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Panama Papers: Onshore, Offshore and Substance

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For the last few years there has been a trend led by the G-7, then the G-20, to encourage transparency and exchange of information on a global level. The issue of the Panama Papers highlights the necessity to differentiate between tax evasion and non-evasion.

I. Offshore, Onshore: the Main Issues

A. Offshore Companies and Anti-Avoidance Legislation

Legislation has evolved considerably over recent years. It was common practice to buy properties in Spain by way of offshore companies before the law changed. If one looks at the publicity around Lionel Messi, one understands why he may have purchased a Panamanian company before changing his mind: however, in this case it does not make him a tax evader! Owning assets in an offshore company is not illegal. If the income is declared within the rules of one's country of tax residence, this should not be an issue.

However, in practice, there are people incorrectly commercializing the use of companies to make money; they do not respect the law nor do they make clear in their advice to their clients the ramifications of the actions instigated by them. The evolution of using even onshore entities involves real substance: "letterbox" companies, whether onshore or offshore, have serious flaws. For many years, people have been carrying out tax planning to reduce taxation legally; conferences and fiduciary companies have been selling solutions as packages. This resulted in countries passing anti-avoidance tax laws to close loopholes in their domestic laws. The chess game then became how to go round the new legislation. More legislation was passed to make this illegal in several countries. Obviously, especially in a poor financial climate, countries cannot afford to lose their tax revenues.

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Governments have introduced more controls, created amnesties and renegotiated treaties to ensure people pay taxes: some still exist, others have expired. Exit taxes from countries were implemented to stop taxpayers going to lower tax countries and the different governments around the world obviously wish to collect more tax. Tougher legislation in Russia, the U.K., the U.S., Italy and France, amongst other jurisdictions, enabled substantial back taxes to be recovered; however, political corruption, particularly in certain former Soviet Union countries, has created a disparity in the enforcement of their tax laws. The same applies to several third world countries, especially in parts of Africa where politicians are enriched through corruption. The irony is that domestic legislation is often applied to international companies but not to resident entities held by local nationals.

There is considerable work left to be done before we live in an equitable world free of corruption: it is therefore hardly surprising that a well-advised rich minority take advantage of the system. As the net closes, bank accounts holding funds become blocked as third party countries refuse to accept the receipt of these funds. Know your client ("KYC") and money laundering rules are applied in the receiving country, and if one party does not follow them, the funds may become unusable. This creates compensation and barter trading by certain individuals who then risk criminal proceedings due to their manipulation of the law.

It is hardly surprising that the press has been able to find anomalies in Panama. However, this is no different to many other offshore centers: the application of law is not efficiently applied and it often suits to turn

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a blind eye. Foreign investments and deposits can influence administrations as well as corrupt officials. The more sophisticated pass legislation to attract inward-bound assets legally—programs for residency and nationality, non-domiciled tax residency, etc., while the less sophisticated simply derogate deliberately from their laws by not respecting them.

B. International Standards and the Case in Panama

So where do all these issues lead? While politicians appear to have two rules, one for themselves and another for their citizens, corruption in the system continues, as well as ambiguity. The enforcement of legislation to curb corruption in external countries will however, and has already, reduced the volume of transactions.

Banks have for a number of years ceased to concentrate on their core activities, and whilst this continues, international scandals will persist in arising. The conflicts of interest within the banks are many; their ambition to obtain assets is often compromised by their methods to achieve this. Some institutions have modified their corporate governance and asked clients to close their accounts; others have simply ignored the problem. In both cases they have not voluntarily denounced their clients hiding behind banking secrecy.

It is clear that many banks are too diversified and lose management control and corporate governance of their employees.

All in all, it is inevitable that offshore jurisdictions will be obliged to conform to international standards. Transparency will be obligatory, which will result in the necessity to negotiate tax treaties to avoid double taxation and respect international obligations.

Coming back to Panama, the President has indicated his intention to comply with exchange of information and money laundering rules and to review internal compliance issues, and also to enter into talks with the OECD. This, whilst it shows there may be better management in future, does not resolve the past issues nor the current scandal. Immediate and unambiguous action was needed to demonstrate to the international community the serious intention to expunge any international tax defrauders that have established businesses and accounts with a view purely to tax evasion.

There is no smoke without fire, and whilst it may not be of the volume initially indicated, this problem cannot be ignored. Concern was created by Panama's slow reaction, which enabled records to disappear and evidence to be destroyed. One can draw one's own conclusions from this: it is therefore not surprising that in the circumstances international governments and press have their knives sharpened.

