

Economic Substance Requirements in the Cayman Islands

Service area / [Taxation and Economic Substance](#)

Location / [Cayman Islands](#)

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A. Introduction

Economic substance requirements have been introduced in the Cayman Islands (along with other no or nominal tax jurisdictions), commencing in 2019, for certain geographically mobile business activities (**relevant activities**), as part of the ongoing OECD/G20 project to combat Base Erosion and Profit Shifting. Introduction of such legislation by 2019 was required to avoid blacklisting on the EU's list of non-cooperative jurisdictions for tax purposes. The aim of the initiative is to stop businesses artificially shifting profits generated in one jurisdiction to another jurisdiction with lower or no taxation.

In the Cayman Islands, the economic substance requirements are set out in The International Tax Co-operation (Economic Substance) Law (as revised) (**ES Law**).

The ES Law is supplemented by guidance notes (**Guidance Notes**) issued by the Tax Information Authority of the Cayman Islands (**TIA**). The current version 3.0, issued on 13 July 2020, provides relevant entities with guidance on the practical steps they must take to comply with the economic substance test set out in the ES Law.

A flowchart to assist with understanding the obligations of an entity under the ES Law is set out in Schedule 1 (Application of the Economic Substance Law) and is based on the ES Law, Guidance Notes and the online portal that has been created for filing ES Notices (defined below).

B. Who does the ES Law apply to?

The ES Law only applies to incorporated entities (**corporate entities**), which include:

- Cayman Islands companies (other than domestic companies) incorporated under:
 - the Companies Law (as revised) (**Companies Law**); or
 - the Limited Liability Companies Law (as revised);
- Cayman Islands limited liability partnerships registered under the Limited Liability Partnership Law, 2017; and
- Non-Cayman Islands companies registered as foreign companies under the Companies Law.

All corporate entities are required to submit an annual notification (to the Registrar of Companies along with their annual return) regarding their status under the ES Law (**ES Notice**), but only corporate entities that are “relevant entities” will have reporting obligations.

The following corporate entities are not relevant entities:

- unincorporated entities;
- investment funds (including vehicles through which they invest);
- entities tax resident outside the Cayman Islands; and
- domestic companies.

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C. Who is excluded from the ES Law?

Unincorporated entities

Entities that are not incorporated, and therefore not listed in B above, are not corporate entities or relevant entities. For the avoidance of doubt, these include limited partnerships and trusts.

Investment funds

Investment fund is defined as *an entity whose principal business is the issuing of investment interests to raise funds or pool investor funds with the aim of enabling a holder of such an investment interest to benefit from the profits or gains from the entity's acquisition, holding, management or disposal of investments and includes an entity through which the investment fund directly or indirectly invests or operates (but not an entity that is itself the ultimate investment held), excluding certain types of licensed entity (banks, trust companies, insurance companies etc.).* **Investment interests** is defined as *a share, trust unit, partnership interest or other right that carries an entitlement to participate in the profits or gains of the entity.*

As noted in B above, investment funds are not relevant entities. The definition of investment fund encompasses pooled investment vehicles that may not typically be thought of as investment funds, such as securitization vehicles.

A corporate entity that is an investment fund must submit an ES Notice annually, claiming the exemption.

Entities tax resident outside the Cayman Islands

A corporate entity will not be a relevant entity in respect of a relevant activity if:

- it is subject to corporate income tax in another jurisdiction on **all** the income from the relevant activity;
- it is a “disregarded entity” for U.S. income tax purposes and has a U.S. corporation as its parent; or
- the relevant activity is carried on by a branch of the entity that is subject to corporate income tax in another jurisdiction on all its branch income.

The corporate entity will be required to file an annual verification form (available on TIA's website) and must produce evidence to TIA substantiating the exemption claimed, such as a Tax Identification Number, tax residence certificate or signed statement that a disregarded entity's income has been included on its U.S. parent's tax return, as applicable.

