PUTTING CAYMAN IN CONTEXT: THE TRUTH ABOUT ONSHORE TAXES

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INTRODUCTION

When taxes become the subject of dinner-table debates, there's usually a political or macroeconomic issue below the surface. Today's conversations about international taxation are no exception. Ever since the financial crisis, governments around the world have been exploring ways to shore up revenues, and for many, cracking down on cross-border activity by corporations and investors seems the obvious route to healthier budgets.

News-making actions mainly involve global multinationals like Apple, Google, and McDonald's, which are criticized for locating operations outside the US with the goal of paying no—or very low—income taxes. Investment flows through offshore financial hubs may get fewer headlines. But tax-neutral domiciles like the Cayman Islands are coming under increasing scrutiny, some of it politically motivated. Allegedly, by helping investors minimize taxes on returns from capital, offshore financial centers rob the investors' home countries of needed revenues.

Tax neutrality is key to efficient financial flows. If citizens of Country A had to pay taxes twice when they made an investment in Country B, they'd likely keep their assets at home.

Do such allegations have merit? To find out, To find out, Cayman Finance commissioned Oxford Economics and the International Tax and Investment Center to closely analyze tax rates in the EU, with the goal of determining whether its member states lose significant revenue when their investors use Cayman-domiciled funds. Our research shows that treaties and elaborate domestic rules in the European Union effectively lower taxes on cross-border investments far below official published rates.

Furthermore, while offshore jurisdictions like Cayman offer one route to tax neutrality, it is by no means the only route. EU member governments have developed complex—and often considerably less transparent—mechanisms to achieve the same objective. In fact, the EU is growing more and more concerned about such complex maneuvers, as evidenced by its Council Directive 2011/16, known as DAC6. The directive requires detailed reporting of cross-border tax arrangements, with the aim of achieving transparency in the complex structures facilitated by tax treaties.

Tax neutrality is a fundamental principle of free-market economics. In essence, it says investors shouldn't make decisions solely on the basis of tax consequences. It is easy to see how letting the tax tail wag the economic dog can lead to market distortions—for example, an unnatural concentration of capital in jurisdictions whose only merit is low taxes, or capital flight from an economically robust but high-tax location. Thus, tax neutrality is key to efficient financial flows around the world, and it underpins the vast global network of tax treaties: If citizens of Country A had to pay taxes twice when they made an investment in Country B, they'd likely keep their assets at home.

For fund investors, tax neutrality means the country where a fund is registered does not add a third layer of taxes onto those already imposed in the investor's home country and in the countries where the fund invests its assets. Tax-neutral does not mean tax-free. In fact, it's arguably more difficult to avoid taxes in a tax-neutral jurisdiction like Cayman, which doesn't participate in tax treaties and therefore does not affect other countries' taxing rights, than in the often opaque system of domestic and international onshore rules governing double taxation.

Offshore investment hubs like Cayman play an important role in helping global investors aggregate and access funds—one of of capitalism's signature goals.

Efficient capital allocation is a cornerstone of economic health, and international tax policy can help support it. But for most governments, achieving a fair, sustainable fiscal policy that strikes a balance between raising revenues and encouraging investment is a struggle. On the one hand, a national government needs to protect its domestic tax base; on the other, it can't risk alienating foreign investors. It's little wonder this balancing act can get politicized.

We hope that, by shedding light on the taxes actually paid when money moves from one jurisdiction to another, our study will allow policymakers to make objective, data-based comparisons between tax regimes. When they do, they are likely to conclude that tax-neutral offshore investment hubs like Cayman play a unique and important role in helping global investors aggregate and access funds—one of capitalism's signature goals.

THE IMPACT OF EU TAX TREATIES

98%

of cross-border trading activity between the 16 countries in our study and their top EU trading partners is covered by tax treaties, which shrink official withholding rates on dividends and general interest.

Our study covered 16 European Union countries that together constitute a representative sample of this highly diverse economic region. The list includes:

- Large economies (the UK, France, Germany, Italy, and Spain);
- Smaller, industrialized economies with high per capita GDP (the Netherlands, Denmark, Sweden);
- Smaller economies with lower taxes (Luxembourg, Ireland);
- Medium-income, newer entrants to the EU (Latvia, Estonia, Poland, Czechia); and
- Very low-tax regimes (Cyprus, Malta[1]).

We found that 98% of the cross-border trading activity that takes place between these countries and their top 20 EU trading partners is covered by tax treaties. Furthermore, tax treaties cover 93% of activity between these economies and their top 10 non-OECD EU trading partners. This near-ubiquitous tax treaty coverage illustrates the lengths to which EU members have gone to lubricate trade within their community by allocating taxing rights, eliminating double taxation, exchanging information, and formalizing non-discrimination and dispute resolution procedures.