C. Impact of the Scandal

In conclusion, this scandal will restart and speed up another wave of anti-avoidance efforts by many countries, resulting in further tightening up of legislation as already seen in the U.S. Institutions will be targeted, as we have seen in the case of certain banks; whether justified or not, time will tell. President Obama has ensured the transparency rules on owning entities by non-U.S. single shareholders are tightened up. As for onshore entities, clients need to understand that there needs to be real substance, and not just letterbox registered offices. This mean a real single dedicated office with staff to carry out real provable justifiable arm's length work. The test of substance will become essential and the definition risks being more challenging in time. Base Erosion and Profit Shifting ("BEPS") issues will be introduced gradually into domestic legislation globally as well as the tightening of transfer pricing policies and the reinterpretation of permanent establishments and liaison offices as defined by the OECD.

In other words, this latest outburst of press articles will not only create issues for Panama but also for offshore centers around the world. If the onshore tax incentive centers believe they have escaped, this will depend on their corporate governance and application in respecting their obligations domestically and with their international partners. The author cannot emphasize enough the importance of the existence of real substance, whether onshore or offshore, and not just letterbox entities. Over and above this, real transactions need to exist, which ultimately are not so simple to implement in practice—as can be seen with recent problems involving Amazon, Starbucks, etc.

Whether government or private agencies, where they do not exist already, bodies will be established to ensure that the rules are applied. Fiduciary companies and professionals will have to be regulated and audited by external inspectors to ensure their application of the rules of practice. Unfortunately, to ensure everyone plays by the rules does indeed involve more policing of one's liberty, further complicating professional lives. Does it matter if one has nothing to hide despite the onerous work involved? Sadly, it will add to administrative costs once again, when we are already drowning in bureaucracy.

II. The Importance of Substance

What is quite clear is that a reflection is underway, catalyzed by the Panama Papers, as to what is "substance." The terms "transfer pricing" and "base erosion and profit shifting" will be overtaken by "is there real substance" to a transaction. The days of the definition of what is a permanent establishment will appear to be old-fashioned. The lines between tax, legal and financial aspects of a transaction will be confused if not merged, as professionals struggle to define new legislation to counteract transparency and tax avoidance.

A clear definition of economic substance will be needed. What is certain is that a tax administration needs adequate competence, with knowledge from the private sector. The lack of human resources (often due to spending cuts) makes it difficult to carry out adequate controls to catch tax evasion/fraud. This means it is generally foreign pressure by fiscal authorities that catalyzes investigations into offshore jurisdictions. The level of sophistication and logistics in countries with small populations which are not subsidized by anyone makes it difficult for them to be the international policeman for developed countries with large populations. Possibly a system of financial support from foreign jurisdictions needs to be envisaged to

enable these smaller countries to cover the costs needed, or the secondment of revenue services to give logistic support.

Tax administrations need to catch up on international tax planning strategies as well as change in foreign legislation. It is clear that training, and professional staff with a sophisticated approach, are required to deal with these issues. With the tightening of legislation, corruption becomes premeditated and therefore a greater issue. The definition and interpretation of substance will be more regulated and more essential. Fines and criminal responsibility for dishonest banks, asset managers, tax administrations, accountants, fiduciaries and lawyers will be even more relevant.

Certain countries are still struggling with old concepts. Pressure from developed countries on the third world or offshore centers pushes them to change their domestic legislation at the risk of exclusion and sanctions.

To realize the scale of the problem is to take a look at the past. What was considered normal then is no longer, and results in real issues for government, professional advisors or bankers. Considerable funds are held in offshore companies, on which no tax has been paid by the beneficial owners. Up to now this had not caused a problem. Many of these funds were inherited. But how does one deal with this today when there is a push for transparency? Countries change legislation and give a period of amnesty to regularize taxpayers' affairs: many taxpayers do not take advantage of this, nor do advisors react by updating their KYC/corporate governance.

The U.S. insists on FATCA declarations by institutions globally. The reverse is not the case for those establishing resident and nonresident bank accounts in the U.S. Whilst President Obama declares the tightening up of transparency of ownership of companies, it is not in his ability legally to implement this idea and only time will tell whether it will be possible to achieve this. In addition, the instability of the current elections in the U.S. makes it unclear as to what they will do in view of their current insular protectionism. What is clear is that the OECD countries are more than likely to replicate their legislation and insist on global declarations to protect their own needs. The world is moving towards policing all transactions of a financial nature to enable tax collection and transparency.

All this comes at a cost. Tax administrations become even more demanding on reporting, depending on more professionals to meet their requirements. This will inevitably transfer these new direct and indirect costs to the customer.

What will come from this evolution? Inevitably, unfair tax competition. Countries may have exchange of information but transparently declaring no tax due is legal. The residency of the taxpayer will define their obligations and taxability.