Domestic companies

A **domestic company** includes any company that is not part of an MNE Group and is:

- only carrying on business in the Cayman Islands in compliance with the local business licensing requirements set out in section 4(1) of the Local Companies (Control) Law (as revised) (**LCCL**) and section 3(a) of the Trade and Business Licensing Law (as revised) (**TBL**); or
- licensed as an association not for profit, pursuant to section 80 of the Companies Law.

The term **carrying on business in the Cayman Islands** has a number of exclusions for regulated activities, entities that have a principal office in the Cayman Islands but carry on all their business outside the Cayman Islands (**external business**), exempted or registered foreign entities carrying on business with other exempted or registered foreign entities in furtherance only of their external business, and concluding contracts etc. in the Cayman Islands in connection with external business. It follows that some businesses operating from premises in the Cayman Islands will not qualify as domestic companies; although they probably qualify if they hold a licence under the LCCL and/or TBL.

MNE Group means any Group that includes two or more enterprises for which the tax residence is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction; and **Group** means 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 exchange.

D. What are the relevant activities requiring economic substance?

Relevant entities are only required to satisfy the Economic Substance Test (**ES Test**) in respect of gross income (**relevant income**) from the following relevant activities:

- banking business;
- distribution and service centre business;
- financing and leasing business;
- fund management business;
- headquarters business;
- holding company business;
- insurance business;
- intellectual property business; and
- shipping business.

Continued

The definition and economic substance required in respect of each relevant activity are set out in Schedule 2 (Relevant Activities).

A relevant entity that carries on more than one relevant activity is required to satisfy the ES Test separately for each relevant activity.

E. Economic Substance Test

The ES Test requires that a relevant entity carrying on a relevant activity during a financial year:

- conducts in the Cayman Islands all core income generating activities (**CIGA**) relating to the relevant activity;
- is directed and managed in an appropriate manner in the Cayman Islands in relation to the relevant activity; and
- having regard to the level of relevant income derived from the relevant activity carried out in the Cayman Islands:
 - has incurred adequate operating expenditure in the Cayman Islands;
 - has an adequate physical presence (including maintaining a place of business or plant, property and equipment) in the Cayman Islands; and
 - has an adequate number of full-time employees or other personnel with appropriate qualifications in the Cayman Islands.

An abbreviated ES Test applies to pure equity holding companies, while presumptions of non-compliance are applied to relevant entities carrying on high risk intellectual property business.

If a relevant entity receives no relevant income from a relevant activity during a financial year the ES Test will not apply, but it must still file a nil return with TIA.

Adequate and appropriate

For purposes of the ES Test:

- **adequate** means *as much or as good as necessary for the requirement or purpose*; and
- **appropriate** means *suitable or fitting for a particular purpose, person or occasion*.

The directors (or equivalent) of a relevant entity should consider and determine in good faith what is adequate and appropriate on the facts of the particular relevant entity and its business activities. They must maintain appropriate records to demonstrate that resources utilised and expenditures incurred are adequate and appropriate.

Directed and managed

A relevant entity will be directed and managed in an appropriate manner in the Cayman Islands in relation to a relevant activity if:

- its board of directors (or equivalent) collectively has appropriate knowledge and expertise to discharge its duties (in the case of corporate directors, this requirement applies to the individual officers of the corporate director actually performing its duties);
- meetings of the board of directors (or equivalent) are held in the Cayman Islands at adequate frequencies given the level of decision making required (with a quorum of directors present in the Cayman Islands) and minutes of such meetings record the making of strategic decisions at the meeting; and
- all minutes of board meetings (or equivalent) and other appropriate records are kept in the Cayman Islands.

F. Outsourcing

A relevant entity may outsource its CIGA in respect of a relevant activity to another person in the Cayman Islands, provided the relevant entity is able to monitor and control that person's carrying out of the CIGA (e.g. to ensure they are actually carried out in the Cayman Islands). For the avoidance of doubt, activities that are not CIGA (i.e. not of central importance in generating relevant income, such as payroll and other back office functions) may be outsourced to service providers outside the Cayman Islands.

