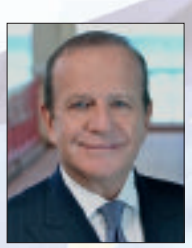
COVER STORY: ECONOMIC SUBSTANCE

The EU, Economic Substance, and Other Complete Nonsense



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"When you are a Bear of Very Little brain, and you Think Things, you find sometimes that a Thing which seemed very Thingish inside you is quite different when it gets out into the open and has other people looking at it." – Winnie The Pooh. But we really shouldn't be laughing. Neither, EU Tax Commissioner, Pierre Moscovici[1], the architect of the EU's arbitrary, discriminatory and reverse-engineered initiative on Economic Substance, nor his compatriots in the (Organisation for Economic Cooperation and Development (OECD), are particularly welcome in this 100-acre wood[2].

'Economic Substance', so called, is a blatantly capricious invention that has nothing whatsoever to do with tax evasion or tax avoidance but is based on a carefully managed and willfully repeated deception.

Regrettably, for want of a coherent and effective public relations campaign from the Cayman Islands and other Overseas Territories establishing the true position, the deception has been so often repeated that it is now entrenched in the public perception and on the coat-tails of that misperception, this EU initiative has advanced.

What is the nature of the deception? We need look no further than the writings of les enfants terribles of the new world economic order, Gabriel Zucman and his colleague Thomas Piketty, who "estimate that 8% of the world's financial wealth, some US$7.6 trillion, is 'hidden' in places like Bermuda, the Cayman Islands, Singapore and Luxembourg"(Gabriel Zucman "The Hidden Wealth of Nations: The Scourge of Tax Havens). For dramatic effect, they add, "That is more wealth than is owned by the world's 7.4 billion people". This narrative is repeated by NGOs like the Tax Justice Network whose Nicholas Shaxson describes the "US$2 trillion 'shoveled' into the Cayman Islands" as if to say, and therefore necessarily evading or avoiding tax. The deception is supported from time to time by 'research'. Jan Fichtner, a researcher at the University of Amsterdam[3] correctly summarises from the IMF data that Cayman Island entities 'hold' US$2.64 trillion of portfolio investment but then, referring to the Tax Justice Network classification of the Cayman Islands as a "secrecy jurisdiction" concludes that Cayman facilitates "opacity" in tax avoidance and operates as a "sink" offshore centre which "attracts and retains" foreign capital, and "where the data trails often end" (Treasure Islands and the Men Who Stole The World). This leads to the implicit but erroneous conclusion that monies are hidden and "therefore lost" to onshore taxation; a conclusion entirely supportive of Piketty and Zucman's equally flawed analysis.

But this is a very harmful and pernicious sort of a fib because the truth is quite the opposite and readily verifiable from publicly available statistics. Experts in economics and international tax[4] have often derided the entirely subjective notion that tax competition is 'harmful' and conclude that the OECD position paper to that effect[5] is no more that statist double speak. Hence the EU, the OECD and their acolyte NGOs seek to obtain traction in the public domain by suggesting that Overseas Territories like the Cayman Islands are involved in cheating the public revenues in the onshore jurisdictions. All of this, though, is propaganda.

The Torch of Truth

If we can illuminate the issue with the torch of truth (at the risk of undermining a number of academic careers and the funding of a number of NGOs), the position is simply this: there is no statistically relevant evidence tax evasion or improper tax avoidance in the Cayman Islands and no harm occasioned. Furthermore, less than 8 per cent of investment in and through the Cayman Islands originates from the EU. Mr Moscovici claims that the rationale of this Economic Substance initiative is to bring the "non-compliant" Cayman Islands into line with international tax standards. "Abusive tax practices and harmful tax regimes breed in the shadows; transparency and co-operation are their natural foes," but nothing he says could be further from the truth.