Whilst the Panama Papers may dig up the past, this does not resolve the future but simply forces jurisdictions to align with global rules. Resolving the past is a real problem due to the penal/civil liability of professionals. The temporary solution of exiting clients to the U.S. will simply speed up the reaction of global countries to legislate controls to force the U.S. to cooperate with the rest of the world. Yet quick fixes lead to a lack of confidence in professional advisors. A clear strategy to deal with the past is needed to legitimize historical funds and allow clients to be at peace with their past, whether such funds were inherited by their ancestors or created by themselves.

Each country will deal with this in its own way. This may be by implementing amnesties into domestic legislation; however, this could result in taxpayers profiting from a different jurisdiction by relocating to take advantage of opportunities.

The process is the first attempt to evaluate the offshore world, and could snowball. Non-domiciled tax residency status assumes importance, and it will be interesting to see how developed countries will compete to deal legally with these issues. It is clear that the problem will not go away.

With regard to banks, they risk refusing to accept funds in cases where proof is not available that the tax has been paid on the funds. They also may ask clients to leave in cases where they cannot justify their new KYC rules, leading to funds being blocked as no one will accept them. This forces clients to find a solution. At the moment there are banks that will still accept these clients, however, in time this is likely to change and careful consideration is needed as how to deal with this problem. Maybe a European amnesty is needed, or an OECD amnesty period to allow taxpayers to regularize their situations; allowing existing fiduciary companies to respect the evolution of legislation without penalizing them for the past when they had no intention of doing anything wrong.

Panama needs to lead a pragmatic drive to realism by demonstrating that this is a world problem by which most developed countries and their taxpayers are equally affected. A witch hunt against a single state does not resolve the problem, rather a united and global effort is necessary to show a willingness to find practical solutions.

Panama is taking a lead on this and intends to cooperate with the OECD by adapting its legislation. Panama is also implementing BEPS initiatives and incorporating them into its legislation. The real issue for Panama is to remain competitive, albeit transparent, and to ensure that the country remains attractive to foreign capital.

Finally, for those who think that transferring capital to the U.S. resolves past issues, they are seriously mistaken. Once deposited in a bank, funds may need to be invested elsewhere. With the evolution of transparency and exchange of information these funds risk becoming blocked as third party institutions insist on KYC and refuse the funds. As previously stated, countries around the world, excluding the U.S., will probably over the next two years install their own global checks and reporting. Checks are already in place but will become more sophisticated.

Tax legislation, as a result of the financial costs of controls, is risk pooling resources, thereby clamping down on those who do not respect tax rules. It remains to be seen how eastern bloc countries will cooperate with western jurisdictions, but we have already seen exchange of information agreements established internationally very quickly. A European tax on the collection of tax arrears could subsidize this task force

on a European level, and possibly the OECD could also act in some capacity for its member countries.

III. Conclusion

The anti-abuse clauses under European Union ("EU") legislation identify four questions, as follows:

- How does one deal in practice with the national legislation of an EU member as defined by Article 1 Part 2 of Directive 90/435/EEC of July 23, 1990?
- How does one interpret Part 2 of the Directive, which allows the members wide scope to determine what action is necessary to avoid fraud and anti-abuse within internal and external transactions?
- If there is a chain of ownership to obtain a tax exemption, how should this be interpreted and dealt with?
- If the ultimate shareholders are not resident in the EU, does this affect the tax treatment?

Perhaps an acceleration of European policy on the above issues could help resolve the misuse of domestic legislation. It would also enable the EU to put pressure on the U.S. to be more attentive to the abuse of their internal legislation by nonresident taxpayers.

Considering that international tax planning currently often entails using onshore jurisdictions with low taxation regimes, should a major renegotiation of controlled foreign company legislation be considered, as well as a rethink of thin capitalization rules? Free circulation within the Union is successful when companies trade at arm's length. However, the definition of "arm's length" as it currently stands has become complicated, as has the interpretation of substance. In addition, issues arise when considering third world countries and transfer pricing.

Another issue to consider is that countries with low corporate taxes often recover their tax revenue by means of dividends or sales taxes. With the lack of harmonization globally between tax authorities and the installation of fractional taxation based on real revenue streams, harmful tax competition will continue to profit the multinationals that are subsidized by medium-sized companies and their global tax planning.

Private clients are more mobile. Exit taxes exist to dissuade them to relocate. There are however still people with no tax jurisdiction at all! It is organizations like the OECD that can positively influence a more equitable respect for global values, however long this may take to implement. Transferring from Panama to elsewhere does not resolve the past nor the future.

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