Only the activities of the service provider attributable to generating income for the relevant entity will be taken into account for purposes of satisfying the ES Test.

For purposes of the ES Test, the resources of the service provider in the Cayman Islands will be taken into account in satisfying the people and premises test. The service provider's employees can be counted as employees of the relevant entity, but only the time of employees directly used in service of the relevant entity, which must be verifiable (through timesheets etc.), may be counted and there must be no double counting of an employee's time.

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G. Commencement dates

A relevant entity must satisfy the ES Test in respect of any relevant activity:

- from 1 July 2019 if it existed prior to 1 January 2019; or
- from commencement of the relevant activity if it did not exist prior to 1 January 2019.

H. Notifications and Reporting

From 2020, each corporate entity is required to submit an ES Notice to the Registrar of Companies annually. Until it submits an ES Notice it cannot file its annual return, so a failure to submit would result in penalties for late filing of the annual return. The ES Notice must state in respect of the financial period that commenced in the preceding year:

- if it carried on a relevant activity;
- if so, if it is a relevant entity;
- if it is a relevant entity that carried on a relevant activity subject to tax outside the Cayman Islands, certain prescribed details; and
- if it is a relevant entity that carried on a relevant activity: (i) the date of its financial year end; and (ii) the name and address of its officer responsible for providing information to TIA.

A relevant entity carrying on a relevant activity that is required to satisfy the ES Test must prepare and submit a report in a prescribed format in respect of the relevant activity detailing the relevant income and associated expenditure and assets etc. (**ES Report**).

ES Reports must be filed with TIA within 12 months of the end of the relevant financial year, with the first ES Reports due for financial years that commenced in 2019.

If an ES Report contains details of outsourcing of CIGA to any person, that person will have 30 days to verify the information to TIA.

Failure to submit an ES Report when required to do so, may result in a penalty of CI\$5,000 (US\$6,250) plus an additional penalty of CI\$500 (US\$625) for each day the failure continues.

I. Consequences of failure to satisfy the ES Test

If TIA determines that a relevant entity has failed to satisfy the ES Test in relation to a financial year, it shall issue a notice to the relevant entity of such failure stating:

- reasons for the determination;
- actions to be taken to satisfy the ES Test and by when;
- the penalty of CI\$10,000 (US\$12,500) and the deadline for payment; and
- the right to appeal to the Grand Court within 28 days.

If in respect of the financial year following such a determination, TIA again determines that the relevant entity has failed to satisfy the ES Test, it shall issue a further notice to the relevant entity of such failure stating:

- reasons for the determination;
- actions to be taken to satisfy the ES Test and by when;
- the penalty of CI\$100,000 (US\$125,000) and the deadline for payment;
- that it will report the failure to the Registrar of Companies; and
- the right to appeal to the Grand Court within 28 days.

If the Registrar of Companies receives a report of a subsequent failure to meet the ES Test, it shall apply to the Grand Court for an order, and if the Grand Court is satisfied of the failure it can make such order as it sees fit, which may include requiring the relevant entity to take specific actions to satisfy the ES Test or declaring that the relevant entity is defunct and should be struck off.

