Economic Colonialism and the European Union Blacklist

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"**THE HIGHER RACES HAVE A RIGHT OVER THE LOWER RACES.** They have a duty to civilise the inferior races." These are the words of Jules Ferry, a leading 19th century proponent of French colonialism. It seems from the extraterritorial expansionist intentions of the EU, now championed by EU Tax Commissioner Pierre Moscovici that, certainly in terms of French thinking, very little has changed in 200 years. And so, offshore financial centres, having received no credit whatsoever for establishing state-of-the-art transparency on tax matters through FATCA, the OECD promoted Tax Information Exchange agreements (TIEAs) and proactive tax reporting pursuant to the Common Reporting Standard (CRS), find the goal posts moved once again. Our 'inferior' financial structuring, established in accordance with the highest standards of English common and commercial law, is to be 'civilised' under threat of a blacklist to accord with Moscovici's newly minted Euro concepts of 'substantial presence' and 'economic substance' (as with a good deal of Euro double-speak, there is no effective distinction in the terms and so we will just refer here to 'economic substance'), without which, it seems, your international financial transaction is, simply, no good.

Moscovici is, of course, right to be concerned. There exists no doubt as to the reasons behind the EU's rapacious need for increased tax revenue.[1] The twin time bombs of a declining birth rate (with the population rising to 528 million by mid-century and then falling below 520 million after 2070) and uncontrolled and uncontrollable welfare spending, undertaken by populist EU politicians seeking to create a delusional Union of wellbeing has, in fact, produced an insatiable need for increased tax revenues.[2] And, there should be no doubt that increased tax rates will be uniformly applied across the EU Member States.

Image: Michelle Bryan

The responses to the recent observation[3] that 'individual EU Member States still, and increasingly delusionally, believe they retain sovereignty over direct taxation' ignore the state of readiness of the EU weapon of choice; the Common Consolidated Corporate Tax Base (CCCTB) which, as Oliver Treidler[4] has pointed out is, "the death knell of tax competition in Europe." He is, no doubt, right. The French president,

1 See Sven Larson 'EU Blacklist: The real story is demographic decline and panic search for revenue', Cayman Financial Review, First Quarter 2018, Issue 50.

2 The developing nightmare for the EU is that whilst representing 7% of the world's population, it expends 56% of the worlds spending on welfare benefit programmes which percentage, apart from the threat of declining birth rates and increased longevity, will be significantly increased with the costs of the immigration crisis.

3 See A. Travers 'Mr Moscovici and his EU list of many colours', Cayman Financial Review, First Quarter 2018, Issue 50, p.19

4 See Cayman Financial Review First Quarter 2018 - ibid

Emmanuel Macron, in discussing the CCCTB, states that; "Efforts are already underway, but we must work faster to harmonise the tax base. And France and Germany should be able to finalise plans within the next four years. We cannot have such disparate corporation tax rates in the European Union. This tax divergence fuels discord, destroys our own models and weakens all of Europe. I commend the European Commission's recent initiatives and, through Margrethe Vestiger and Pierre Moscovici, its push for certain players and countries to make changes."

A great deal has been written[5] by expert economists about the fallacies and entirely subjective and nonsensical assumptions contained in the 1998 OECD Report; 'Harmful Tax Competition: An Emerging Global Issue'. No-one, and certainly not the OECD, has established or presented any evidence or economic grounds to date as to how or why low tax rates in offshore financial centres, which structure onward investment into taxable jurisdictions, are in any way harmful, nor have they provided a statistical basis to support the theory. Nor do the Cayman Islands or other offshore financial centres, including the Crown Dependencies, which are not party to double tax treaty networks, meet the OECD test of having enacted special tax provisions to 'erode the tax base' of others.

Nor do we dwell here on the disingenuity of the OECD's strategy in dropping 'substantial presence' from its definition of a tax haven in the 1998 report with a view first to securing full tax transparency through the medium of TIEAs and the Common Reporting Standard, only to see the EU reintroduce 'economic substance' as the test for EU 'whitelisting'. The genesis of this heresy appears in veiled terms in the 1998 report where the OECD first assumes the non-existent distinction in stating that "tax incentives designed to attract investment in plant building and equipment have been excluded at this stage" and are therefore, not "harmful." Ironically, as many economists, from Adam Smith[6] on have agreed, if EU Member States elected to have a land-based revenue raising system, there could be no concern, legitimate or otherwise, about mobile capital fleeing their jurisdictions.[7] The OECD ignores this and the EU, with barefaced hypocrisy, now ignores the most significant examples of global tax avoidance which occur within its Member States. The aggressive tax avoidance practiced by Google, Starbucks and other US corporates in relation to non US based sales, relies entirely on the deficiencies in the EU double treaty tax network (double tax treaties which follow the now useless OECD model). These treaties have proved wholly inadequate in dealing with cross-border royalty and interest payments but it was the EU jurisdictions, notably Ireland, Luxembourg and the Netherlands which played the system by permitting structures (including the Double Irish and the Dutch Sandwich) that enabled US corporates to minimise EU payable taxation to what may be regarded as unreasonably low levels, not the offshore financial centre.

