Implications of the EU blacklisting of Cayman Islands for businesses

March 3, 2020
Issue 3

In brief

On February 18, 2020, the European Union (EU) decided to include the Cayman Islands on its list of non-cooperative jurisdictions for tax purposes¹ (i.e. the EU blacklist) for the reason that "Cayman Islands does not have appropriate measures in place relating to economic substance in the area of collective investment vehicles" by the timeline set by the EU.

This News Flash discusses the circumstance leading to the blacklisting of the Cayman Islands, the response of the Cayman Islands Government and the implications of the blacklisting for businesses with Cayman entities in their group structures.

In detail

Latest update of the EU blacklist

On February 18, 2020, the Council of the EU decided to add the following four jurisdictions to the EU blacklist: (1) the Cayman Islands, (2) Palau, (3) Panama and (4) Seychelles due to the reason that these jurisdictions did not implement the tax reforms to which they had committed by the agreed deadline. After the revision, the EU blacklist currently contains 12 jurisdictions².

The response of the Cayman Islands Government

The Ministry of Finance Services of the Cayman Islands Government issued a media release on February 18, 2020 in response to the blacklisting³. The media release stated that "the Cayman Islands Government has already contacted EU officials to begin the process of being removed from the EU list of non-cooperative jurisdictions as soon as possible, which is understood to be October this year".

Based on the media release, it appears that the circumstance leading to the blacklisting of the Cayman Islands is because the Private Funds Law⁴ and the Mutual Funds (Amendment) Law⁵, which the Cayman Islands Government introduced to address the EU's concerns about the economic substance for collective investment vehicles (CIVs) / funds, did not come into force by February 4, 2020 – the date on which the EU's Code of Conduct (Business Taxation) Group met to review the EU blacklist. Both laws were passed on January 31, 2020 and came into force on February 7, 2020. As such, the blacklisting appears to stem from a timing issue only.
Implications of the EU blacklisting for businesses

As for the potential implications of the blacklisting for business groups with Cayman entities within their structures (e.g. a Cayman fund, fund manager or holding company), the EU has issued a guidance to its Member States on the tax and non-tax defensive measures to be implemented against the non-cooperative jurisdictions.6

1. Administrative defensive measures in the tax area

The EU recommends that Member States apply at least one of the following administrative defensive measures in the tax area to the non-cooperative jurisdictions:

- reinforced monitoring of certain transactions;
- increased audit risks for taxpayers benefiting from a regime in a blacklisted jurisdiction; and
- increased audit risks for taxpayers using structures or arrangements involving a blacklisted jurisdiction.

2. Legislative defensive measures in the tax area

The EU guidance also recommends that Member States adopt at least one of the following legislative defensive measures from January 1, 2021, without prejudice to the respective spheres of competence of the Member States to apply the measures:

- denying tax deduction for payments (e.g. interests, royalties and service fees) made to a blacklisted jurisdiction;
- amending the controlled foreign company (CFC) rules to target CFCs in a blacklisted jurisdiction;
- applying a higher withholding tax rate on payments (e.g. interest, royalties and service fees) made to a blacklisted jurisdiction; and
- denying or limiting the "participation exemption" for dividends or profits received from a blacklisted jurisdiction.

3. Additional tax reporting / disclosure

Potential additional reporting / disclosure of information for tax purposes arising from the blacklisting include:

- stricter reporting obligations under the EU’s Directive on Administrative Cooperation on the mandatory disclosure and automatic exchange of information in the field of taxation7 (the EU Mandatory Disclosure Regime or DAC6) – cross-border transactions involving a Cayman entity (e.g. a Cayman fund) may fall within the scope of "reportable cross-border arrangements" under DAC 6 and may need to be reported by taxpayers and intermediaries (e.g. tax advisors) to the relevant tax authorities. The information disclosed will then be automatically exchanged among EU Member States. The first reporting will be due on August 31, 2020 but the DAC6 provides that reporting should be made in respect of arrangements dated back to June 25, 2018.
- there could also be stricter reporting requirements for businesses transacting with entities in the blacklisted jurisdictions under the EU’s public Country-by-Country Reporting proposal.

4. Defensive measures in non-tax areas

Other non-tax defensive measures towards the blacklisted jurisdictions recommended by the EU include denial of access to EU financing and funding (i.e. EU external development and investment funds may not be channelled through entities in the blacklisted jurisdictions) and Member States to take into account the EU blacklist as appropriate in foreign policy, economic relations and development cooperation with the relevant third jurisdictions.

The way forward

As the inclusion of the Cayman Islands on the EU blacklist seems to stem primarily from a timing issue rather than a substantive technical issue, and that the Cayman Islands Government has already approached the EU to start the delisting process, the blacklisting could be temporary. The Cayman Islands may be removed from the EU blacklisting during the next review of the list, which is scheduled to take place in October 2020.

Given that the EU only recommends implementing the legislative defensive tax measures mentioned in (2) above from January 1, 2021 and there are currently no targeted or direct sanctions imposed by EU Member States on the Cayman Islands as a result of the blacklisting, there may not be any significant real impact on the use of Cayman entities within a business structure from a short-term perspective. The actual impact of the defensive measures will also very much depend on how and when
individual EU Member States implement those measures. The more relevant immediate implications of the blacklisting for Cayman funds or business groups with Cayman entities may be the concerns of investors (e.g. investors from the EU) about the potential reputational risks of investing in a Cayman fund or dealing with a Cayman entity, and the stricter reporting requirements under DAC6.

The takeaway

While the inclusion of the Cayman Islands in the EU blacklist could be temporary and significant short-term impact of the blacklisting on the use of a Cayman domiciled vehicle is not anticipated, Cayman fund groups or other business groups with Cayman entities within their group structures should effectively communicate with their investors / stakeholders to ensure that they are well informed of this development and in particular, the real practical implications of the blacklisting. They should also closely monitor any future developments in this area, perform an impact assessment as appropriate and consider options for alternative holding/business structures where necessary.

Endnotes

1. The revised EU list of non-cooperative jurisdictions for tax purposes can be accessed via this link (Annex 1 is the blacklist and Annex 2 is the grey list: https://www.consilium.europa.eu/media/42596/st06129-en20.pdf

2. The 12 jurisdictions on the EU blacklist are: American Samoa, Cayman Islands, Fiji, Guam, Oman, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, US Virgin Islands and Vanuatu.

3. The media release can be accessed via this link: https://www.mfs.ky/news/cayman-contacts-eu-to-begin-the-delisting-process/

4. The Private Funds Law, 2020 can be accessed via this link: https://www.cima.ky/upimages/commonfiles/PrivateFundsLaw2020_1581524961.PDF

5. The Mutual Funds (Amendment) Law, 2020 can be accessed via this link: https://www.cima.ky/upimages/commonfiles/MutualFundsAmendmentLaw2020_1581524462.PDF


Let’s talk
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