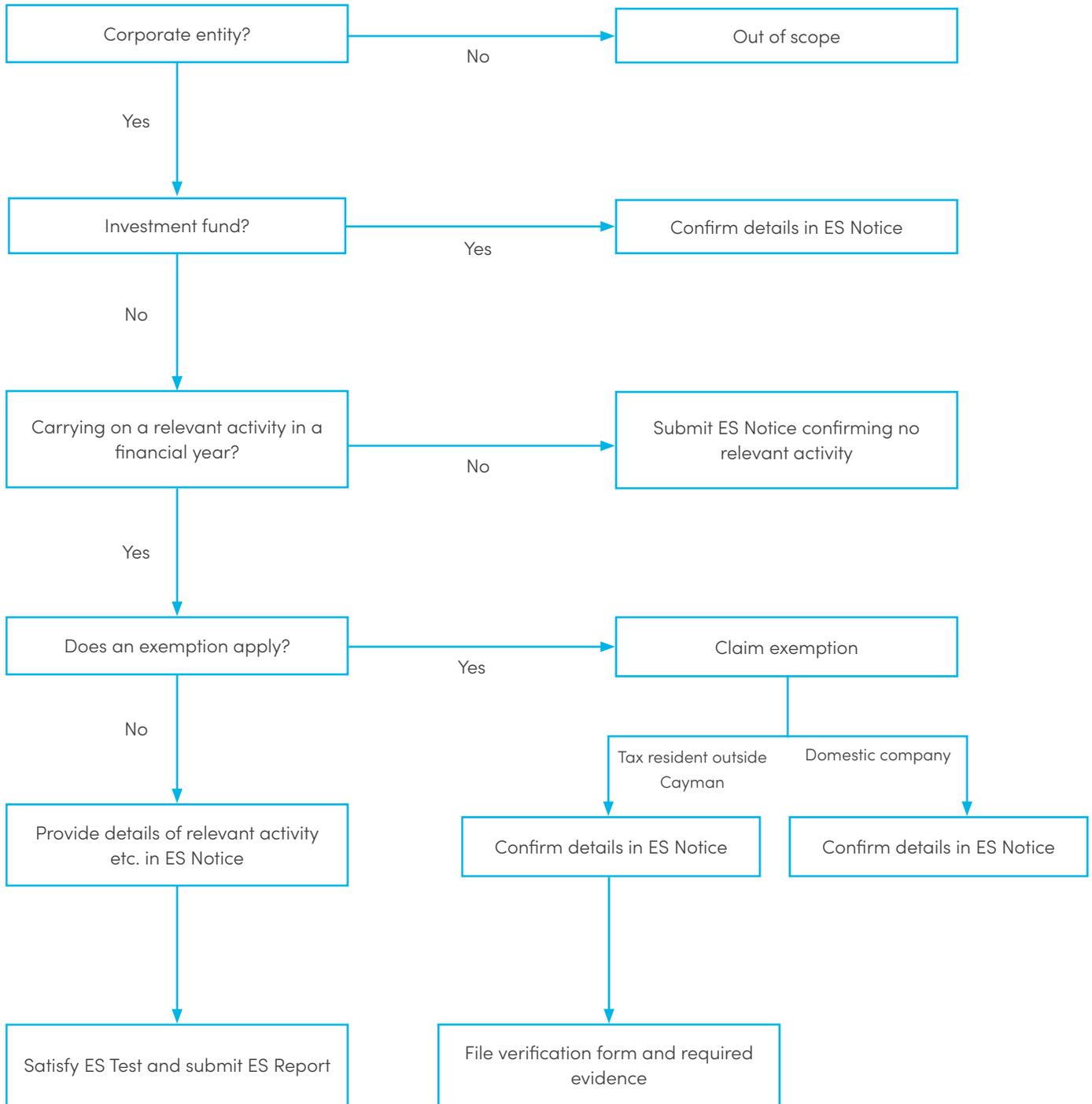
J. Relevant entities in liquidation

The obligations to satisfy the ES Test and to notify and report to TIA continue during liquidation of a relevant entity so long as it continues to carry on a relevant activity. However, if a relevant entity dissolves or completes its winding up prior to the date when notification and/or reporting is possible in respect of a financial year, such notification and/or reporting is not required. Liquidators must ensure the relevant entity's records are maintained for 6 years after its dissolution.

Continued

Schedule 1

(Application of the Economic Substance Law)



Continued

Schedule 2 (Relevant activities)

A. Banking business

Definition: the business of receiving (other than from a bank or trust company) and holding on current, savings, deposit or other similar account money which is repayable by cheque or order and may be invested by way of advances to customers or otherwise.

Domestic company exemption?