Offshore financial centres are, however, the new EU target. The fact that these financial centres have superior legislation, certainty of the courts and reliable legal and regulatory infrastructures doesn't seem to matter. Without any statistical or economic support, Moscovici's position appears to be entirely dependent on the proposition that the offshore financial centre targeted by the EU blacklist is 'non-compliant'. But, non-compliant with what? Cayman meets or exceeds every international standard on reporting and transparency. Is this a glitch in the Euro-speak translator? In light of the TIEAs and the automatic reporting obligations of FATCA and the CRS, tax evasion is, both theoretically, and as any Cayman Islands practitioner will say, practically, off the table and tax avoidance may be investigated. No EU jurisdiction can therefore claim that its residents – by investing in an offshore fund or entity – are not paying their proper share of corporate, income, capital gains or other tax in accordance with the laws of that EU jurisdiction. So, how precisely, is structuring in and through the Cayman Islands to be regarded as harmful to that EU jurisdiction? That question is unanswerable. Nevertheless, the EU initiative seeks to blacklist an international financial transaction based on whether or not there is 'economic substance' attached to the entities involved in the structuring. This requirement for 'economic substance' does not sit well with the time honoured approach of the Supreme Court[8] and English statute and common law which describes the legal tests for recognising separate corporate personality, with as close as may be, certainty. We can also say that this new Euro principle does not exist anywhere in the common law or commercial world. All international financial transactions routed in and through the Cayman Islands involve the structuring of intangibles whether equity, debt, a hybrid or derivative. A billion dollars may be transferred by a computer keystroke. Under no recognised system of law or accounting principle is the validity of that transfer measured or tested by reference to the size of the building in which the computer is housed, nor the number of employees required to effectuate the keystroke.[9] If that were the test, a great number of financial centres in the onshore and offshore financial world would not meet it, and what then of the transactions otherwise perfectly effectively and transparently structured through them? This then is simply a 'test', perniciously and transparently designed politically to advance the EU's extraterritorial claims over global financial services at the expense of the legitimate offshore financial centre; it is impossible to conclude otherwise.

To the legitimate criticisms of the 1998 OECD report we can now add a further point. Mobile capital flows in and through the Cayman Islands are not only, not harmful in accordance with the tests suggested by the OECD, but actually conform with Action 5 of the Base Erosion Profit Shifting Initiative (BEPS)

5 See 'Is Tax Competition Ever 'Harmful'? – The OECD Dogma' by Dr Terry Dwyer and 'International Tax Competition: Harmful or Beneficial?' by Mason Gaffney

6 Adam Smith was an 18th-century Scottish philosopher known as the father of modern economics, and a major proponent of laissez-faire economic policies.

7 But this artificial convenience is relevant to the debate if it allowed EU member country, Ireland, with its corporate tax rate of 12.5 per cent to grow by more than 26.3 per cent in 2015 alone. This growth resulted from a number of multinationals moving headquarters to Ireland to the tune of some €200 billion of assets. This is effective 'poaching' of the tax base.

8 See Petrodel Resources Ltd and other v Prest [2014] 1 BCLC 30 and Halsburys Laws of England 'Piercing the Corporate Veil'

9 The transaction may be taxed based on concepts of management and control or permanent establishment which are well recognised but those concepts assume the validity of the transaction.

which is intended "to identify features of such regimes that can facilitate base erosion and profit shifting and therefore have the potential to unfairly impact the tax base of other jurisdictions." Cayman Islands structures do no such thing. Cayman Islands' structuring conforms with Action 5 because it results in taxes being paid in the jurisdiction where profits are made, which is entirely consistent with the BEPS principles of capital import neutrality. If we take the aggregate flow-through of mobile capital in Cayman Islands' offshore vehicles as between US$4-5 trillion, we can say with certainty that all of it is invested and taxed in onshore jurisdictions in accordance with the laws of those jurisdictions. The nonsense of the 1998 OECD report and the EU blacklist proposals is that they presuppose that the entire US$5 trillion is invested in the Cayman Islands and taxed by nobody outside of the Cayman Islands. Those monies are invested and taxed in G20 countries. That the OECD could have gone so far and have been so broadly accepted by G20 countries by setting out theories which are not merely manifestly inapplicable, contain no effective or meaningful definition of 'harmful tax competition' and provide no economic analysis by way of support is extraordinary enough. For the EU to accept these propositions and apply arbitrary and discriminatory practices against jurisdictions in seeking to apply EU tax policy on an extraterritorial basis is a good deal worse.

