

**APPLEBY**

**Guide to the EU Savings Directive:  
Its relevance for Cayman Islands  
Investment Funds**

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## **PREFACE**

With several thousand investment funds of various types, representing billions of dollars invested, the Cayman Islands are a leading jurisdiction for funds. The availability of expert professional advice, together with the relative speed and comparatively modest cost of establishing a mutual fund in the Cayman Islands all contribute to the success of the Islands' funds business.

Appleby's experienced mutual funds team provides a highly responsive, competitively-priced service for our funds clients. We can advise on requirements for establishing a mutual fund, establish the appropriate vehicle for the fund whether corporate or otherwise, prepare the offering documents and arrange for its registration under the Mutual Funds Law. As Listing Agents for the Cayman Islands Stock Exchange, we can also arrange for the listing of eligible funds. It is now possible to make use of segregated portfolio companies for multi-class funds, and we can advise on and set up fund structures of this type as well as traditional umbrella or master/feeder structures using groups of companies. Increasingly, we are also involved in mergers and acquisitions of mutual funds.

Our private equity funds team advises a broad range of clients including leading private equity firms, asset managers, institutional investors and companies seeking funding. The team is involved in a wide variety of transactions conducted through Cayman Islands companies and exempted limited partnerships. Our lawyers have extensive experience of all the structures used in the private equity sphere and focus on delivering high quality, practical and commercially minded advice. The investment sectors covered are wide-ranging, and include media, manufacturing and technology as well as more traditional hard asset based businesses.

Appleby Spurling Hunter is the longest established law firm in the Cayman Islands. Our success is built on giving timely, clear and sound advice that reflects an understanding of our clients' business needs. We regularly work with – and many of our lawyers come from – the world's leading international firms. We aim to provide world-class quality of service and expertise, combining in-depth knowledge of Cayman Islands laws and regulations with international experience.

## **SCOPE AND PURPOSE OF THE DIRECTIVE**

In February 2004 the Cayman Islands (which are not part of the European Union) agreed in principle to implement the EU Savings Directive (2003/48/EC) (EUSD). According to Article 1 of the EUSD, its ultimate aim is “to enable savings income in the form of interest payments made in one Member State to beneficial owners, individuals, resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the national laws of the latter Member State.”

The EUSD applies:

- only to interest or interest-derived payments;
- only to payments to EU resident individuals (“beneficial owners”) and certain EU intermediary entities (“residual entities”);
- only when payments are made by paying agents in the EU and other defined territories (including the Caribbean Overseas Territories); and
- only when payments are made cross-border.

The extension of the EUSD to the Cayman Islands resulted from a commitment given by the UK government to the other Member States. The Government of the Cayman Islands agreed to implement the EUSD, but only after securing important benefits for the Islands’ financial services industry. Since the Islands are not directly subject to EU law, implementation will be by way of bilateral agreements between the Cayman Islands and each EU Member State. The Cayman Islands government has agreed a model for these bilateral agreements (“Model Agreement”), which sets out the manner in which the EUSD will be implemented in relation to the Cayman Islands.

### **Timing of Implementation**

The EUSD has two start dates: the first is 1 January 2004, by which paying agents are required to collect sufficient information from customers to enable them to satisfy the information reporting requirements of the EUSD; and the second is 1 July 2005, by which paying agents are required to report interest payments.

The second start date was initially 1 January 2005 and was conditional on the implementation of identical measures in certain of the dependent and associated territories of the Member States (namely the Channel Islands, the Isle of Man and the dependent or associated territories in the Caribbean) and of “equivalent measures” in the principal third countries (Switzerland, Monaco, Andorra, San Marino and Liechtenstein). On 1 July 2004 the Members of the EU were to have decided whether these conditions have been satisfied. Although the dependent and associated territories and the principal third countries referred to above have reached agreement in principle in all matters of substance, on 25 June 2004 the Members of the EU decided to postpone the second start date to 1 July 2005 because of

concerns that Switzerland would not be able to implement equivalent measures by 1 January 2005.

### **Interest Payments**

For the purposes of the EUSD, interest payments include interest paid in relation to debt claims, which include bonds and deposits, but not equities. Such payments also include interest accrued or capitalized at sale or redemption of debt claims.

Where an investment fund has interest income, distributions (e.g. dividends) made by the fund or the income derived from the sale or redemption of the shares or units may also constitute interest payments for the purposes of the EUSD.