Any banking business carried on by a Cayman Islands company or by any person in or from within the Cayman Islands would require a licence from the Cayman Islands Monetary Authority (**CIMA**) under the Banks and Trust Companies Law (as revised).

A company holding a banking licence will only qualify as a domestic company (in which case it would not be a relevant entity) if it is actually carrying on business in the Cayman Islands (i.e. dealing with the public in the Cayman Islands and not just transacting with other Cayman Islands banks, exempted entities or persons outside the Cayman Islands). In practice, this means that holders of category "B" banking licences will not qualify as domestic companies, while holders of category "A" banking licences may qualify.

Core Income Generating Activities

If a relevant entity is carrying on banking business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- raising funds, managing risk including credit, currency and interest rate risk;
- taking hedging positions;
- providing loans, credit or other financial services to customers; and
- managing capital and preparing reports or returns, or both, to investors or CIMA, or both.

B. Distribution and service centre business

Definition: the business of either or both of the following:

- a. purchasing from an entity in the same Group:*
- i. component parts or materials for goods; or
 - ii. goods ready for sale, and reselling such component parts, materials or goods outside the Cayman Islands;
- b. providing services to an entity in the same Group in connection with the business outside the Cayman Islands, but does not include any activity included in any other relevant activity except holding company business.

***Group** means 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.

Intra-Group services

While part (a) of the definition only relates to transfers of physical goods between Group entities, part (b) will capture most intangible services provide intra-Group, such as administrative and consulting services, except for activities falling within other relevant activities, such as intra-Group lending or Group management.

Core Income Generating Activities

If a relevant entity is carrying on distribution and service centre business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- transporting and storing goods, components and materials;
- managing stocks;
- taking orders; and
- providing consulting or other administrative services.

C. Financing and leasing business

Definition: the business of providing credit facilities for any kind of consideration to another person but not including financial leasing of land or an interest in land, banking business, fund management business or insurance business.

Intra-Group and third party lending

It is important to bear in mind that intra-group lending, as well as lending to third parties, will fall within the scope of this relevant activity. Many types of transaction are structured with intra-group loans, and any such loans from a relevant entity could fall within this relevant activity.

Core Income Generating Activities

If a relevant entity is carrying on financing and leasing business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- negotiating and agreeing funding terms;
- identifying and acquiring assets to be leased;
- setting the terms and duration of financing or leasing; and
- monitoring and revising financing or leasing agreements and managing risks associated with such financing or leasing agreements.

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D. Fund management business

Definition: the business of managing securities* as set out in paragraph 3 of Schedule 2 to the Securities Investment Business Law (as revised) (SIBL) carried on by a relevant entity licensed or otherwise authorised to conduct business under that law for an investment fund.

***managing securities** means managing securities** belonging to another person in circumstances involving the exercise of discretion.

****securities** means any of the assets, rights or interests specified in Schedule 1 to SIBL. This encompasses all types of stocks and shares, limited partnership interests, trust units, debt instruments, warrants and options relating to securities, futures contracts and contracts for differences as well as digital tokens representing or convertible into any of the foregoing.

Licensed or otherwise authorised

Relevant entities that are licensed by or registered with the Cayman Islands Monetary Authority (CIMA) under SIBL as discretionary managers of securities will be carrying on fund management business if they manage the securities of an investment fund. Note that if they are only dealing, arranging deals or advising on deals in securities, they will be out of scope, notwithstanding their licensed or registered person status under SIBL. Relevant entities that were managing securities for investment funds and were registered as excluded persons under SIBL prior to the termination of that regime, will be out of scope for the period when they were so registered.

Core Income Generating Activities

If a relevant entity is carrying on fund management business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- taking decisions on the holding and selling of investments;
- calculating risk and reserves;
- taking decisions on currency or interest fluctuations and hedging positions; and
- preparing reports or returns, or both, to investors or CIMA, or both.