The Cayman Islands is already fully compliant. It has, since 2000, established full tax transparency (and anti-money laundering transparency) with every major European Union jurisdiction pursuant to the Tax Information Exchange agreements. No European Union-based corporate (or, indeed, any other) utilising the Cayman Islands can claim secrecy with regard to its Cayman Islands affairs. Apart from the highly developed controlled foreign corporation legislation, which exists in every sophisticated onshore tax jurisdiction (and has done so in the United States since it was introduced in the early 1960s), any Cayman

Islands subsidiary of a major onshore corporate will have its financial position consolidated in accordance with usual accounting principles and available for scrutiny by the tax authorities in the onshore jurisdiction. That blindingly obvious point apart, we now have the Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS) which provide proactive reporting of every account maintained in the Cayman Islands by any individual or entity and directly to the tax authorities of ultimate residence of the beneficial owners (a conclusion which, it should be said, provides greater transparency with regard to individuals and entities operating in the Cayman Islands than would be the case if they were operating in the United States). And so, we can state with a high degree of certainty that the tax transparency in the Cayman Islands is absolute and incapable of improvement[6] and it follows that the public in onshore jurisdictions are not being cheated[7]. Nor do any of the major tax avoidance techniques undertaken in and through the EU utilise the Cayman Islands.

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But all of that also misses the point. In fact, Zucman is wrong for two additional reasons. Firstly, the total investments in and through the Cayman Islands greatly exceed his estimates. We can put the number between US$4-5 trillion. But here is the second point that is missed in the great deception. We can also say that all or virtually all of that US$4-5 trillion is onward invested in markets or assets in onshore jurisdictions and taxed in accordance with the laws of those jurisdictions. Anecdotally, as far as the Cayman Islands is concerned, the major beneficiaries of this funding throughput are portfolio, bond, and real estate investments in the United States. (If we were to look by way of comparison to, say, the Crown Dependencies, we could say that the major beneficiary of their throughput investment is the United Kingdom). But the same principle would apply; unless you are the DART corporation investing, say, (the numbers are anecdotal) some US$2-3 billion in Cayman Islands tourism and infrastructure development, every dollar invested in and through a Cayman Islands entity is ultimately onward invested into an onshore taxable jurisdiction, and, here is the critical point, taxed in accordance with the laws of that jurisdiction.

Now, it may be that to induce inward investment, the laws of the onshore jurisdiction, as a matter of its internal policy, provide a tax-free exemption on capital gains tax on the sale of portfolio securities or a withholding tax exemption on portfolio interest; the United States and many onshore jurisdictions have similar tax incentives. But that has nothing whatsoever to do with the tax policy of the Cayman Islands. It is tax competition introduced by the onshore jurisdiction. And very sensibly, too. The EU and the OECD may regard these onshore tax incentives as "harmful" but invariably, they are powerless to do anything about them directly[8].

So as simply put as may be, if monies conduited through Cayman Islands structures are taxed in the jurisdiction of investment and taxable on receipt in the jurisdiction of tax residence of the ultimate investor in accordance with the laws of those jurisdictions, that

structuring in and through the Cayman Islands cannot, as matter of logic or tax law, be regarded as harmful. Taxes are paid on the profit or gain and again on receipt by the investor. Not only that; the Base Erosion Profit Shifting (BEPS) initiative is supposed to ensure precisely that result: that taxes are paid in the jurisdiction of sale and where the profit is made, in accordance with the principle of capital import neutrality. Cayman Islands and other offshore financial centre structuring conforms to precisely that principle and the independent application of Action 5 of the BEPS Action Plan is ill- founded and arbitrary[9]. If the EU and OECD suggest that the absence of an additional layer of taxation in the Cayman Islands is "harmful", what, as a matter of logic and tax law, the EU and the OECD must be arguing, for is that onshore investment structured in and through Cayman Islands vehicles should be taxed twice while investments in and through Dutch, Luxembourg and Dublin structures should only be taxed once. The EU and OECD's position is intellectually and economically hopeless. If the EU intention is that no EU person or entity should invest in a lower tax jurisdiction outside the EU, it should introduce exchange control. In that way, mobility of capital will mean mobility within the EU only.

Economic Time Bomb

It is reasonable to suppose that Moscovici and his colleagues in the OECD fully understand the foregoing analysis. The Cayman Islands operates to facilitate the flow of funds into jurisdictions like the United States where the lower tax rates result in an improved return of capital to investors. And thus, we can say the Economic Substance legislation has nothing whatsoever to do with economically mobile activities being attracted to the Cayman Islands to the harm of the European Union.

