Q&A

The Cayman Islands and the EU 'blacklist'

Speed read

On 18 February, the EU Council confirmed that the Cayman Islands had been added to the EU's official list of non-cooperative jurisdictions for tax purposes, commonly referred to as the 'EU blacklist'. This is a significant development, but, except in limited circumstances, in the short term it is not expected to give rise to any immediate adverse tax consequences. Any longer-term impact will depend both on (i) whether this turns out to be a temporary or more permanent status and (ii) investor perceptions, particularly for EU based investors.

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What is the EU blacklist?

The stated purpose of the EU blacklist is to assist EU member states in taking a more robust approach towards jurisdictions which are perceived to be encouraging so-called abusive tax practices. Abusive tax practices are regimes which provide for a low or zero rate of tax without requiring a sufficient degree of connection to, or substance in, the relevant jurisdiction, or which do not provide for an adequate degree of transparency, or which do not correspond to internationally accepted principles of profit determination.

Why has the Cayman Islands been added to the blacklist?

Although the Cayman Islands has recently introduced economic substance requirements for certain Cayman entities, the EU Council stated that the Cayman Islands does not have appropriate measures in place, specifically in the area of collective investment schemes. It has been reported by Cayman Islands sources that the decision, announced on 18 February, may not reflect laws passed by the Cayman Islands on 31 January this year which only came into effect on 7 February, but it is not yet entirely clear whether the EU considers these adequate or whether further reforms will be required.

What are the consequences?

Access to EU governmental funding may be restricted, although this is unlikely to be material to commercial clients. There may also be increased administrative disclosures required in EU member states in relation to transactions involving Cayman entities (for example, targeted questions in EU member state tax returns, or increased requirements for reports under the 'DAC 6' mandatory disclosure regime). Otherwise, the EU has recommended that member states implement at least one of four possible defensive tax measures by 1 January 2021:

- withholding taxes on payments from entities in EU member states to blacklisted jurisdictions;
- loss of tax deductions on payments from entities in EU member states to blacklisted jurisdictions;
- enhanced requirements for CFC inclusion under the laws of EU member states of the profits of entities in blacklisted countries; and
- loss of participation exemption benefits on profits distributed from blacklisted countries.

However, EU member states are not currently obliged to follow that recommendation and, to date, we are not aware of a significant movement among member states to implement any of these measures (including with respect to existing EU blacklisted countries), albeit that we understand that the EU listing may have the consequence of the Cayman Islands being added to the French tax system's list of non-cooperative states and territories, and also that the Dutch CFC regime does make specific reference to the EU blacklist (as well as the Netherlands' own blacklist, which already includes the Cayman Islands).

Nevertheless, the EU Council has stated that a review of member state implementation of defensive tax measures will begin by July 2021 at the latest and that, during 2022, it will assess whether to require more coordinated action from member states.

Any immediate consequences for the funds industry?

It is unlikely that there will be any immediate tax impact for fund structures which include Cayman entities. The most significant of the EU recommended measures – imposition of withholding taxes and loss of deductions – might typically arise on a payment by a fund subsidiary to a parent fund. However, based on conversations with counsel in Luxembourg and Ireland, two jurisdictions which are often utilized by Cayman funds for platforms or holding companies for European activities, there will be no immediate technical impact.

Nevertheless, it is possible that, in specific cases, payments by portfolio companies to EU blacklisted parent entities, or lenders, could also be or become an issue. In addition, EU investors in Cayman funds could potentially suffer adverse consequences under their home country CFC regimes if the relevant member state has implemented or does implement that applicable EU recommendation and, in any event, the blacklisting may affect investor perception of structures which include Cayman entities. Sponsors that have agreed to side letter provisions relating to blacklisted or non-cooperative jurisdictions will also need to consider those on a case by case basis. There may also be enhanced reporting requirements, including under DAC 6. From a European regulatory perspective, it is worth noting that this development is not expected to directly impact the ability to market Cayman investment funds in the EU in accordance with existing national private placement regimes.

What is likely to happen next?

We would expect the Cayman Islands to take all necessary steps to satisfy the EU Council that it should be taken off the blacklist. The EU Council decision suggests that the earliest possible opportunity for this is likely to be in October 2020. The result may be increased substance requirements for funds or SPVs established in the Cayman Islands. Any other longer-term impact of the listing, assuming it is temporary, is likely to depend principally upon any lasting effect on investor perception of the Cayman Islands as a fund jurisdiction. ■

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