Cayman Islands Added to EU Tax Blacklist—Consequences for Investment Funds

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Cayman Islands added to blacklist. The EU Council (comprising the finance ministers of the 27 EU Member States) announced on 18 February 2020 that the Cayman Islands, alongside Palau, Panama and the Seychelles, has been added to the EU's list of non-cooperative jurisdictions in tax matters, known as the EU's tax haven "blacklist".

What is the significance of the blacklist? The blacklist is a tool used by EU Member States to address the use of non-EU jurisdictions that are perceived to encourage abusive tax practices—in particular, regimes which provide low or zero tax rates without a sufficient degree of substance in the jurisdiction. It covers jurisdictions which do not meet international standards on transparency and exchange of information and whose tax regimes are perceived to offer unfair tax competition. Jurisdictions whose tax systems are deemed unsatisfactory are expected to remedy them within an agreed timeframe, with the attendant risk of moving to the blacklist. As we describe below, establishment of an investment fund in a blacklisted jurisdiction *may* result in individual EU Member States imposing "defensive" tax measures (such as applying higher withholding taxes) and may make the fund unattractive to EU institutional investors.

Whether a jurisdiction should be on the blacklist is subject to continuing review. For example, Bermuda moved from the blacklist to the EU's "greylist" after a number of weeks of being blacklisted last year and was removed altogether on the same day that the Cayman Islands was moved to the blacklist.

Cayman Islands response to its inclusion on the blacklist. The specific basis of the decision to place the Cayman Islands on the blacklist was 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 responded by stating that it was added to the blacklist because of a technical timing issue, pointing out that it has already passed the necessary legislation to address the EU Council's concern by bringing certain categories of Cayman Islands investments funds within the regulatory framework for the first time. This legislation

came into force on 7 February 2020, a few days after the date of the EU Council's meeting. On this basis, the Cayman Islands is confident that the EU Council will remove it from the blacklist when it next reviews the list, expected to be later in the year.

Consequences for Cayman Islands investment funds. The inclusion of a jurisdiction on the blacklist does not trigger material sanctions by the EU or amount to a prohibition on marketing a Cayman Islands fund (under national private placement regimes) in the EU. However, individual Member States may impose penalties on a national level and, as described in more detail below, the EU has recommended that Member States adopt "defensive" measures from 1 January 2021. Further, the EU is unlikely to make EU capital (*e.g.*, via the European Fund for Sustainable Development) available to or through entities established in a blacklist jurisdiction.

Although Cayman Islands funds will continue to be widely offered to private and institutional investors, the addition of the Cayman Islands to the blacklist is likely to make EU institutional investors increasingly averse to Cayman Islands funds for a number of reasons. EU institutional investors with connections to EU governments (such as state pension plans) may be dissuaded from investing in Cayman Islands funds as a matter of policy or government pressure. There may be enhanced administrative disclosures required in EU Member States in relation to transactions involving Cayman entities, such as increased requirements for reporting (*i.e.*, under the EU Directive on mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC 6) and in relation to country-by-country reporting under EU legislation). EU investors also perceive an increased risk of local tax audits on investments in Cayman structures. Some non-EU investors may likewise dislike the profile associated with investment in Cayman Islands funds.

EU recommended "defensive" measures for blacklist jurisdictions. The EU has recommended that EU Member States adopt at least one of the following "defensive" measures from 1 January 2021: (*i*) denying a deduction for costs and payments from entities in EU Member States to entities or persons in a blacklisted jurisdiction (*ii*) applying controlled foreign companies rules to companies in a blacklisted jurisdiction (*iii*) applying higher withholding taxes to payments treated as received in a blacklisted jurisdiction and (*iv*) limiting the benefits of a participation exemption for payment from subsidiaries in a blacklisted jurisdiction. In practice, EU Member states already apply some or all of these measures with regard to zero-tax jurisdiction outside the tax-treaty network.

What should fund sponsors do as a result of the Cayman islands being added to the blacklist? In the immediate term, sponsors of existing funds should review their side letters in case they contain undertakings relating to entities in blacklisted jurisdictions, which will need to be considered on a case-by-case basis. Given that the blacklisting of

the Cayman Islands is not expected to extend beyond 2020, changes to existing structures are unlikely to be necessary at the moment.

Sponsors seeking to raise capital from European institutional investors may wish to give greater consideration to an alternative fund vehicle (*e.g.*, a Luxembourg, U.K. or Channel Islands partnership), although this will need to be balanced against considerations of the substance required to establish a fund vehicle in that jurisdiction. In addition, recent proposals to change the U.S. tax controlled foreign corporation (CFC) rules that look through U.S. partnerships allow greater flexibility for sponsors to consider using U.S. partnerships as fund vehicles for international investing. However, because the proposed changes stop short of looking through U.S. partnerships for all purposes of the CFC regime, U.S. sponsors will likely continue to prefer non-U.S. vehicles for their international investment platforms.

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