What is harming the European Union is that tax rates in the EU must increase substantially to adjust for excessive welfare spending, a declining birth rate, and longevity; an economic time bomb exacerbated by the recent untrammelled immigration[10]. The problem the EU has is not with the Cayman Islands but with the United States and other jurisdictions which not only see low taxes and smaller government as not harmful but also entirely beneficial in promoting economic growth[11]. This barefaced EU attempt at extraterritorial tax legislation has nothing to do with the absence of taxation in the Cayman Islands but everything to do with The Tax Cuts and Jobs Act 2017 and the reduction in tax rates in the United States. There is little doubt either about the upward direction of EU tax rates. President Macron recently renewed calls for the introduction in Europe of Common Consolidated Corporate Tax Base which will override Member State vetoes and establish common rates of taxation across the European Union. No doubt, any EU Commissioner of Taxation would then see it as imperative that there remain no offshore financial centres in existence to redomicile the inevitable transactional outflows from Dublin and Luxembourg.

The Economic Substance invention is no more than the battle cry of the European Union in the ongoing war for financial services in which the EU, with its inevitable high taxation, finds itself ill equipped and uncompetitive. Wiser heads in the OECD fully recognise that they lack a global consensus to enforce the imposition of taxation in jurisdictions like the Cayman Islands which remain internally self-governing and which, in any event, as mentioned above, would result in the double taxation of profits and gains made on inward investment into onshore jurisdictions. But neither the OECD nor the EU are shy about invoking the threat of blacklists to secure their extraterritorial tax ambitions.

And so, cowed into submission by these threats of blacklists, politicians in the Cayman Islands and the other Overseas Territories and the Crown Dependencies have introduced legislation requiring Economic Substance for companies and partnerships that are "in scope".

It would be wrong to descend into the detail of Economic Substance without first reiterating that these provisions are, of course, from the technical perspective, also complete and utter nonsense. At no time in the common law world, and it should be noted that the majority of global financial transactions are governed by English or New York law, has it been necessary to validate a transaction by reference to the size of the building from which it emanated or the number of employees under that roof responsible for the trade.

The common law rules on what creates a legally enforceable obligation in relation to intangibles are well settled and do not imply validity and enforceability by reference to a formula mandating a number of bricks per dollar of value. It is worse than that. At a time when blockchain transactions rely on decentralised ledgers and a billion dollars (or more) can be traded from an iPhone, a requirement for economic substance appears laughably inappropriate and anachronistic. But the EU Commissioner believes Economic Substance to be the strategy that will cut off the flows of capital passing through the Cayman Islands into the United States and the United Kingdom which are the true targets. The EU intention is that the cost of establishing Economic Substance in the offshore financial centre will simply render the Cayman Islands (and other overseas financial centers) cost ineffective.

EU Masterstroke

In this endeavour, the EU masterstroke, facilitated by appeasing offshore politicians, is to have secured legislation of these provisions without ever specifying (and nor to date in the final version of the Economic Substance guidance notes) what may be regarded as "adequate" expenditure. The consequent and current uncertainty is no doubt intended to create confusion in the minds of offshore clients. As matters stand, advisors are not yet able to establish with absolute certainty what expenditure (for entities "in scope") may or may not constitute sufficient expenditure to satisfy the Authority in the Cayman Islands which in turn, of course, will be subject to EU and OECD review[12]. Somewhat perversely, the Economic Substance initiative has been greeted by major accounting firms and some service providers with equanimity, no doubt in the mistaken belief that offshore clients will be entirely happy with the increased cost of their services necessary to support the third-party professional assistance to establish the Economic Substance.

But the lines between the advantages of offshore and onshore structuring are fine, and it is highly unlikely that the EU initiative will find favour in the United States under the current Administration. If the tax consequences are otherwise equal, profit margins in the offshore jurisdiction will be further squeezed

if seeking to compete with US entities in Delaware, Wyoming, South Dakota, which will now obtain a significant economic edge. If that is right, and if the United States or other tax competitive jurisdictions are the real target of the EU extraterritorial tax initiatives, then to the extent the EU initiative is successful, the EU will have picked off the lower-hanging fruit and Cayman Islands' financial structuring, along with that of other offshore financial centres, will be collateral damage; but without the EU having ever solved the real issue of onshore jurisdictions with lower and more competitive tax rates causing the EU continued tax leakage.