In circumstances where the investor in the offshore financial structure is unequivocally subject to taxation in his jurisdiction of residence and where the investments made through that structure are unequivocally taxed in the jurisdiction of that investment, as a matter of pure logic, it is impossible to argue that any harm is occasioned by the structure. As it transpires, only eight per cent of investment in Cayman Islands structures comes from the EU, but no harm could be alleged on the foregoing analysis if that figure were 100 per cent. If we apply the Euro-speak translator to the ramblings contained within the OECD BEPS initiative, we can only conclude that Moscovici's real concern is that EU capital is mobile. It is not the fact of the Cayman Islands structuring that adds or detracts anything from the argument. What is troubling Moscovici is that EU investors want to invest in markets outside of the EU, particularly in the US and the United Kingdom, and increasingly in Asia and Africa. Cayman Islands structuring simply facilitates those investments. We can conclude, therefore, that one of the four cornerstones of the EU – freedom of movement of capital – in effect means freedom of movement of capital within the EU, but not outside its borders. If Moscovici's concern is that EU investors want to invest outside of the EU because the EU creates a hostile environment for investment with an uncompetitive rate of return, or lacks the entrepreneurs to create exciting investment opportunity, then he should stop wasting his and everyone's time with 'blacklists' based on spurious reasoning, and consider introducing European Union wide exchange control.

> "The aggressive tax avoidance practiced by Google, Starbucks and other US corporates in relation to non US based sales, relies entirely on the deficiencies in the EU double treaty tax network (double tax treaties which follow the now useless OECD model)."

Offshore financial centres should identify the inherent danger in these Euro notions (and of agreeing any form of accord in relation to them) by considering the proposed changes to the Dutch Dividend Withholding Tax (DWT) rules to which the Netherlands as an EU Member State must be subject. DWT exemption is to be denied under new 'subjective' and 'objective tests'. These require that the intermediary holding company incur wage costs of at least €100,000 per annum for employees that perform the linking function at the level of the intermediary holding company and that the intermediary holding company have its own office space which needs to be equipped and used for the linking function. Thus, we see the EU intention laid bare. What is clear from this is that it cannot conceivably be applied to the financial structuring in offshore financial centres and nor should it be. The EU is perfectly entitled to apply its own sets of rules and principles within its territorial borders. But the application of novel tests such as this, outside of the EU, in the area of international financial transactions, whether conducted through offshore or onshore financial centres, would amount to an unprecedented arbitrary and unjustifiable extraterritorial extension of EU tax policy, and one with which an offshore financial centre cannot comply.

Any 'negotiation' on the principles underlying these proposals should be summarily rejected by all offshore financial centres. If established in principle the economic substance test will surely be ratcheted up over time to the point where, as is intended, the compliance cost is unacceptable to the clients and the offshore financial centre fails. Simply put the EU intentions are political and entirely based on removing the embarrassment of the offshore financial centre with low or no rates of direct taxation from international financial structuring. Given the relative unimportance of the EU to a jurisdiction like the Cayman Islands, Moscovici does not have a carrot. He therefore threatens with his stick. His arguments raise gauche to the grotesque. But in contemplating the outcome we should not ignore the desire, however naïve, of politicians in offshore financial centres to be accepted as a part of the 'Club'. Rather than a summary rejection of these EU proposals, regrettably, history shows us that some form of further appeasement is predictable but wholly neglectful of the intended damage that will be caused to offshore structuring and to the offshore financial centre in the long term.

But those with a better understanding of the long term EU strategy might also reflect, that the reoccurrence of unjustifiable, extremist and arbitrary behaviour from European powers of this sort, whether from the right or left, was one of the very things that the European Union was designed to prevent. As Churchill once remarked "If Britain must choose between Europe and the open sea, she must chose the open sea. The same is true of the Cayman Islands. Plus ça change. ■