



WHAT IS PARADISE?

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The power of the free press should never be underestimated or should it?

On Sunday 5 November the International Consortium of Investigative Journalists (ICIJ) published new revelations about tax evasion and avoidance schemes. These revelations seem to be even more significant than the Panama papers and Lux Leaks. The moniker they have bestowed on these leaks is "Paradise papers". Journalists have promised that this time the focus will not be so much on money laundering as on schemes that are used by multinationals for fiscal optimisation. Schemes which are formally legal according to current laws now are being questioned from the perspective of morality.

This blog is a personal opinion by Kristina Budryté-Ridard, Director in FTI Consulting Brussels Financial Services Team

Is it a major revelation or "yet another" scandal that the broader public is already getting used to? Each revelation must break even bigger stories to grab the public's interest and to ensure the continuous pressure on policy makers. The ICIJ has definitely delivered, and did so – again -with impeccable timing. It is however now up to the legislators to see through the 'catchy stories' and ask themselves the right questions:

- Who is to blame - the multinationals, the tax systems of EU member states or the small 'Paradise' islands offering preferential tax systems?
- Are the rules of the 'game' at fault and if so how do we amend the rules while ensuring the least undesirable side implications to countries' budgets and companies long term growth?

The timely publication of the "Paradise Papers" that coincides with major legislative changes in the EU as well as in the US has already ignited a number of debates on both sides of Atlantic, and undoubtedly in many more jurisdictions. These revelations will most likely impact tax reforms worldwide.

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The US Tax reform

Just few days ahead of the Paradise Papers announcement, the US Congress Ways and Means committee proposed its tax reform. Of course it remains to be seen whether the Republican tax reform will make it through the Congress and Senate, but definitely the Paradise Papers give a special flavour to the whole debate.

The US tax reform is long awaited, not only because the tax rates should be lowered but also because the US tax system should go back to the 'territorial taxation'. This means that the US would no longer oblige US multinationals to pay taxes for the profits made worldwide but only for those made in the US. Currently - the US multinationals do not pay taxes on profits made overseas as long as these are not repatriated to the US - some argue that these companies actually are enjoying the US government subsidies vis-a-vis their global competitors. If this reform passes, would it mean that there wouldn't be any new EU competition investigation similar to the Apple/Ireland state aid case?

But even without this major change, the proposed US tax reforms have strong Anti-Base Erosion rules, which could potentially create tensions with non-US companies and limit aggressive taxation:

- **"Minimum Tax"**: The proposal would create a 10% tax on US companies' high-profit foreign subsidiaries, calculated on a global basis (not country-by-country).
- **Excise Tax** : Payments made by a US corporation to a related foreign corporation that are deductible would face a 20% tax on payments sent back to foreign affiliates as a way of levelling the playing field with US-based multinationals.
- Denial of Interest **"Thin cap rule"**: This provision would deny interest to domestic corporations which are members of an international financial reporting group to the extent that the US corporation's share of the group's global net interest expense exceeds 110% of the US corporation's share of EBIDTA. This provision is meant to prevent the parking of interest expenses in the U.S.

Tax policy in the European Union

In the EU, the revelations of Paradise Papers will almost certainly influence two important tax policy decisions that EU Ministers of Finance need to take by the end of 2017.

EU tax haven blacklist

Firstly, the common EU list for non-cooperative third country jurisdictions, or better known as the "EU tax haven blacklist". The Paradise Papers make painstakingly clear how multinationals use low tax/non-transparent jurisdictions to

optimise their taxes. The outcry from the Members of the European Parliament as well as NGOs after the revelations emphasised the need to have a 'real' list and 'effective' sanctions for such jurisdictions. This puts the EU Finance Ministers on the hot seat. Their decisions will be closely scrutinized and in any case, as long as the list will be - it would still not satisfy the critics. However, will they go as far as having a closer look on the role of EU countries in schemes that use tax havens? Probably not.

Reportedly after examining 92 jurisdictions, the EU has communicated to 53 countries and territories that they are potentially targeted to be put on the blacklist. These countries now need to either promise to change their tax rules or face blacklisting and sanctions. Importantly, Council explicitly states that simply having a 0% tax rate is in itself not reason to be included in the list, but with this high level of public pressure Member States would have a hard time explaining why some of the zero-tax jurisdictions are not on the final list.

