GLOBAL riskupdate

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10 Years and Growing

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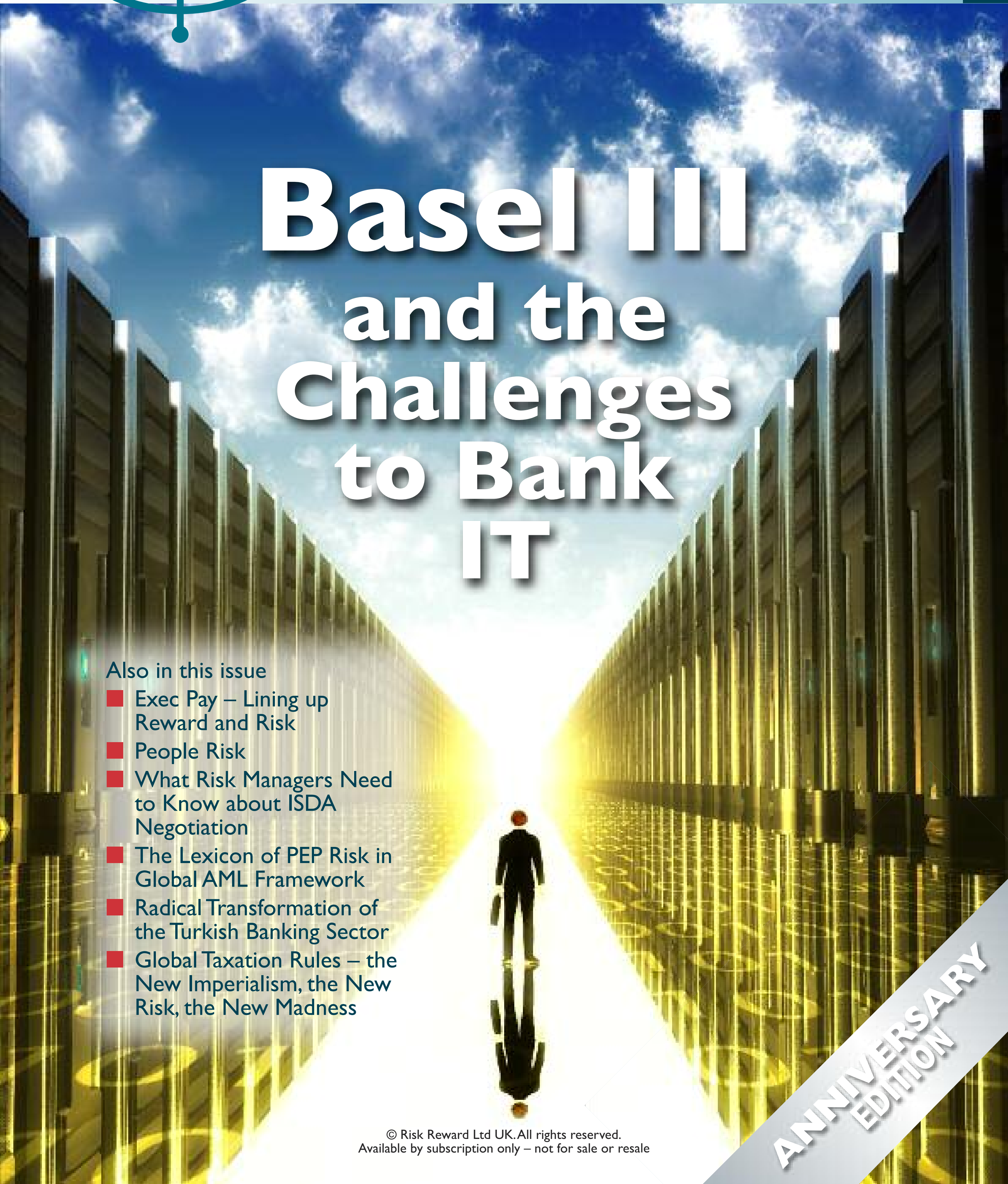

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ANNIVERSARY EDITION

Global Taxation Rules – the New Imperialism, the New Risk, the New Madness

David Millar is an independent risk management journalist and consultant and trainer. As a process and operations expert with 40 years experience in banking and financial markets, he has provided advisory services to banks, financial institutions and central authorities. Until recently he was Chief Operating Officer at the Professional Risk Managers' International Association, PRMIA, a trade association focussed on improving financial risk management through professional membership events, training and certifications. In this article David asks if the new FATCA rules are worth the impact on international trade and investment.

