

The European Union Blacklists the Cayman Islands

February 19, 2020

On February 18, 2020, the ECOFIN group included the Cayman Islands in the European Union's list of non-cooperative third country jurisdictions (the "EU Blacklist"). This action may (i) affect the tax treatment of income streams sourced in or flowing to the Cayman Islands; as well as (ii) trigger ad hoc reporting obligations.

In addition, because of the implications of the Cayman Islands' demotion to the EU Blacklist in the various EU Member States and, in any event, given the expected reputational impact, it is possible that the Cayman Islands' blacklisting may dissuade the use of Cayman Islands entities. If the Cayman Islands do not take measures to put an end to the blacklisting, the blacklisting may also encourage established businesses having material interactions with the European Union to assess the potential consequences thereof and to eventually consider moving to non-blacklisted jurisdictions. If the Cayman Islands take all the necessary measures to put an end to the blacklisting, they could be removed from the EU Blacklist in the next update which is expected in October 2020.

This note provides some background on the EU Blacklist, discusses the implication of the EU Blacklist inclusion and then takes a more in-depth look at the impact on some of the European major economies (France, Germany, Italy and the United Kingdom).

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:

ROME

Vania Petrella
+39 06 6952 2204
vpetrella@cgsh.com

Paola Albano
+39 06 6952 2637
palbano@cgsh.com

PARIS

Anne-Sophie Coustel
+33 1 40 74 68 17
acoustel@cgsh.com

Cécile Mariotti
+33 1 40 74 68 14
cmariotti@cgsh.com

LONDON

Richard Sultman
+44 20 7614 2271
rsultman@cgsh.com

Jennifer Maskell
+44 20 7614 2325
jmaskell@cgsh.com

FRANKFURT

J.F. Daniel Weyde
+49 69 97103 127
jweyde@cgsh.com

Jens Hafemann
+49 69 97103 251
jhafemann@cgsh.com



I. Background

The blacklisting of the Cayman Islands resulted from a 2016 initiative by the EU Code of Conduct Group on Business Taxation, a working group set up by the ECOFIN,¹ to encourage good tax governance and transparency outside the European Union. The screening process performed by that group prompted the publication of both the EU Blacklist and a grey list (the “EU Grey List”) in December 2017. The EU Blacklist comprises jurisdictions labeled as non-cooperative on the grounds that they are not complying with international standards of tax transparency, fair tax competition and/or anti-BEPS measures’ implementation. By contrast, the EU Grey List identifies jurisdictions which raise concerns but are committed to adopt acceptable tax governance standards no later than 2018 (or 2019 for certain jurisdictions). The Code of Conduct Group has been monitoring the progress made by the EU Grey-listed countries and periodically updating the EU Blacklist.

In 2017, the Cayman Islands were included in the EU Grey List because they were perceived to facilitate offshore structures that would attract profits away from other taxing authorities notwithstanding the lack of a real economic activity. Since then, the Cayman Islands did adopt a number of legislative measures to respond to that criticism, including the International Tax Co-Operation (Economic Substance) Law which provides for reporting an “economic substance” requirement for certain entities conducting activities in the Cayman Islands. However, these measures were not deemed sufficient to meet the minimum EU standards.

II. What Are The Main Implications of an EU Blacklist Inclusion?

EU Member States are generally required to adopt a number of effective and proportionate tax and non-tax measures to discourage non-cooperative practices of countries that are on the EU Blacklist. However,

where such measures are construed on criteria other than mere blacklisting (such as minimum taxation levels not being met) or there are information exchange agreements in force, inclusion in the EU Blacklist may not necessarily trigger negative tax consequences.

Tax Measures

In December 2019, the ECOFIN group approved recommendations by the Code of Conduct Group that EU Member States should introduce no later than January 2021 at least one of the following measures in connection with both (i) income sourced in a country that is on the EU Blacklist and (ii) income earned by a taxpayer resident or located in a country that is on the EU Blacklist:

- Deny the allowance of any expense otherwise deductible (such as interest, royalties or service fees);
- Withhold taxes on outbound payments at higher rates;
- Apply CFC rules;
- Deny or limit access to beneficial regimes, such as the participation exemption.

Non-Tax Measures

Inclusion in the EU Blacklist also entails:

- Denied access to the European Fund for Sustainable Development (EFSD), the European Fund for Strategic Investment (EFSI) or the External Lending Mandate (ELM) financings;
- Possible reporting consequences pursuant to DAC6. The EU Council Directive 2011/16 in relation to cross-border tax arrangements, known as DAC6, has been in force since June 25, 2018 but will go live on July 1, 2020 on a retroactive basis. DAC6 aims at transparency and fairness in taxation by ensuring full disclosure to EU tax authorities of cross-border tax arrangements which

¹ The ECOFIN is the Economic and Financial Affairs Council of the European Union and is composed of the finance and economic ministers of the EU members States.

meet one or more specified characteristics (hallmarks) and which concern either more than one EU country or an EU country and a non-EU country. One such hallmark applies in the case of arrangements involving deductible cross-border payments made between certain kinds of associated enterprises, where the recipient of the payment is resident for tax purposes in a jurisdiction on the EU Blacklist. Failure to comply with DAC6 could mean facing significant sanctions under domestic law in EU countries and reputational risks for businesses, individuals and intermediaries.

