

CLIENT ALERT

Implications of the Cayman Islands' Inclusion on EU Tax Blacklist

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On 18 February, the Council of the European Union (“**EU Council**”) updated its list of non-cooperative tax jurisdictions to include (among others) the Cayman Islands. The EU Council stated in its conclusions that *“the Cayman Islands does not have appropriate measures in place relating to economic substance in the area of collective investment vehicles”*.

The Cayman Islands passed legislation intended to meet the EU Council’s requirements on 31 January and the new law came into force on 7 February. Unfortunately, the new rules did not have effect by the cut-off date of 4 February when the recommendation for blacklisting by the EU Code of Conduct Group (“**COCG**”) was made. Despite the new legislation being in place and in force, the EU Council followed the recommendation of the COCG on 18 February.

It is understood that the Cayman Islands’ inclusion on the blacklist is because of a slipup rather than a fundamental issue with its tax regime or the legislation it has enacted. Its inclusion is consistent with the EU Council’s approach of using the list to ensure that the changes it requires are made within the timescales it demands, on the basis that any deviation is likely to have (potentially severe) consequences. We understand that, having picked up discussions with the EU following the blacklisting, the Cayman Islands government anticipates that it will be removed from the blacklist in October 2020 when the list is next revised.

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Consequences of blacklisting

UK's implementation of EU Directive 2011/16 on Administrative Cooperation ("DAC6")

DAC6 imposes reporting obligations on businesses and their advisers in respect of cross-border arrangements that meet one or more specified characteristics (referred to as hallmarks). In order for DAC6 to apply, at least one entity involved in the arrangements must be based in an EU country. Substantial penalties may be imposed on those that fail to comply.

The UK's implementation of DAC6 is due to take effect on 1 July 2020, with the first reports being made in August. Deductible cross-border payments between associated enterprises where one entity is located in a blacklisted jurisdiction are reportable under "hallmark C1(b)(ii)", irrespective of there being a tax advantage to the arrangement. Equivalent provisions may be triggered in other EU member states.

Even if the Cayman Islands is removed from the blacklist in October, a very large number of historical transactions with Cayman Islands entities are likely to be reportable in August. This imposes a significant compliance burden on European investors, investment funds and their advisers.

EU tax consequences

For now, the direct tax consequences of the Cayman Islands being on the blacklist are not so severe. However, EU member states have each committed to implementing at least one legislative tax defensive measure from the following list by 1 January 2021:

- Deny tax deductions for payments made to entities in blacklisted jurisdictions;
- Amend controlled foreign company regimes to better catch controlled companies in blacklisted jurisdictions or impose a higher tax rate if they are caught;
- Deny participation exemptions on distributions from entities in blacklisted jurisdictions; or
- Apply higher or impose new withholding taxes on payments made to entities in blacklisted jurisdictions.

No EU member state has yet implemented any new measures in response to this initiative.

French blacklist of non-cooperative jurisdictions

However, under pre-existing law, we should expect France to add the Cayman Islands to its domestic blacklist of non-cooperative jurisdictions by decree in the coming months.

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The effect of France's blacklisting of a jurisdiction depends on the EU's justification for its own blacklisting of that country. The most punitive implications are reserved for those jurisdictions that the EU has declared 'facilitate structures to attract profits that do not reflect real economic activity' and, in respect of payments to them, France imposes a 75% dividend withholding tax rate and disallows deductibility of interest payments. As the Cayman Islands has been blacklisted for reasons pertaining to economic substance, we do expect that these severe consequences would apply to payments out of France to entities in the Cayman Islands.

However, such is the pace of legislative change that there is a real possibility France will not update its blacklist again in 2020. If so, and the Cayman Islands is removed from the EU's blacklist in October, it could miss the next French update and escape this further blacklisting.

Parallel European investment structures – the way forward?

Multilateral cooperation is putting increasing pressure on offshore investment structures, even where they are intended only to be tax transparent and therefore tax neutral. It is no longer unusual for conservative European investors to request parallel EU investment structures, although as yet they are typically only offered at the behest of a cornerstone investor. However, we anticipate that, as the multilateral approach to tax avoidance becomes more sophisticated and the downside risk of negotiating offshore structures looms larger, fund managers will find the expense and aggravation of establishing such parallel structures increasingly worthwhile.

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