Cayman Finance Submission | December 2020

Pillar One and Pillar Two Blueprints

Cayman Finance Response to the OECD Secretariat Consultation

A. Introduction

Cayman Finance[1] welcomes the opportunity to respond to the invitation to provide input on the Pillar One and Pillar Two Blueprints released for public consultation on 12 October 2020 by the OECD/G20 Inclusive Framework on BEPS (Inclusive Framework). Where relevant, we refer to our previous submissions to the two public consultations in 2019.

The Cayman Islands is a tax neutral hub that supports global economic growth and recovery. This is achieved through efficiently connecting law-abiding users and providers of investment capital and financing around the world. The Cayman Islands financial services industry has been recognised for decades as a strong partner with other leading jurisdictions and industries in promoting transparency to combat corruption, money-laundering, terrorism financing and tax evasion. The Cayman Islands is a fully cooperating member of the Inclusive Framework.

Given the particular economic policy considerations that apply generally to tax neutral jurisdictions, and to the Cayman Islands in particular, this submission will focus on those aspects of the Pillar Two proposals that are of particular relevance in that context. For that reason, this submission covers a number of aspects that go beyond the specific questions in the Consultation Document. Our key observations are set out below.

B. Key observations

B.1. Cayman Islands tax and economic profile

Contribution of the Cayman Islands to global economic growth and welfare

- Tax neutral jurisdictions such as the Cayman Islands play a key enabling role in the efficient allocation of capital providing unparalleled access to global finance and liquidity leading to more trade, innovation, economic growth, employment, and government revenue in both

[1] Cayman Finance is the association of the financial services industry of the Cayman Islands, an Overseas Territory under the jurisdiction and sovereignty of the United Kingdom.

developed and developing nations.

Cayman Islands economic and tax policy

- The Cayman Islands exercises a legitimate economic policy choice to apply a zero rate of tax on all corporations and meets its revenue needs through customs duties and fees.

International acceptance of zero tax rates

- A zero tax rate on corporations is recognised at both OECD and EU levels as not being harmful unless combined with harmful elements such as ring fencing, lack of transparency and the absence of adequate substantive activities.

The Cayman Islands transparent and neutral tax policy

- The Cayman Islands is fully transparent and recognised as compliant with internationally accepted standards of tax good governance, including economic substance regulations.

Relevance of tax treaties

- As a tax neutral jurisdiction, the Cayman Islands is not party to any double tax treaties that would result in the reduction of withholding taxes and does not therefore pose a risk to other countries in terms of eroding their tax base or preventing another country from asserting its taxing rights.
- The Cayman Islands has entered into a range of bilateral and multilateral information exchange arrangements that fulfil the "prevention of fiscal evasion" aspect of tax treaties.

B.2. Key comments on Pillar Two Blueprint

Investment fund neutrality

- The proposed tax neutrality of investment funds can be strengthened by using a supplementary alternative principles-based definition in the interests of furthering effectiveness, certainty and sustainability of the rules, and will facilitate innovation in the sector.
- The policy rationale for providing tax neutrality to investment funds should be accepted independently of whether that neutrality derives from specific regimes derogating from the regular tax regime or from the tax neutrality of the system itself.
- The tax neutrality of indirectly owned investment funds should be preserved in order to maintain a level playing field, for example by pro rating the income received and taxes suffered by the fund to the investors.
- Potential improper use of such arrangements under the Undertaxed Payments Rule (UTPR) can be adequately addressed through the information exchange framework, without requiring substantial and impractical additional compliance burdens on the funds themselves.

Scope of the carve-out for substantive activities

- Limiting the substance carve-out to a formula partly based on tangible rather than all business assets is inconsistent with the principles underlying the BEPS project, unnecessary given the checks and balances in the existing BEPS actions, and potentially discriminatory as regards smaller jurisdictions.

Use of jurisdictional blending to compute effective tax rates

- Jurisdictional as opposed to worldwide blending is not only less efficient in terms of the compliance and administrative burden it imposes, but can also lead to distortions that create an unlevel playing field in favor of larger jurisdictions, including the risk of encouraging relocation of businesses to jurisdictions with an effective tax rate at or just above the minimum. It is also inconsistent with the worldwide blending proposed under the simplified approach for Associates and JVs.