In addition, seven of the countries in our sample—the UK, France, Germany, Italy, Sweden, Malta, and Cyprus—have concluded tax treaties with Mauritius, a low-tax hub for capital-exporters investing in Africa and parts of Asia. Combined with intra-EU agreements and domestic laws, these treaties reduce effective tax rates on active and passive income alike.

The logic behind tax treaties is simple. EU officials recognize that cross-border trade and investment will suffer if more than one nation claims the right to tax the resulting income. For example, imagine a French investor buys dividend-paying shares in a German company. The French government can tax the dividends because they are received by a French taxpayer; the German government can tax them because they are paid by a German company. Tax treaties are designed to mitigate the punitive effect of double taxation on the investor.

In our example of the French stock investor, the German government would levy its tax by withholding 25% of the dividend. Thanks to a tax treaty between the two nations, however, the withholding rate falls to 15%. And if the French investor were a corporation, and had bought a substantial holding in a German enterprise rather than portfolio shares, the German government would withhold 0% of dividends from that investment.

[1] Although the headline tax rate in Malta is 35%, a system of imputation and refunds applies to the distribution of taxable corporate profits, such that shareholders can claim a refund of part or all taxes paid. The effective tax rate can therefore be as low as 0% to 10%.

The tables below illustrate how tax treaties shrink the official withholding rates on dividends and general interest paid by companies in Germany, Denmark, and Poland. Importantly, these tax reductions don't apply just within the EU. Countries commonly sign double taxation treaties with their principal trading partners, whether they are in the same region or halfway around the world.

DENMARK			
	Portfolio dividends	Dividends on substantial holdings	General interest
Domestic withholding	27%	15%	0%
Rates under treaties			
Germany	15%	0%	0%
Sweden	15%	0%	0%
Italy	15%	0%	0%
Poland	15%	0%	0%
Switzerland	15%	0%	0%
US	15%	5%	0%
Japan	15%	0%	0%

GERMANY			
	Portfolio dividends	Dividends on substantial holdings	General interest
Domestic withholding	25%	25%	25%
Rates under treaties			
France	15%	0%	0%
Hungary	15%	0%	0%
Italy	15%	0%	0%
Poland	15%	0%	0%
US	15%	5%	0%
Switzerland	15%	15%	0%
Japan	15%	5%	0%

POLAND			
	Portfolio dividends	Dividends on substantial holdings	General interest
Domestic withholding	27%	15%	0%
Rates under treaties			
Germany	15%	0%	0%
France	15%	0%	0%
Hungary	10%	0%	0%
Italy	10%	0%	0%
Switzerland	15%	0%	5%
US	15%	5%	0%
Japan	10%	10%	10%

By nature, tax treaties are reciprocal: They are designed to help taxpayers in the signatory countries, with each country offering relief to the other's residents. But residents of a third country not party to a particular treaty might reduce taxes by nominally satisfying its formal requirements, or a treaty country's domestic rules, to gain treaty benefits unfairly. For example, a lender in Country X might route an interest-bearing loan to a French borrower through a subsidiary in Poland. Interest on the loan is then subject to zero withholding tax under the French-Polish treaty—even though the ultimate lender is in a non-treaty country. This practice, known as "treaty shopping," is widespread enough that many countries have taken measures to combat the abuse. It's worth noting that, since Cayman does not participate in tax treaties, Cayman entities investing in Europe are subject to taxes in the target country at the highest rate, and in most cases there is no mechanism to reclaim the withholding.

Companies operating in the EU can and do combine national tax systems, tax treaties, and special EU directives to reduce their tax bills significantly.

Indeed, the OECD's Base Erosion and Profit Shifting (BEPS) initiative is aimed at onshore corporate tax arbitrage as well as aggressive tax strategies involving offshore jurisdictions. To cite one example, in line with BEPS standards, EU members have tightened rules on how tax strategies are reported to national authorities—showing their governments are on board, up to a point, with fighting the market distortions that can result when businesses shift activities from one jurisdiction to another for tax reasons alone.

But unless national corporate income tax rates within the EU are harmonized, companies and investors can be expected to take advantage of the differences, which in some cases are substantial. And the ample opportunities for treaty shopping and similar arbitrage within the EU has raised questions about why the OECD and the European Commission itself (not to mention advocacy groups like the Tax Justice Network) tend to focus on offshore jurisdictions like Cayman when they turn a spotlight on aggressive tax maneuvers. For instance, the EU's published blacklist of so-called non-cooperative jurisdictions has not, so far, applied to EU member states, such as Cyprus and Malta.

Yet companies operating within the EU can and do combine national tax systems, tax treaties, and special tax-related EU directives and freedoms to reduce their tax bills significantly. Given their economic importance, it can be argued that the tax policies of G20 nations deserve the same attention as offshore hubs like Cayman—if not even more attention.

