The Royal Gazette

Tax creep and some implications for Bermuda

Nathan Kowalski

September 19, 2016

Apple's huge cash hoard is very tempting. Especially for governments which are unable to control their ever escalating public debts and spiralling entitlement deficits. The recent case where the EU decided that Apple had received illegal state aid from Ireland and that the technology company should pay 13 billion euros in additional corporate income tax (plus interest) to Ireland simply highlights the almost silent shift we are seeing in global tax policy which unfortunately appears to be expanding.

Recently the Economic Working Group of the Bermuda Chamber of Commerce had the pleasure of listening to Dan Mitchell, a senior fellow from the Cato Institute, discuss global tax policy and the current shifting trends to bigger government.

His message was rather dire for those who prefer smaller governments to larger ones or less taxes to more. He mentioned how the Obama administration is supportive of the OECD's Base Erosion Profit Shifting project. BEPS was created to increase corporate tax burdens by limiting the tax avoidance strategies where multinationals like Apple shift profits from high tax jurisdictions to low or no-tax jurisdictions like Bermuda. BEPS, as Dan mentioned, may unfortunately be the tip of the spear to the ever expanding push for higher coordinated corporate taxes.

In the near term, the optimists will point to there being a great opportunity for a tax competitive jurisdiction such as Bermuda. Whatever the ultimate outcome, changes are likely to take time. This would seem to offer a great window for Bermuda to sell its tax legitimacy. While some nations may question "name plate" companies that confer tax advantages for multinationals, Bermuda could encourage the creation of legitimate offices that come with legal tax structures.

In doing so, Alphabet (formerly known as Google) for example, may wish to hire a group of tax, treasury or other managerial suite of employees in Bermuda. Voila, job creation for Bermuda, driven by the need to enhance the legitimacy of any offshore tax structure, by potential requirements to employ a set of managers in the jurisdiction in question.

Some may feel there is no long-term threat and will scoff and point to the fact that the world will never harmonise a tax system and that those nations or regions that chose to be competitive will simply steal business.

To this I do see merit but I would caution those optimists. Tax changes do not necessarily need to be absolute and require full adoption to be effective. Shifts could happen on the margin and the creep of bigger government that demands more money could become a very popular political slogan for the growing hoard of people that continue to either not reap most of benefits of globalisation or see themselves continuing to lag those which benefit from access to complex tax advantages.

Fatca, I once heard, would never happen because the US would make itself uncompetitive. In fact, I heard from many intelligent people that if Fatca was enacted, the US would lose billions of dollars of investments as people who chose not to conform would simply do a wholesale withdrawal from every investment in the US. Guess what? It didn't happen and investing in the US has not suffered. Investors and business are not going to invest in something or do business somewhere just because of a tax ruling if the potential benefit far exceeds the cost. I would argue that outright dismissal of large-scale change in global tax policy is a similar mistake.

There are two major reasons that seem to be driving this undercover creep of larger government tax grabs for revenue increases:

1. Debt is not shrinking. In the February 2015 McKinsey Global Institute report "Debt and (Not Much) Deleveraging", it is noted that government debt in the world has increased $25 trillion since 2007. The off balance sheet environment is not much better as many nations continue to gorge on entitlement systems that are quite frankly unsustainable. As a result, the need for revenue is almost at a level of desperation. When your liabilities are not shrinking and you are not able or unwilling to cut expenses your only option is to raise revenue. In some cases it is politically much easier to get this revenue from large foreign multinationals than your own electorate. As a result the bias towards favouring expanding tax policy seems almost inevitable and thus one betting for the opposite is implicitly suggesting governments will get smaller and/or cut spending and/or entitlements significantly. I for one don't see that as a high probability — unfortunately.

2. Inequality. The inequality debate and movement can be portrayed in the growing popularity of leftist movement or socialist political party's popularity growth globally. This divide is causing dissent among those whom do not benefit like the elite and/or large corporations. In a recent article by The Economist: "A giant problem: the rise of the corporate colossus threatens both competition and the legitimacy of business", they state:

"The heft of the superstars also reflects their excellence at less productive activities. About 30 per cent of global foreign direct investment (FDI) flows through tax havens; big companies routinely use 'transfer pricing' to pretend that profits generated in one part of the world are in fact made in another. The giants also deploy huge armies of lobbyists, bringing the same techniques to Brussels, where 30,000 lobbyists now walk the corridors, that they perfected in Washington, DC. Laws such as Sarbanes-Oxley and Dodd-Frank, to say nothing of America's tax code, penalise small firms more than large ones … Paying tax seems to be unavoidable for individuals but optional for firms. Rules are unbending for citizens, and up for negotiation when it comes to companies."

This, of course is not going unnoticed by the OECD, whose BEPS project seems to be gaining momentum as a result of this growing discontent and the crushing weight of escalating government liabilities.

One conclusion of this analysis would suggest that those business models that involve any form of tax arbitrage as one of their competitive advantages may need to be analysed further.

I would caution any company or country that relies on this extensively in some shape or form to seriously consider the effect that major tax reform could ultimately have on future profitability.

Personally I am for tax competition as a check on rampant government expansion and see it as a free-market tool, but have come to appreciate that the world we live in is increasingly less likely to agree with me.

In the longer run I remain in the camp that true competitive advantage results from truly excellent products and services that are delivered faster, cheaper or better and their existence does not hinge on any form of regulatory arbitrage. In our world of ultra fast-paced competition and virtual production, this will be ever more important for all nations including Bermuda.