Use of statutory tax rate for Subject-To-Tax Rule

- As a matter of principle Cayman Finance sees the use of nominal or statutory rates in the Pillar Two proposals as undesirable and where used for part of those proposals, as creating complexity and the risk of disputes. When used for simplification, as in the creation of 'white lists' or the STTR, the benefits need to be carefully weighed against the risks of inaccuracy and the resulting risk of further distortions.

Commercially neutral business activities

- Cayman Finance would welcome further consideration being given to how other largely tax neutral activities that are regularly carried out by multinational enterprises for sound commercial reasons accompanied by adequate substance could be accommodated under the Pillar Two proposals

C. Background and context

While noting that the public consultation on Pillar Two addresses the more technical aspects rather than the issues that still require political agreement, Cayman Finance considers it important that these broader, more fundamental issues should not be closed off from further public debate and, in particular, should not be relegated to political 'horse-trading'. Nevertheless, Cayman Finance recognises that 'the devil is often in the detail' and commentary is included below on relevant technical aspects.

The titles of the two Blueprints make clear that the overarching aim of the OECD/G20 Inclusive Framework Blueprints is to provide a solution to the tax challenges of digitalisation. The Pillar Two Blueprint restates its aim of addressing the "remaining BEPS challenges'', thus indicating that the aim of introducing a global minimum tax is essentially to address the risk of tax avoidance in the form of base erosion and profit shifting that is perceived still to exist, notwithstanding the other 14 BEPS final reports issued in 2015.

We note in that respect the often-heard criticism that it is too early to assess the extent to which further measures are necessary and that more time is needed to allow the 2015 actions to play out. We also note the related doubts that have frequently been expressed as to whether the real aim is to address a 'race to the bottom' rather than the stated objective of addressing tax avoidance (although it is recognised that there is some connection between the two).

However that may be, Cayman Finance believes that, in the first place those concerns arise outside the scope of the primary business activities carried out in the Cayman Islands, that are mainly limited to financial services and collective investment facilitation, and secondly, that the Cayman Islands in any event has the necessary legal and regulatory checks and balances in place to address both concerns.

D. Key features of the Cayman Islands economic and business environment

The Cayman Islands, through its pivotal role in facilitating international investment and finance, supported by its robust and well-regulated financial services industry, generates enormous benefits to jurisdictions across the world, including both developed and developing countries.

In particular, the Cayman Islands is home to a significant portion of global hedge, private equity, and venture capital funds. In fact, approximately 70 percent of non-US domiciled alternative investment funds managed by US Securities and Exchange Commission-registered advisors are domiciled in the Cayman Islands. A recent study performed by Capital Economics estimates that foreign investment mediated through the Cayman Islands was around US$4.5 trillion and supports in the region of 5 million jobs globally. Additionally, the research found that investment through the Cayman Islands supports estimated tax revenues of approximately US$60 billion for the United States government.

These funds fulfill a crucial role in facilitating co-investment by investors from around the globe providing substantial foreign direct investment, infrastructure financing, and liquidity to both G20 countries as well as developing countries, with resulting economic benefits that include:

- Boosting economic growth in invested economies, including those struggling to recover from health pandemics and other social and economic disruption
- Facilitating sustainable investment, specifically, Environmental, Social and Governance (ESG) investments
- Supporting technology innovation and development
- Realisation of infrastructure developments such as hospitals, schools, roads, power plants, etc.
- Financial support including the outright purchase of failing businesses and corresponding job security for their employees
- Providing access to globally diversified investments with a corresponding reduction of risks for institutional investors such as pension funds
- Generation of profits and tax revenues in financial centres around the world from asset managers services provided to Cayman Islands funds

Such benefits have never been more important than they are today when the world’s economies are struggling under the impact of the COVID-19 pandemic and associated economic crisis. However, these are not short-term benefits and there is no doubt they will continue to prove their worth in the years to come.