THE "TAX GAP" FROM EXEMPTIONS AND DEDUCTIONS

Like tax treaties, domestic tax regimes in the EU are broadly aimed at encouraging the free flow of goods, services, capital, and people. And, like tax treaties, rules under these national regimes can greatly reduce effective tax rates (ETRs), particularly for companies earning passive income in certain jurisdictions (see table).

Jurisdiction	Headline rate (2016)	ETR of company with mostly active income	ETR of company with mostly passive income	ETR for patent box* companies
UK	20%	12.93%	6.29%	10%
France	33.33%	22.55%	13.03%	NA
Germany	15%	13.23%	11.71%	NA
Italy	27.5%	17.58%	8.21%	NA
Spain	25%	16.76%	9.19%	NA
Netherlands	25%	16.59%	8.81%	7%
Denmark	22%	18.89%	17.24%	NA
Sweden	22%	20.1%	17.81%	NA
Luxembourg	21%	15.73%	7.58%	3.85%
Ireland	25%	10.06%	8.31%	6.25%
Latvia	15%	12.2%	10.24%	NA
Estonia	20%	17.84%	15.24%	NA
Poland	19%	11.28%	3.76%	NA
Czechia	19%	15.77%	13.67%	NA
Cyprus	12.5%	10.34%	7.74%	NA
Malta**	35%	30.26%	27.86%	NA
Mean average	22.27%	16.38%	11.67%	6.775%

*Rate applied to eligible income from the development of patented inventions or products.

**Although the headline tax rate in Malta is 35%, a system of imputation and refunds applies to the distribution of taxable corporate profits, such that shareholders can claim a refund of part or all taxes paid. The effective tax rate can therefore be as low as 0% to 10%.

Our research found that while they vary from country to country depending on domestic laws and case-specific circumstances, these rate reductions can be dramatic. Overall, the average effective tax rate on cross-border trading activity for companies with a mix of active and passive income is about 26% lower than the headline rate. For companies with only passive income, the average effective rate is almost 50% lower than the statutory rate. And when special regimes like "patent box" rules come into play, average effective rates in the jurisdictions we studied are more than 70% lower than headline rates. Thus, tax rates in offshore international financial centres are not as different from onshore effective rates as is often claimed.

Countries apply tax deductions and exemptions to specific types of income to encourage a broad range of corporate behaviors. Ultimately, governments hope to create incentives for stimulating economic growth, boosting employment, implementing environmentally sound business practices, and other desirable activities. Among the largest tax incentives are aimed at innovation. For example, the UK, the Netherlands, Luxembourg, and Ireland substantially reduce taxes on income from newly developed intellectual property. Common examples of such tax benefits in the EU include so-called patent box regimes; deductions or credits for research and development; accelerated capital allowances for certain types of assets that greatly exceed normal depreciation; lower rates for small profits; capital gains and dividend exemptions for substantial shareholdings; and withholding tax exemptions for certain dividends and interest. Many incentives are aimed at attracting foreign investment, especially in particular sectors or enterprise zones.

EU governments gather statistics tracking the effects of tax incentives. The need for such monitoring underlines the fact that many companies do move activities between EU member states for tax reasons alone.

The European Court of Justice has ruled that taxpayers may take advantage of the differences between national tax rates to reduce their taxation. However, the EU does not favor incentives that merely divert business from one member state to another, and it is moving to phase out rules that don't result in the desired economic outcomes. To that end, governments gather statistics tracking the effects of tax incentives—for example, actual job creation in economic development zones, or the number of new patents registered.

The need for such monitoring underlines the fact that many companies do move activities between EU member states for tax reasons alone. In March 2019, a special tax committee of the European Parliament adopted a plan to tackle financial crimes, tax evasion and tax avoidance within the EU. The committee said seven EU countries—Belgium, Cyprus, Hungary, Ireland, Luxembourg, Malta and the Netherlands—exhibit the characteristics of tax havens and regularly facilitate aggressive tax planning. "Europe has a serious money laundering and tax fraud problem," declared Jeppe Kofod, MP from Denmark and co-sponsor of the plan.

THE FUND FACTOR: HOW CIVS ARE TAXED

A globally accepted principle of collective investment vehicle (CIV) taxation holds that investors in a fund should not have to shoulder a heavier tax burden than they would bear if they invested directly in its underlying assets—another version of tax neutrality that also underpins a hugely complex network of international laws and regulations. In the EU, each member state has a range of investment fund types, and distinctions between regulatory classifications (retail or alternative), legal forms, and tax regimes are not always clear-cut. All the EU countries in our study treat fund income differently from corporate profits for tax purposes, applying tax regimes that result in an effective exemption from tax on fund income. The point of these rules is to combine the benefits of capital aggregation with the benefits of cross-border investments.