III. What Happens in France, Germany, Italy and the United Kingdom?

The lack of conventions for the avoidance of double taxation between all the EU Member States and the Cayman Islands implies that domestic tax rules apply in full.

While the consequences of the Cayman Islands' demotion to the EU Blacklist will depend on the specific domestic provisions enacted by each EU Member State against uncooperative countries, it is worth noting that the application of the required counter-measures may not be automatic but rather result from the absence of information exchange agreements or other criteria.

France

In France, the Cayman Islands' inclusion in the EU Blacklist should result in their being automatically included in the French non-cooperative jurisdictions list (the "French Blacklist") which could lead to the application of the French specific anti-evasion rules applicable to income accrued, paid or earned in non-cooperative jurisdictions. The inclusion of the Cayman Islands in the French Blacklist will not become effective until the first day of the month following the publication of an updated French

Blacklist (in the form of a ministerial executive order). If the Cayman Islands were removed from the EU Blacklist before the update of the French Blacklist (as it was the case for the UAE recently), it may be that in practice they would never be included in the French Blacklist.

The French tax consequences of being included in the French Blacklist as a result of being included in the EU Blacklist depend on the reasons for such inclusion. The consequences would be more severe for the Cayman Islands as they were included in the EU Blacklist because of their non-compliance with the EU test relating to the facilitation of offshore structures or arrangements aimed at attracting profits which do not reflect real economic activity. In this situation, *all* the French punitive measures apply.²

Assuming the French Blacklist is updated to include the Cayman Islands, we expect the following implications and subject to the application of safe harbor provisions that vary depending on the anti-evasion rule concerned (*e.g.*, where the concerned taxpayer is able to prove the absence of tax fraud purpose or that the purpose of a transaction involving a blacklisted jurisdiction is not mainly to transfer income in such jurisdiction):

- Income of a Cayman Islands entity (including Cayman Islands limited partnerships):
 - The application of a 75% withholding tax on French source income (interest, royalties, service fees, dividends, capital gains) paid to a Cayman Islands entity irrespective of the ownership threshold;
 - The non-deductibility of interest income, royalties and service fees paid to a Cayman Islands entity if not subject to a minimum taxation. The disallowed amounts would be treated as deemed distributions subject to 75% withholding tax;

² Where a state or a territory is included on the EU Blacklist for reasons other than the facilitation of structures or arrangements aimed at attracting profits which do not reflect real economic activity,

consequences are more or less limited to the non-deductibility of interest expenses, royalties or service fees paid to a non-cooperative jurisdiction.

- The taxation of capital gains on the sale of French shares, irrespective of the ownership percentage;
- Income of a French taxpayer from the Cayman Islands:
- The exclusion from the benefit of the parent-subsidiary regime in France for dividends paid by a Cayman Islands entity;
 - The exclusion from the benefit of the participation exemption regime in France for the capital gains resulting from the disposal of the shares of a Cayman Islands entity;
 - This would also lead to more stringent French CFC rules for both individuals and corporates holding interests in Cayman Islands entities (whether directly or indirectly) and also enhance transfer pricing requirements, including more burdensome reporting obligations.

Regardless of the inclusion of the Cayman Islands in the French Blacklist, this should trigger DAC6 reporting obligations, once reports are due.

Germany

Germany enacted legislation that provides for the above-mentioned counter-measures against uncooperative countries. However, their application is not automatically linked to an inclusion in the EU Blacklist but rather to the absence of information exchange agreements. As of 2010, Germany has an information exchange agreement in place with the Cayman Islands.

Accordingly, based on the current German tax landscape, the inclusion of the Cayman Islands in the EU Blacklist has limited practical effects in Germany. It should, however, trigger only DAC6 reporting obligations once reports are due.

Italy

The Italian system mimics the German one.

Italy has an information exchange agreement with the Cayman Islands as of 2015 and, as of 2017, the

Cayman Islands are included in the Italian list of countries or territories allowing for an adequate exchange of information.

In other words, the only immediate consequence in Italy given the current legislative setting would be related to DAC6 reporting once reports are due.

The United Kingdom

Based on current UK laws, the inclusion of the Cayman Islands in the EU Blacklist has limited practical effect in the United Kingdom; for tax purposes, the only immediate consequence should be DAC6 reporting obligations once reports are due.

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