For a more detailed account of the beneficial role of the Cayman Islands for global economic welfare, we refer to our March 2019 submission to the public consultation on the OECD’s Policy Note: Addressing the Tax Challenges of the Digitalisation of the Economy (https://www.dropbox.com/s/zrj1e14mdxd7fmv/OECD-Comments-Received-Digital-March-2019.zip?dl=0). For a more detailed statistical review of the Cayman Islands’ fund activity, we refer to the 2018 Investments Statistical Digest drawn up by the Cayman Islands Monetary Authority (https://www.cima.ky/upimages/publicationdoc/InvestmentsStatisti_1606474237.pdf).

E. Cayman Islands as a fully cooperative and transparent tax jurisdiction

As a tax neutral jurisdiction, the Cayman Islands does not add an extra layer of tax to financial services transactions. It does not have a preferential tax regime, but rather is a transparent system with a stated tax rate of zero that is the same as the effective tax rate.

Preferential tax regimes that provide effective rates that derogate from a jurisdiction’s headline tax rate can encourage treaty shopping and facilitate base erosion. The Cayman Islands does not pose such risks, given the full transparency of its system and the fact that it has not concluded any tax treaties that would result in the reduction of withholding taxes. It has long been acknowledged at both OECD and EU levels, that tax competition arising from different tax rates – including the absence of a corporate tax rate - is not in and of itself harmful[2]. Tax competition may be harmful only if combined with other elements such as ring fencing, lack of transparency or insufficient economic substance or where a tax treaty or other similar measure exists to prevent a jurisdiction from asserting its taxing rights. Logically this also means that corporate and investment structures should not be penalised for being present in such jurisdictions where such other elements are lacking. Other jurisdictions are free to decide how to tax activities of their residents outside their jurisdiction, e.g. application of source rules, transfer pricing and CFC regimes, etc. as long as they respect the above principle of legitimate tax competition.

In this regard, it should be noted that in its 2019 and 2020 peer review reports on harmful tax practices the Inclusive Framework assessed the Cayman Islands in respect of the expanded BEPS Action 5 substantial activities factor for no or only nominal tax jurisdictions as not harmful both as regards its economic substance requirements that took effect from 1 January 2019, and as regards the related domestic legal framework meeting all aspects of the standard.

Furthermore, the Cayman Islands has put in place all relevant measures to ensure that it complies with the European Union's tax good governance standards and is accordingly classified as a fully cooperative jurisdiction. These standards cover not just economic substance but also tax transparency, in particular compliance with internationally accepted standards on information exchange, as well as compliance with the BEPS minimum standards. This includes being a signatory to the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information as well as the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports.

In this regard it should be noted that the OECD's first Peer Review of the Automatic Exchange of Financial Account Information released on 9 December 2020 confirmed that the Cayman Islands legal framework implementing the AEOI Standard is in place and is consistent with the requirements of the AEOI Terms of Reference, specifically as regards the domestic legislative framework requiring Reporting Financial Institutions to conduct the due diligence and reporting procedures and its international legal framework to exchange the information with all of the Cayman Islands' Interested Appropriate Partners.

The Cayman Islands has 36 international instruments for the exchange of tax related information. This includes the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Therefore, Cayman has in excess of 120 potential exchange partners. Such transparency ensures that investor jurisdictions have the necessary information to ensure that their own taxpayers declare and pay the tax properly due. The revenue accruing to that jurisdiction is not impacted by an additional layer of tax on the investment fund.

F. Specific comments on the Pillar Two Blueprint

[2] See, e.g. "Resumption of Application of Substantial Activities Factor to No or Only Nominal Tax Jurisdictions, BEPS Action 5"; OECD (2018), para. 20, and "Criteria and process leading to the establishment of the EU list of non-cooperative jurisdictions for tax purposes", 6325/17, Council of the European Union, (2017), Annex II, para. 3.

Excluded entities and arrangements

Cayman Finance notes with satisfaction that investment funds would be excluded from the scope of Pillar Two according to the Blueprint, in line with Cayman Finance's submission to the public consultation on Pillar Two in November/December 2019. As such it reflects the tax neutral effect of investment funds and the significant benefits to global trade and investment they promote. It is noted that this exclusion would cover both the GloBE rules as well as the STTR.