Digital Taxation

Secondly, both the EU and the OECD are working on a proposal to address the so-called "Digital Taxation". This should provide a tax framework appropriate for the new ways of doing business in a digitalising economy. The EU Ministers of Finance – at their December meeting – are planning to clarify the Member States' view on the way forward on Digital Taxation. This will feed into the European Commission's work on a new legislative proposal due in Q1 2018 and the OECD's interim report to be delivered by April 2018.

In this context, the Paradise Papers risk doing more damage than good. The question how and whether to address digitalisation and how to tax profits companies are making online is too complex to be just rushed through because of yet another scandal. However, the debate on digital taxation, especially in the European Parliament, seems to be driven by a wish to tax multinationals more in their own home country forgetting the spill-over effect that new taxes can have on start-ups, mid-sized digital companies and to the wider economy. With so many questions, one can wonder whether the desperate wish to move "somewhere" as fast as possible, will actually lead to well-thought through and effective outcomes.

According to the public consultations both at OECD and EU level three main options for taxation in the digital economy are

- the **'equalisation'** tax which would be based on the turnover the 'digital' company makes generated from "digital activities" in each jurisdiction,

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- the **withholding tax** on certain digital transactions (like payments to non-resident providers of goods/services ordered online) and / or
- the introduction of the so-called '**Virtual Permanent Establishment (PE)**', when certain digital activities would trigger the right of the jurisdiction to tax profits.

While the first two options are heavily criticized by industry, think tanks and even some of the countries for potentially creating double taxation, the last one seems to be most promising at first glance but also raises many questions.

If the idea is to continue with the commonly agreed principle that profits should be taxed where value is created, then clear definitions of what "value" encompasses and how to establish in which jurisdiction it is created in the digitalising world are crucial.

For instance, the virtual permanent establishment is thought to be created by the number of clients that a business reaches via digital sales. However, it is very difficult to understand why a mere distant sale of a good in a country would create a right of that country to tax the profit. The value of the good sold did not change merely because it was sold there. The same goes for the services. At my work I do consult my clients that are based all over the globe. Would this mean that by providing my service to clients who are based in country X – I have created a virtual Permanent Establishment there? Or would this rather be in Belgium where I go to the office each day and use public goods and services? And if not – then what's the conceptual difference?

Digitalisation simplifies the supply chain and allows for more direct marketing but the value for the consumer receiving its good or service is still the same. For instance, watching a movie in a cinema or via streaming at home – the value of the movie does not change for the viewer. The cinema can definitely increase the satisfaction, with visual and sound effects - but this is a separate service that a person pays when they choose so. Therefore, as long as the movie creator gets his reward for the creation– why should the value of the movie differ depending on the way of accessing it? Well if it is watched from home – the state loses its rights to tax the extra service of the cinema – but that's a choice of the consumer! If the digital technology removes certain

stages from the supply chain and thus removes taxing opportunities – it does not mean that the state has artificially to create more of those.

Another option to determine the virtual permanent establishment is by looking into the collection of data in a territory. Data is of course an asset. However, again the question of the value comes in – the mere data is much less valuable than analysed one. So would it be fair imposing taxes on the collected data as if it had the value of the analysed data? This is yet for the legislators to answer.

Maybe we are asking the wrong questions? The world is increasingly digitalised, but not everybody is doing it at the same speed, some economies are gaining more than others. But the same was happening a few hundred years ago – when machines were replacing manual labour. Sooner or later – changes happened everywhere. Could it be that with time the tax challenges of the digital economy will recede once it will become mainstream and digital exports will spread more evenly among countries?

So what is Paradise? I would dream of one where the legislators do not need to be pushed or incentivised to make the right decisions by leak scandals like the Paradise Papers. But well, nobody is perfect.

This blog was prepared and accomplished by Kristina Budrytė-Ridard in her personal capacity. The opinions expressed in this article are the author's own and do not necessarily reflect the view of FTI Consulting.

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