the adequate number of employees and operating expenditures and the adequate degree of control.

The CIGA required for both A and B above will depend on the nature of the asset and how that asset is being used to generate income for the relevant entity.

(c) Exceptional Cases:

In certain situations, a relevant entity may be able to prove it is conducting substantial activities even if this did not involve R&D (for patents and similar assets) or branding, marketing and distribution (for trademark IP assets) where it undertakes the CIGA as outlined in part (ii) of the definition below.

- (iii) In exceptional cases, except if the relevant activity is a high risk IP business, other core income generating activities relevant to the business and the IP assets, which may include –
- A. taking strategic decisions and managing (as well as bearing) the principal risks related to development and subsequent exploitation of the intangible asset generating income;
 - B. taking the strategic decisions and managing (as well as bearing) the principal risks related to acquisition by third parties and subsequent exploitation and protection of the intangible asset;
 - C. carrying on the underlying trading activities through which the tangible assets are exploited leading to the generation of income from third parties.

The definition makes clear that such situations will be the exception rather than the rule and that this provision does not apply in the case of high risk IP business (further details below). An example of where ‘exceptional case’ CIGA may apply is where a relevant entity purchases an already developed IP asset from a (non-Group) third party. At this stage in the life cycle of the IP asset, the R&D to create it has already occurred, rendering only the elements of exploitation, maintenance, protection and enhancement (i.e. subsequent development) of application.

As with all relevant activities the ES Test will be determined on a case by case basis however, the substantial activities requirements for IP income will always be insufficient if the relevant entity only passively holds IP assets created and exploited on the basis of decisions made and activities performed outside the Islands. Furthermore, the ES Test will never be met if the only activities contributing to the income are the periodic decisions of non-resident board members in the jurisdiction.

Source: Cayman Islands Economic Substance Guidance Notes v3.1, pages 74-76

High Risk IP

The ES Test is more difficult for IP businesses that are high risk.

“High risk intellectual property business” means an IP business carried on by an entity that –

- (a) did not create the IP in an IP asset that it holds for the purposes of its business;
- (b) acquired the IP 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

- (c) licenses the IP asset to one or more entities in the same Group to otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same Group.

“Group” in this context is defined as “a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange”.

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 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 [Tax Information Authority](#) (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 “DEMPE”) of the IP asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and/or perform their activities within the Islands.

A relevant entity will not be conducting high risk IP business where it is the sole creator of the IP asset and undertook the CIGA in the Islands. The Authority recognises that it is a question of fact as to who is the creator of an IP asset and that there may be more than one creator of such IP and creation may take place over time over the course of a chain of ownership. However, where there is more than one creator of the IP asset and the relevant entity entered into a cost sharing agreement this could be considered high risk IP business.

The Authority’s approach regarding the rebuttable presumption will be aligned with the policy articulated by the OECD Forum on Harmful Tax Practice in paragraphs 32 to 39 of their report; Resumption of application of substantial activities for no or nominal tax jurisdictions.

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.

As outlined above, periodic decisions by non-resident directors or board members, or local staff passively holding IP 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.

The Authority will systematically spontaneously exchange information provided to it by relevant entities carrying on high risk IP business in accordance with relevant international standards and scheduled agreements under the Tax Information Authority Act (2017 Revision) with other competent authorities.

The table in “Figure 4. Application of substance requirements for IP income” below provides an overview of the requirements as they apply for IP income and high risk IP business. In that table, reference to “foreign related parties” in the context of the higher risk scenario means an entity that is not incorporated or established in the Islands and that is in the same Group as the high risk IP company.

Figure 4. Application of substance requirements for IP income

Lower risk scenarios				Higher risk scenarios (i.e. involvement of foreign related parties)			
1. IP assets (e.g. patents and similar to patents) Substantial activity = R&D	+ Necessary staff, premises, equipment, expenditure, decision-making, etc.	+ <u>Filing information</u> Type A. Business type, gross income, expenses and assets, premises, employees, proof of CIGA, etc.	= <input checked="" type="checkbox"/>				
2. Other IP assets (e.g. trademarks) Substantial activity = branding and marketing	+ Necessary staff, premises, equipment, expenditure, decision-making, etc.	+ <u>Filing information</u> Type A. Business type, gross income, expenses and assets, premises, employees, proof of CIGA, etc.	= <input checked="" type="checkbox"/>				
3. In exceptional cases Substantial activity = Strategic decision-making, managing and bearing principal risks, underlying trading activities, etc.	+ Necessary staff, premises, equipment, expenditure, decision-making, etc.	+ <u>Filing information</u> Type A. Business type, gross income, expenses and assets, premises, employees, proof of CIGA, etc.	= <input checked="" type="checkbox"/>	3. In exceptional cases Substantial activity =	+ Necessary staff, premises, equipment, expenditure, decision-making, etc.	+ <u>Filing information</u> Type A. information PLUS Type B information:	= <input checked="" type="checkbox"/>
				<ul style="list-style-type: none"> High degree of DEMPE; & Full time highly skilled employees that permanently reside and perform CIGA in the Cayman Islands 		<ul style="list-style-type: none"> Detailed business plans Employee information Proof of decision making in jurisdiction 	
Scenarios which are <u>not</u> sufficient to meet substance requirements for IP income							
4. Merely passively holding the IP asset in the Islands			= <input type="checkbox"/>				
5. Periodic decisions of non-resident board members			= <input type="checkbox"/>				

Source: Cayman Islands Economic Substance Guidance Notes v3.1, pages 76-78

Economic Substance Reporting

Entities that are in-scope under the International Tax Co-operation (Economic Substance) Act (2021 Revision), as amended (the “ES Act”) (i.e. ‘relevant entities’ conducting ‘relevant activities’) will be required to report certain information on their relevant activities in the Cayman Islands, in particular the extent to which core income generating activities are being conducted in the Cayman Islands, on an annual basis to the Authority.

An Economic Substance Return (“ES Return”) must be submitted each year within twelve months of the relevant entity’s financial year end. Together with the ES Return, the entity will be required to upload appropriate documents (i.e. financial statements or books of account) that give a true and fair view of the state of the entity’s affairs and to explain its transactions.

Source: Cayman Islands Economic Substance Guidance Notes v3.1, page 28

Contact your Campbells attorney or regulation@campbellslegal.com if you have questions about Economic Substance Reporting.

For more information about Relevant Activity, CIGA, the ES Test and Economic Substance Reporting, please review the *Cayman Islands Economic Substance Guidance Notes v3.1* and additional DITC-issued Resources available [here](#).

Disclaimer

The contents of this website are not intended to constitute legal, tax, investment or other advice and you are advised to seek independent legal counsel regarding your particular circumstances.