The Blueprint lists a number of "entities and arrangements", including "investment funds" that would be out of scope of Pillar Two (specifically the GloBE rules (Income Inclusion Rule (IIR) and UTPR) and the Subject To Tax Rule (STTR)). The exclusion is expressed to be subject to compliance with the conditions in the provided definitions. In addition, the Blueprint notes the following three principles that guide such exclusion:

1) Whether the tax policy rationale for the residence jurisdiction providing a nil or low rate of taxation for the sector is consistent with the GloBE tax policy rationale;
2) Whether the exclusion is necessary to avoid the compliance and administration costs that might otherwise arise where such entities derive income that could fall within the scope of the rules;
3) Whether an exclusion would be contrary to the policy of the GloBE rules by creating material competitive distortions as compared to other internationally operating businesses.

It is unclear what role these principles would play in determining whether a given entity or arrangement that satisfied the definition in question was in fact covered by the exclusion. Subject to a caveat as regards the first principle, Cayman Finance submits that it would be in the interests of certainty if these principles were used as an alternative, default criterion to justify bringing a given entity or arrangement within the exclusion. Correspondingly, it would not be in the interests of certainty if the principles were used as an additional criterion to be satisfied. An additional benefit from such an approach would be that the conditions for qualifying for the exclusion would be fairer, more effective and sustainable, in particular where due to business, legal or regulatory developments a given entity or arrangement technically came to fall outside the strict wording of the definitions. Such an approach would also ensure that other commercial and financial arrangements, such as securitisation vehicles, that reflect these principles would not unintentionally be brought within the scope of Pillar Two.

The caveat referred to above is that the first principle appears to assume that the nil or low rate of taxation is the result of a specific policy rationale of the residence jurisdiction for the sector in question. Jurisdictions such as the Cayman Islands, that have adopted a single transparent zero rate of corporate taxation across all economic sectors, clearly do not have any such preferential sector specific policy rationale. There seems no valid/justifiable reason to exclude tax neutral jurisdictions such as the Cayman Islands for this reason. To do otherwise would be to create an unlevel playing field with jurisdictions offering preferential tax regimes, or providing tax neutrality through other means such as the use of tax transparent entities, such as exist in many OECD and EU jurisdictions.

As rightly pointed out in the Blueprint, the question of exclusion does not arise where an entity or arrangement would otherwise be outside the scope on the grounds that it is not a constituent entity. This would be of particular relevance to those entities or arrangements that would otherwise be at the top of the group ownership chain and would not be required to consolidate with investments they control.

Investment funds definition

The Pillar Two Blueprint provides a number of criteria to define what entities or arrangement would be considered as investment funds and therefore qualify for exclusion. We note that the definition of investment fund draws on the definition of “investment entity” in IFRS 10, European Union Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD), and the IMF definition of collective investment schemes used in the Balance of Payment statistics. The Blueprint suggests that it is not intended to result in only those investment funds that come within all three definitions would qualify for the exclusion, for example, a fund could qualify provided it invests in accordance with a defined investment policy and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively. Cayman Finance supports such an approach that ensures the definition covers internationally accepted forms of collective investment, aligning with the GloBE tax policy and avoiding international distortions.

Cayman Finance welcomes the inclusion in the definition of investment funds entities and arrangements owned by the principal fund. It is understood that the definition would be adjusted to ensure that such entities and arrangements would be treated as an Ultimate Parent Entity together with the principal fund. This reflects the commercial necessities for how funds are structured, so as to include arrangements such as master-feeder arrangements (including arrangements involving a single aggregating investor (or "feeder fund") that comprises a number of investors), and umbrella/sub-fund arrangements (notwithstanding that the latter may be contractually ring-fenced from each other) without conflicting with the principles underlying the exclusion.

While such criteria can be useful, in line with our above submission, Cayman Finance sees a valuable role for the three principles that underlie the proposed exclusions (as adjusted for tax neutral jurisdictions) as a supplementary alternative means of qualifying for an exclusion. As pointed out above, an alternative principles-based definition has the key benefit of ensuring a sustainable scope to the rule, that can more easily respond to business, legal or regulatory developments, and ensure the continued efficient allocation of capital. Quick response to commercial and market developments has traditionally been a hallmark of the Cayman Islands’ financial service industry and a contributing factor to its success, to the considerable benefit of jurisdictions around the world in which Cayman Islands funds invest.