E. Headquarters business

Definition: the business of providing any of the following services to an entity in the same Group:*

- a. the provision of senior management;
- b. the assumption or control of material risk for activities carried out by any of those entities in the same Group; or
- c. the provision of substantive advice in connection with the assumption or control of risk referred to in paragraph (b),

but does not include banking business, financing and leasing business, fund management business, intellectual property business, holding company business or insurance business.

***Group** means 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.

Core Income Generating Activities

If a relevant entity is carrying on fund headquarters business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- taking relevant management decisions;
- incurring expenditures on behalf of other Group entities; and
- co-ordinating Group activities.

F. Holding company business

Definition: the business of a pure equity holding company; meaning a company that only holds equity participations in other entities and only earns dividends and capital gains.

Reduced ES Test

A relevant entity only carrying on a relevant activity that is the business of a pure equity holding company is subject to a reduced ES Test if it confirms that:

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

*It is unclear if this means that LLCs and LLPs cannot qualify as pure equity holding companies. We do not believe this is the intention, notwithstanding the failure to refer to their governing laws.

**If the relevant entity is passively holding interests in other entities, it may satisfy these requirements merely by maintaining its registered office with a Cayman Islands registered office provider.

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G. Insurance business

Definition: *the business of accepting risks by effecting or carrying out contracts of insurance, whether directly or indirectly, and includes running-off business including the settlement of claims.*

Domestic company exemption?

Any insurance business carried on by a Cayman Islands company or by any person in or from within the Cayman Islands would require a licence from the *Cayman Islands Monetary Authority (CIMA)* under the *Insurance Law (as revised)*.

A company holding an insurance licence will only qualify as a domestic company (in which case it would not be a relevant entity) if it is actually carrying on business in the Cayman Islands (i.e. dealing with the public in the Cayman Islands and not just transacting with exempted entities or persons outside the Cayman Islands). In practice, this means that class A and class D insurers carrying on business in the Cayman Islands may qualify as domestic companies, while class B insurers will not, and for class C insurers it is unlikely.

Core Income Generating Activities

If a relevant entity is carrying on insurance business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- predicting or calculating risk or oversight of prediction or calculation or risk;
- insuring or re-insuring against risk; and
- preparing reports or returns, or both, to investors or CIMA, or both.

H. Intellectual property business

Definition: *the business of holding, exploiting or receiving income from intellectual property assets.**

***Intellectual property asset** means an intellectual property right including a copyright, design right, patent and trademark.

Core Income Generating Activities

If a relevant entity is carrying on intellectual property business, it must carry on any CIGA relating to that activity in the Cayman Islands. Unless it is a high risk intellectual property business (see below), this will include any of the following activities that it actually undertakes:

- where the intellectual property asset is a patent or an asset that is similar to a patent: research and development; and
- where the intellectual property asset is a non-trade or intangible (including a trademark): branding, marketing and distribution.

High risk intellectual property business

Holding and licensing intellectual property in preferential tax regimes to artificially shift profits within multi-national groups was one of the main targets of the BEPS project. In preferential tax regimes it was possible to implement a “nexus” test, where only income from intellectual property generated in the jurisdiction could benefit from preferential tax treatment and any other income had to be taxed at the standard higher rate in that jurisdiction. Of course, this can’t be implemented in no tax and nominal tax jurisdictions, so the OECD has imposed the standard ES Test above with a carve out for **high risk intellectual property business**, defined as:

Intellectual property business carried on by an entity that:

- did not create the intellectual property in an intellectual property asset that it holds for the purpose of its business,*
- acquired the intellectual property asset:*
 - from an entity in the same Group;* or*
 - in consideration for funding research and development by another person situated in a country or territory other than the Cayman Islands; and*
- licenses the intellectual property asset to one or more entities in the same Group or otherwise generates income from the asset in consequence of activities (such as facilitating sale agreements) performed by entities in the same Group.*

***Group** means 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 carrying on high risk intellectual property business is presumed not to satisfy the ES Test for a financial year, even if carrying on its CIGA in the Cayman Islands (as above).