In adopting a policy of appeasement, the Cayman Islands government is betting its financial services industry on any one of the following: (i) The EU and OECD initiative failing to gain traction as a global standard, in which event the Cayman Islands' legislation will be revisited; (ii) the EU imploding; or (iii) that economic activity generated by companies establishing physical presence and Economic Substance with personnel in the Cayman Islands will outweigh the inevitable losses to government revenue that will result from the exodus of those companies that do not. The application of these circumstances will be further complicated if the current legislative enactments do not cause a cessation of the financial services industry in the Cayman Islands to the satisfaction of the EU Tax Commissioner. We can then be assured that the EU will seek further expansion of the scope of Cayman Islands' entities to include funds within the Economic Substance legislation. The outcome of those approaches will require careful consideration and we can only hope that the Cayman Islands' government will then seek better advice than it appears to have relied on to date.

All that said, a measured and forensic case-by-case approach to the application of these new provisions reveals there is a good deal less to be concerned about than may have been supposed from the panicked and often self- serving "updates" currently in circulation from a broad range of professional advisers. In this writer's view the EU and OECD initiative will fail in its darkest intentions simply because both organisations make the mistake of believing their own negative PR about the Cayman Islands. They therefore continue wholly to misunderstand the sophistication and technical propriety of Cayman Islands' financial structures which do not shift profits (a strictly European based pastime) and are intended at all times to be tax-compliant, as mentioned above, in both the jurisdiction of investment and the jurisdiction of the investor. Given the levels of governance and compliance already exhibited by all Cayman entities with sound advice, the adjustment required to comply with the new Substance provisions should, in most cases, be minor and the effects of the new legislation by no means unmanageable. However, no good can come of allowing the EU and the OECD to continue to present delusional misunderstandings as fact. At some point, the Cayman Islands government will have to draw a line in the sand. IFC

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The illustration, by Michelle Bryan, was commissioned by the author.

1 Not a simple Communist, a sometime member of the Revolutionary Communist League, a Trotskyist organisation

2 I don't speak for the Crown Dependencies who appear to have embraced the notion of Economic Substance with greater ardour, accepting that general partners of closed ended investment entities should be within scope

3 The Cayman Conundrum: Why is one tiny archipelago the largest financial center in Latin America and the Caribbean?

4 See "Is tax competition ever "harmful"? – The OECD dogma" - Dr. Terry Dwyer; and "The Worldwide Benefits of International Tax Competition" - Mason Gaffney

5 Harmful Tax Competition and Emerging Global Issue" - OECD 1998

6 No one doubts of the four "tax haven" indicia suggested by the 1998 OECD Report "Harmful Tax Competition: An Emerging Global Issue" that the resulting tax transparency is not a helpful outcome. The problem however is that no genuine credit has been accorded by the EU or the OECD for the Cayman Islands having established that transparency. The negative propaganda has not abated.

7 Very often the opposite. Cayman Islands fund structures are typically the investment vehicles of choice for major pension funds and their superior returns boost the returns available to onshore retirees.

8 When presented with this analysis, a BBC interviewer, having been indoctrinated no doubt with Tax Justice Network propaganda, asked me "What on earth then was the purpose of the Cayman Islands structuring?" One answer to that is that Cayman legislation provides for structuring in a way that is intended to mesh with the available onshore tax concessions. (Unsurprisingly, this exchange was cut from the final BBC transmission).

9 It is outside the ambit of this article to discuss the BEPS initiative which appears to be designed to avoid the OECD admitting that the major tax avoidance undertaken by certain US corporations in Europe was facilitated because those corporations with the benefit of expert advice drove a coach and horses through the wholly ineffective OECD model Double Tax Treaties. However, it should be noted that avoidance of that sort could only be undertaken through EU jurisdictions, notably Ireland and the Netherlands and Luxembourg which had the benefit of the Double Tax Treaty Networks. The Cayman Islands does not.

10 See also Economic Colonialism and the European Blacklist – IFC Review 2018 – Anthony Travers

11 See also the various writings of Dan Mitchell, Center for Freedom and Prosperity

12 In the Cayman Islands, open and closed ended investments funds are out of "scope", which may be the temporary saving grace. In "scope" are the following lines of business activity – (a) banking business; (b) distribution and service center business; (c) financing and leasing business; (d) fund management business; (e) headquarters business; (f) holding company business; (g) insurance business; (h) intellectual property business; (i) shipping business. The position in the Cayman Islands should be contrasted with the position in the Crown Dependencies where, due to an inexplicable burst of enthusiasm for the concept, open and closed ended funds are not specifically excluded