The Blueprint notes in the context of funds that the domestic tax outcome may, for example, be designed to ensure a single layer of taxation on vehicles used by investors. In the case of tax neutral jurisdictions such as the Cayman Islands, the tax outcome is a function of the system itself, that results in a single layer of taxation for those funds that wish to avail of it. However, the end result is the same whether under a tax neutral jurisdiction or a special derogation from a jurisdiction’s normal tax regime, i.e. that investors are put in the same position as if they had invested in the underlying assets of the fund directly, rather than through an investment fund vehicle. As the Blueprint points out, this widely recognised tax neutrality principle justifies a special exemption, deduction, or other preferential treatment. At the end of the day it should not matter how that result is achieved.

If the suggested approach based on the ‘three principles’ alternative is adopted, the practical application would need to be addressed to ensure a simple and certain process and minimal compliance and administrative burden for taxpayers and tax administrations. A possible approach might be a local certification procedure backed up by a dispute prevention mechanism.

Lower tier investment funds

The Blueprint definition of investment funds is explicitly limited to entities or arrangements that are at the top of the ownership chain. As it correctly points out, this "does not comprehensively address the issues associated with controlled investment funds (i.e. a fund that is controlled by a Constituent Entity of an MNE Group that is not an Excluded Entity)".

If such structures are not brought within the scope of the exclusion, this would create a potentially distortive distinction between the two situations. It appears from the Blueprint that the Inclusive Framework would agree that the tax neutrality of such structures should be preserved in principle by excluding them from the IIR. However, if the income of such funds is not included in the consolidation of the MNE parent, this could result in the income being excluded from the IIR tax base. The Blueprint asks what additional rules might prevent this.

Cayman Finance would submit that the approach should be to attribute a pro rata amount of the income to the MNE parent for purposes of the IIR. This would be in line with the Blueprint proposals for attributing income of tax transparent entities in the case of jurisdictional blending, although adjustments may be needed to take account of timing where the jurisdiction of the MNE parent does not tax the income immediately. In such a case it would be appropriate also to attribute a pro rata amount of any withholding taxes suffered by the fund on the attributed income. This would also align with the principles underlying the proposals for attributing 'cross-jurisdictional' taxes under the Blueprint. It is also the corollary of the principle explained in the Blueprint that any "tax paid in connection with excluded income must be excluded from the numerator of the GloBE ETR computation for the jurisdiction of the owner".

The Blueprint also asks what additional rules might ensure related party payments to and from the fund cannot be used to circumvent the UTPR. This presumably addresses the consequence of being an excluded entity under the GloBE rules, that include the UTPR, so that payments made to an investment fund, being an excluded entity, would not be subject to the UTPR notwithstanding the fact that, in the hands of the fund itself that income may be subject to low or no tax.

As the Blueprint points out, the tax neutrality of the fund does not mean that the investment returns earned by the fund go untaxed. The investment return will be subject to tax to the extent that the source country has chosen to impose taxation (e.g. by way of withholding tax on an investment return and a further layer of taxation may be imposed in the hands of the ultimate investor either on distribution or as the investment return accrues). That taxation should therefore be taken into account in the payor jurisdiction in determining whether or not the UTPR is triggered. In practice it would raise considerable practical difficulties for the fund itself to obtain details from its investors as regards the effective tax rate borne by the investors on the fund's income and to provide this to the payor jurisdiction.

Cayman Finance submits that the more appropriate approach both in terms of practicalities and proportionality would be to rely on the information exchange framework to ensure the relevant information is obtained.

G. Additional observations

Substance carve out

Cayman Finance notes that the Pillar Two Blueprint includes a ‘formulaic substance carve-out’ that excludes a fixed return for ‘substantive activities’ within a jurisdiction from the scope of the GloBE rules.

While this reflects in part Cayman Finance’s submission to the public consultation on Pillar Two in November/December 2019, its scope is unnecessarily restrictive from a policy perspective. ‘Substantive activities’ are defined in the Pillar Two Blueprint by reference to a payroll component and a tangible asset component. This effectively makes it practically impossible for activities that do not require substantial tangible - as opposed to intangible - asset investment but which do involve an adequate degree of (alternative) substance - to come within the scope of the carve-out. We would query whether such result is, in fact, in line with the policy intention of Pillar Two.