The presumption can be rebutted by the relevant entity if it can produce evidence that there is, and has historically been, a high degree of control over the development, exploitation, maintenance, protection and enhancement of the intangible asset, exercised by an adequate number of full-time employees with the necessary qualifications that permanently reside and perform their activities in the Cayman Islands. The evidential threshold requires:

- detailed business plans demonstrating the commercial rationale for holding the intellectual property assets in the Cayman Islands;
- employee information, including level of experience, type of contracts, qualifications and duration of employment; and
- evidence that decision making is taking place within the Cayman Islands; and
- any other information reasonably required by TIA.

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I. Shipping business

Definition: any of the following activities involving the operation of a ship anywhere in the world other than in the territorial waters of the Cayman Islands or between the Cayman Islands:

- a. the business of transporting, by sea, passengers or animals, goods or mail for a charge;
- b. the renting or chartering of ships for the purpose described in (a);
- c. the sale of travel tickets and ancillary ticket related services connected with the operation of a ship;
- d. the use, maintenance or rental of containers, including trailers and other vehicles or equipment for the transport of containers, used for the transport of anything by sea; or
- e. the functioning as a private seafarer recruitment and placement service,

but does not include a holding company business or the owning, operating or chartering of a pleasure yacht.*

***pleasure yacht** includes a pleasure vessel** and any vessel to which regulations made in respect of vessels in commercial use for sport or pleasure are stated to apply.

****pleasure vessel** means:

- a. a vessel which at the time it is being used is:
 - in the case of a vessel wholly owned by an individual or individuals, used only for the sport or pleasure of the owner or the immediate family or friends of the owner;
 - in the case of a vessel owned by a body corporate, one on which the persons on the vessel are employees, officers or shareholders (including beneficial owners of shares) of the body corporate, or their immediate family or friends; or
 - in the case of a vessel owned by a trust or other ownership arrangement, one on which the persons on the vessel are beneficiaries under the trust or beneficial owners of the ownership arrangement, or their immediate family or friends; and
 - in private use; or
- b. a vessel wholly owned by or on behalf of a club formed for the purpose of sport or pleasure which, at the time it is being used, is used only for the sport or pleasure of members of the club or their immediate family, and for the use of which any charges levied are paid into club funds and applied for the general use of the club; and

In this definition “immediate family” means, in relation to an individual, the husband or wife of the individual, or a relative of the individual, or of the individual’s husband or wife; “relative” means brother or sister, ancestor or lineal descendant; “owner” includes charterer; and “private use” means that the vessel is used on a private voyage or excursion, and during such use is not engaged in trade by transporting merchandise or carrying

passengers for reward or remuneration (other than as a contribution to the actual cost of the vessel or its operation for the period of the voyage or excursion), and is not offered to the public for use.

Core Income Generating Activities

If a relevant entity is carrying on shipping business, it must carry on any CIGA relating to that activity in the Cayman Islands. This will include any of the following activities that it actually undertakes:

- managing crew (including hiring, paying and overseeing crew members) (including compliance with the Maritime Labour Convention, 2006 by a ship owner or a private seafarer recruitment and placement service);
- overhauling and maintaining ships (including procuring and/or overseeing the overhauling and maintaining of ships);
- overseeing and tracking deliveries (including tracking package and cargo deliveries as part of the business services of a vessel); and
- determining what goods to order and when to deliver them, organizing and overseeing voyages (including carrying out these activities by an agent or manager).

Performance in transit

It is recognised that given the nature of shipping business, significant Cayman Islands CIGA may be performed in transit outside the Cayman Islands rather than from a fixed location within the Cayman Islands. Accordingly, a relevant entity carrying on shipping business may satisfy the ES Test by having Cayman Islands CIGA undertaken by the master of a ship.

Employment of seafarers

Employment of seafarers by a company, or other ownership structure owned by a ship-owner solely to crew vessels owned by the ship-owner does not constitute functioning as a private seafarer recruitment and placement service.

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