Techniques for achieving tax neutrality vary widely from one EU member state to another. The table below gives just a few examples of how a few countries tax different types of fund income.

Member state*	CIV tax regime	Effective corporate income tax exemption?	Neutrality technique	Treaty benefits?	Withholding tax on fund distributions?	Net asset taxes?
Ireland	Regulated funds in corporate form	Yes (for non-Irish resident investors)	Income exemption	Potentially yes	No (for non-Irish resident investors)	No
Luxembourg	Regulated funds in corporate form	Yes	Income exemption	Potentially yes	No	Yes (annual subscription tax)
Netherlands	Exempt income institution	Yes	Full exemption	No	No	No
Netherlands	Fiscal investment institution	Yes	0% CIT rate	Potentially yes	Yes (but credited against income)	No
UK	Open-ended investment companies	Yes	Participation exemption and dividend deduction	Potentially yes	No	No

* Based on available information at year-end 2018.

All countries in our study used one or more of the following techniques, leading to an effective exemption from tax on fund income:

- Participation exemption (income and capital gains)
- 0% corporate income tax rate
- Entity tax exemption
- Tax transparency
- Tax-deductible distributions

EU member countries must go to considerable lengths to make their tax regimes more CIV-friendly—and the more complex the technique, the more difficult it becomes to ensure transparency and protect against abuse.

For cross-border investors, achieving tax neutrality gets even more complex. In some cases tax treaties pave the way, and in others, investors may route capital through a third country to gain treaty benefits. Generally speaking, EU member countries must go to considerable lengths to make their tax regimes more CIV-friendly—and the more complex the technique, the more difficult it becomes to ensure transparency and protect against abuse. Rules proliferate, systems grow even more complicated, and the fundamental tension between protecting a tax base and facilitating investment gets more acute and political.

It's worth noting that techniques for achieving tax neutrality for investment funds are by no means limited to the countries in our study, or even to EU member states. US funds, for example, are typically structured as "pass-through" or "transparent" entities, like limited liability companies or partnerships. Japanese funds classified as collective investment trusts are effectively tax-exempt. And Canadian funds may be structured as transparent limited partnerships—or, in the case of investment trusts, can deduct income distributions from their otherwise taxable income. In Cayman, by contrast, tax neutrality is the baseline. The jurisdiction does not tax fund income or withhold taxes on fund distributions, just as it does not tax corporate profits, capital gains, or personal income. This straightforward policy allows Cayman to leapfrog the regulatory quagmire that describes so many countries' and regions' tax regimes.

BEYOND TAXATION

As our data have shown, the effective tax rates on corporate and investment income in EU nations are so far below statutory rates that comparisons between, say, Cayman's and France's headline corporate tax rates have little meaning—especially for estimating "lost" revenues when activity takes place offshore. In addition, as we have seen, the Byzantine network of national and regional rules in the EU tends to make transparency more difficult, not less so. And practices like treaty shopping, which raise the specter of base erosion and tax base shifting, don't pose a risk when a domicile doesn't participate in treaties.

This suggests that criticisms of offshore domiciles have less to do with their tax regimes than with their advantageous business environment—which makes them difficult to compete with. Indeed, contrary to popular perception, most investors do not turn to Cayman only because of its tax-neutral regime. According to experts, the jurisdiction has over decades built efficient legal, accounting and governance expertise, and regulatory infrastructure, which it continues to refine.

"Cayman keeps taking these steps to create regulations that actually lower transaction costs overall, rather than imposing costs," says Andrew Morriss, law professor and dean of the School of Innovation at Texas A&M University. "And Cayman has made a significant investment in a very high-quality judiciary." This infrastructure, he says, adds value in insurance, trusts and estates, and private wealth management, among other areas of finance.

Cayman also serves as a neutral territory for international investors whose home countries do not make it particularly simple for them to do business together. If a French investor and a German investor wish to commingle funds, Morriss explains, neither will be keen to do it under the other's legal system. "Cayman's got structures that investors understand," he says. "It's just an aggregator of funds."

Politicians who claim that Cayman's tax neutrality costs their countries hundreds of millions in tax revenues may do so for self-interested reasons. In the US, for instance, a leader who persuades a tax committee that tighter restrictions on Cayman activity will "save" $100 million may get approval to *spend* $100 million. And when it comes to cracking down on actual malfeasance, like money laundering, it is often easier to target people and institutions outside one's own constituency.

Cayman's prompt cooperation with BEPS requirements and continuing efforts to maximize information sharing and reporting have kept it off the EU's blacklist. Now, if global policymakers can take an objective look at the workings of onshore tax regimes, perhaps the myth that Cayman robs other countries of needed funds can be put to rest for good.

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