Under the EUSD, there are certain exclusions to the definition of interest payments. These include the following:

- the interest component of true insurance and pension products;
- income derived from EU non-UCITS (non-retail) funds: as explained below this is of particular significance for Cayman funds by virtue of the agreed basis of implementation.
- income derived from distributions made by an EU UCITS fund if less than 15% of such fund's assets are invested in debt claims. This exclusion does not apply to non-EU funds.
- income realized upon the sale/redemption of shares or units of a fund (whether a EU UCITS fund or not) if less than 40% of such fund's assets are invested in debt claims.

In determining the percentage of a fund's assets that are invested in debt claims, reference may be made to the investment policy stated in the fund's offering document. However, if this policy does not place a limit on the amount of its assets that may be invested in debt claims and it is unknown from the information available what percentage of the fund's assets are in fact so invested, the fund will be deemed to exceed the 15% or 40% limits set out above.

### **Paying agents**

A paying agent is defined as an economic operator established in the EU or certain defined territories (including the Cayman Islands) that either pays interest to, or secures the payment of interest for the immediate benefit of, the beneficial owner. In a chain of economic operators, the last economic operator is the paying agent.

Even if an economic operator is not the paying agent, it may be required to collect and pass on to the paying agent such information as would enable the paying agent to satisfy its obligations under the EUSD.

In the context of the regulated funds industry, there are several ways by which payments of distributions or redemption proceeds could be paid to investors, including the following:

- the fund itself could make the distribution or redemption payments. In this case, if the fund were to make those payments directly to beneficial owners the fund would be considered to be the paying agent;
- the fund could outsource the custody and administration of fund payments to a third party, with the third party making payments from its own account or from the fund's account. In this case, if the third party were to make payments to beneficial owners the third party would be considered to be the paying agent;
- the fund or its administrator could make the distribution or redemption payments to a professional nominee, which in turn would forward the payments to the ultimate beneficial owner. In this case, the professional nominee would be considered to be the paying agent.

As stated above, the EUSD does not apply to payments made by paying agents that are not located in the EU and the other defined territories.

### **Beneficial Owners and Residual Entities**

The EUSD defines a beneficial owner of interest income as an EU tax-resident individual (i) who receives an interest payment, or (ii) for whom an interest payment is secured, unless:

- the paying agent identifies someone else as the beneficial owner (in which case the paying agent is required to conduct an appropriate investigation to determine whether this is in fact the case);
- the individual provides the paying agent with evidence that the payment was not made for his benefit, e.g. if the individual acts as nominee for another person or entity.

The EUSD also applies to certain residual entities. The purpose of the residual entity reporting requirements is to prevent individuals avoiding the effect of the EUSD by arranging to receive interest payments via the relevant entities. However, there are some significant exclusions from the definition of residual entities.

An entity is not deemed to be a residual entity if it is located outside the EU or, if located within the EU, (i) it is a legal entity (e.g. a company), or (ii) its profits are taxed under the general arrangements for business taxation, or (iii) it is an EU UCITS fund. Accordingly, if interest payments are made to a Cayman Islands company owned by an EU resident

individual, no reporting by the paying agent will be required (though of course the individual may well have to declare dividend income from the company to his home tax authorities).

The burden of deciding if an EU entity falls within one of the excluded categories rests on the paying agent making the interest payment to that entity.

### **Reporting Requirements**

Certain of the countries to which the EUSD applies have opted for a withholding model, pursuant to which a 15% tax (rising ultimately to 35% in 2011) will be applied. Others have opted for an automatic information exchange model. The Cayman Islands have opted for the latter model.

If a paying agent located in one country (Country A) determines that the EUSD applies to an interest payment made to a beneficial owner who is a tax resident in another country (Country B), the paying agent would be required to report the payment to the tax authority of Country A. At least once a year the tax authority in Country A would be required to exchange information with the tax authority of Country B.

Under the EUSD, the minimum amount of information that is required to be reported is:

- the name and address of the paying agent;
- the identify and residence of the beneficial owner;
- the account number of the beneficial owner (or, if none, identification of the debt-claim);
- the following information on the amount of an interest payment:
  - for sales/redemptions of debt claims or fund units, either the full amount of the proceeds, or the interest/income component;
  - for fund distributions, either the full amount of the distribution, or the interest component.

### **The position of Cayman Islands Mutual Funds**

Purely by virtue of the principals set out above, the actual need for Cayman funds to report interest payments would likely be limited – many funds invest primarily in equities, and most have relatively few investors that are EU-resident individuals. However, important further principals have been established as part of the process of agreeing how the EUSD will be implemented.