However, as we have previously stated, it is precisely that kind of issue that the economic substance regulations are designed to address. These were specifically introduced by the Cayman Islands to address concerns raised by the OECD and the EU regarding the risk of multinationals exploiting tax neutral jurisdictions for profit shifting purposes. The proposed substantive activities definition in Pillar Two falls far short of the economic substance regulations promoted and approved by the OECD/Inclusive Framework and the EU under its listing process of non-cooperative jurisdictions. There is an equal misalignment between the proposed definition and other elements of the BEPS initiative, for example the DEMPE principles in BEPS actions 10-12.

We would further submit that limiting the application of substance to the set criteria is somewhat redundant in the new global economy, where value creation takes place through a rapidly changing combination of factors. Care should be taken to not discriminate against small economies that have highly skilled workforces and strong capital formation through a limited formulaic application of substance rules.

The same applies, but to a greater degree, as regards the Pillar One Blueprint proposals that envisage the allocation of global (residual) profits – i.e., profit generated primarily from intangible assets and related activities, to market jurisdictions where those assets and activities are, by definition, absent. If such an allocation is permissible, it is hard to see the logic that would cause income that is attributable to intangible assets and related activities that <u>are</u> present in a jurisdiction to be taxed in a completely different jurisdiction. Cayman Finance would welcome further consideration being given to how such activities could be accommodated under the Pillar Two proposals.

Blending

Cayman Finance is disappointed that the Pillar Two Blueprint put forward jurisdictional blending instead of worldwide blending. We have previously pointed out that the potentially significant complexity and compliance burdens could be associated with a narrow blending approach. The jurisdictional blending proposal also raises policy concerns that could adversely impact small tax neutral jurisdictions such as the Cayman Islands. By blending at jurisdiction level it would be possible to mix (and thereby average out) high and low taxes within a single jurisdiction, for example, where low taxes are applied to income realised under patent box regimes (that would not be carved out under the current proposals) in a jurisdiction where regularly taxed activities are also carried on.

The above approach gives a clear advantage to larger jurisdictions that are better able to host both types of activity, resulting in an unlevel playing field. A similar distortion could arise if the tax associated with income covered by the proposed substance carve-out is not also excluded in computing the ETR in a given jurisdiction: such tax could otherwise be used to ‘average up’ a lower tax rate under a patent box or similar regime in the same jurisdiction.

In addition to the above distortions caused by jurisdictional blending, there is a significant risk that multinational enterprises will be incentivised to minimise their global tax burdens by allocating as much revenue as possible to entities tax resident in jurisdictions that have tax rates at or just above the global minimum level. Thus, Pillar Two would simply have replaced a ‘race to the bottom’ with a ‘race to the minimum’, with a corresponding impact on businesses behaviour.

Tax rate

Cayman Finance recognises the importance from a policy perspective of using an effective rate of tax rather than a statutory or nominal rate in applying the GloBE rules. To do otherwise would encourage jurisdictions to adopt relatively high statutory rates but apply base narrowing rules to reduce the effective rate. At the same time, it acknowledges the additional complexity and compliance burden this gives rise to and is therefore sympathetic to the proposal to have regard to the nominal rate for purposes of applying the STTR. That said, this not only creates an inconsistency from a design perspective but also still encourages jurisdictions to avoid the application of the STTR by designing their rules in the way described above to lower the effective rates, thus encouraging profit shifting, in particular relying on tax treaty networks to obtain lower or zero withholding tax rates. That said, as noted above, the Cayman Islands does not have double tax treaties so is not as such impacted by this.

A similar concern could arise in respect of the proposed simplification measure whereby certain jurisdictions would be identified as ‘low risk’ so that ETR computations would not be required in those jurisdictions. The proposed approach would be an ex-ante process whereby jurisdictions would be identified where the tax base does not materially depart from the GloBE tax base (other than in areas where different accounting-tax approaches are common and low-risk, for example dividends may be taxable under local tax rules) and the tax rate is sufficiently high. In principle, such an approach would be acceptable to the extent it was reliable and transparent, but otherwise could lead to distortions.

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