Under the Model Agreement a mutual fund licensed under Section 5 of the Cayman Islands Mutual Funds Law is deemed to be equivalent to a UCITS fund. However, such funds constitute only a small minority of the Cayman Islands funds business. By virtue of direct arrangements with the UK and Ireland, UK and Irish paying agents will be able to treat all other Cayman funds regulated under the Mutual Funds Law, such as hedge funds regulated under Section 4(3) of the Mutual Funds Law, in the same manner as they are entitled to treat EU non-UCITS funds, that is, as falling outside the scope of EUSD. Paying agents in the Cayman Islands will be able to do so likewise.

According to Swiss rules published April 1 2005, a Swiss-based paying agent, when attempting to determine whether a fund based in a dependant territory (e.g. the Cayman islands) is within the scope of the EUSD, is entitled to look to the laws of the fund's "home country". Accordingly, if the fund would be considered to be outside to scope of the EUSD for the purposes of the laws of the jurisdiction in which the fund is based, a Swiss-based paying agent is entitled to treat the fund as falling outside the scope of the EUSD.

Under the Model Agreement, other EU Member States may also take the same position as the UK and Ireland have taken with respect to Cayman non-UCITS funds. If the paying agent of a Cayman fund is located in a EU Member State other than the UK or Ireland then advice should be obtained in the relevant jurisdiction as to whether local legislation will apply to the Cayman fund. If the advice obtained indicates that the local legislation will apply to the Cayman fund, consideration should be given to appointing another paying agent located in a jurisdiction in which the Cayman fund would be treated as falling outside the scope of the EUSD.

After initial and genuine concerns that the burden of the information-gathering and reporting requirements might be disproportionate to the number of EU-resident individuals beneficially owning interests in Cayman Islands mutual funds, it appears that the adverse impact of the EUSD in the Cayman Islands will be minimal, and indeed by the terms of the implementation agreements with Member States and by opting for the disclosure model rather than withholding tax, the Cayman Islands may actually be better placed than competing jurisdictions that are not covered by the EUSD.





For more specific advice on trusts in the Cayman Islands, we invite you to contact one of the following in the Corporate and Commercial Practice Group

**Bruce Putterill**

Partner, Local Corporate and Commercial Practice Group Head  
bputterill@applebyglobal.com

**Bryan Hunter**

Partner, Corporate and Commercial Practice Group  
bhunter@applebyglobal.com

Appleby is one of the largest and most well respected providers of offshore-based legal, fiduciary and administration services. With over 600 lawyers and staff, the organisation is uniquely positioned in the key offshore jurisdictions of Bermuda, the British Virgin Islands, the Cayman Islands, Jersey and Mauritius as well as the financial centres of London and Hong Kong.

Appleby provides sophisticated, specialised legal services primarily in the areas of: Corporate and Commercial, Litigation and Insolvency, Trusts and Property. Complementing our legal expertise is our Fiduciary and Administration group of companies. This group provides services in the areas of: Corporate Services, Employee Benefit Trusts, Fund Administration, Insurance Management, Listing Services, Management and Accounting Services, Special Purpose Vehicles and Trust Services.

Appleby is also a member of TerraLex, an international association of law firms; the World Services Group, a global multi-disciplinary network of service providers; and is represented in many of the major international legal organisations.

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# APPLEBY

[info@applebyglobal.com](mailto:info@applebyglobal.com)

The Right People. The Right Places.

#### Bermuda

Canon's Court  
22 Victoria Street  
PO Box HM 1179  
Hamilton HM EX  
Bermuda

Tel +1 441 295 2244  
Fax +1 441 292 8666

#### British Virgin Islands

Palm Grove House  
PO Box 3190  
Road Town  
Tortola  
British Virgin Islands

Tel +1 284 494 4742  
Fax +1 284 494 7279

#### Cayman Islands

Clifton House  
75 Fort Street  
PO Box 190  
Grand Cayman KY1-1104  
Cayman Islands

Tel +1 345 949 4900  
Fax +1 345 949 4901

#### Hong Kong

5511 The Center  
99 Queen's Road Central  
Central  
Hong Kong

Tel +852 2523 8123  
Fax +852 2524 5548

#### Jersey

PO Box 207  
13-14 Esplanade  
St Helier  
Jersey JE1 1BD  
Channel Islands

Tel +44 (0)1534 888 777  
Fax +44 (0)1534 888 778

#### London

2nd Floor  
2 Royal Exchange Bldgs  
London EC3V 3LF  
United Kingdom

Tel +44 (0)20 7283 6061  
Fax +44 (0)20 7469 0540

#### Mauritius

Level 11  
One Cathedral Square  
Jules Koenig Street  
Port Louis  
Mauritius

Tel +230 203 4300  
Fax +230 210 8792