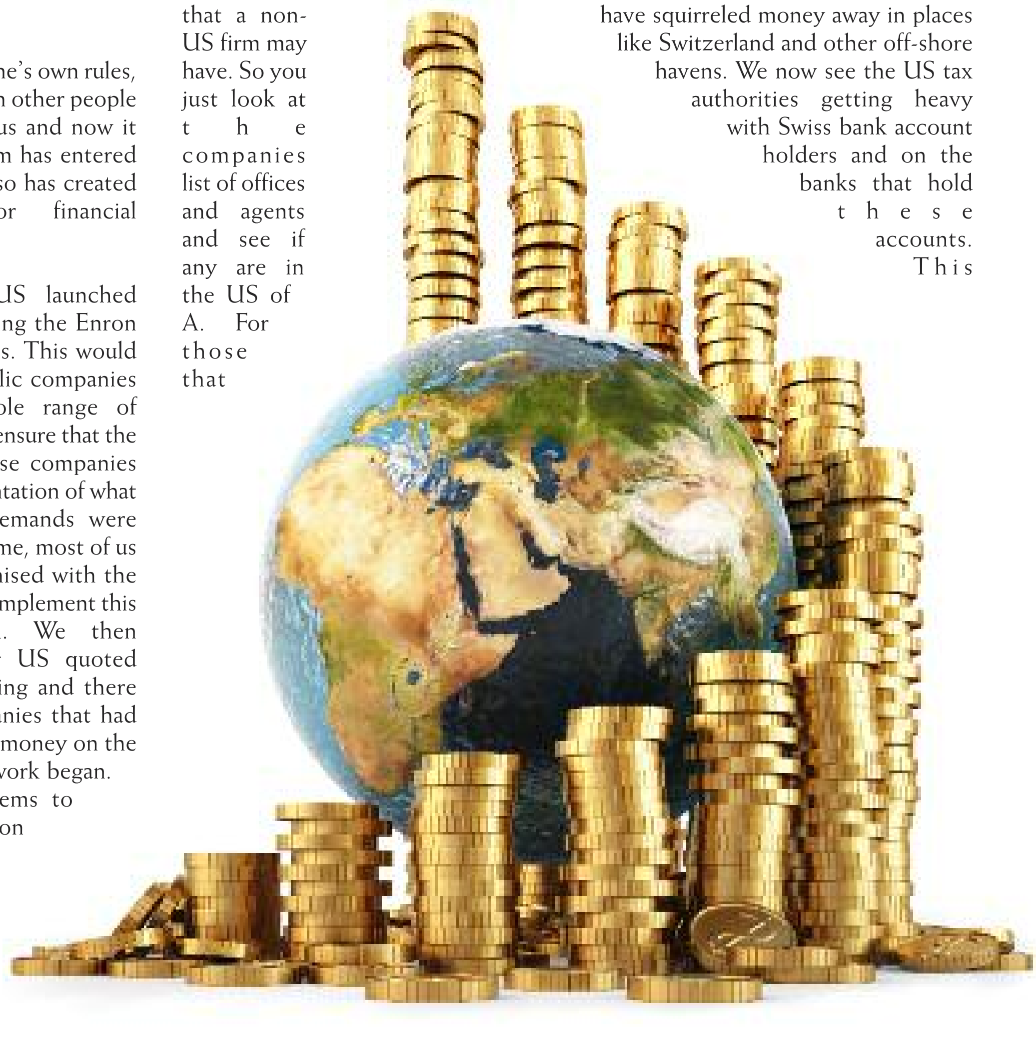
Imperialism is now a derogatory word in any language or vocabulary. From the military conquests of Ancient Macedonia, to the trade-driven acquisition of foreign lands in the 17th and 18th centuries, to the outright commercial "Coca-Cola" conquest of the world by large global firms in the past 50 years, imperialism has been seen as the unjust exercise of power over unwilling subjects.

But the will to impose one's own rules, cultures and practices on other people seems to still be with us and now it seems a new imperialism has entered our lives; and in doing so has created significant risks for financial institutions.

Back in 2003 the US launched Sarbanes-Oxley following the Enron and Worldcom collapses. This would impact US-quoted public companies and presented a whole range of regulations designed to ensure that the public accounts of these companies was an accurate representation of what was going on. The demands were significant and, at the time, most of us looked on and sympathised with the US managers having to implement this gargantuan legislation. We then discovered that being US quoted covered secondary listing and there were few global companies that had not at some time raised money on the US exchanges. So the work began. Thankfully the US seems to have given up on Sarbanes-Oxley, at least for small firms, and it remains something that large multinationals only have to cope with.

The US has now gone for us again with Dodd-Frank, and its love-child, FATCA. Dodd-Frank, although even more complex that Sarbanes-Oxley, is easier to cope with as it impacts any US operations that a non-US firm may have. So you just look at the companies list of offices and agents and see if any are in the US of A. For those that tick this box there will be significant compliance work and the subsequent risk of failed processes.

FATCA, though, is something else again. The US needs cash to pay for job stimulation schemes (and the cost of Dodd-Frank) and is looking to tighten the screws on all those Americans who are avoiding tax and have squirreled money away in places like Switzerland and other off-shore havens. We now see the US tax authorities getting heavy with Swiss bank account holders and on the banks that hold these accounts. This



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is all because, differently from most (all?) of the rest of the world, US citizens are taxed on their worldwide income and assets – a citizenship-based taxation system, whereas the rest of us are taxed on the basis of where we are and where our assets are at any one time.

FATCA goes further than simply insisting that Americans declare and pay tax on their worldly good. It assumes that these assets are not hidden underneath the bed and are managed through a financial institution. FATCA requires that all financial institutions, American or not, both inside and outside the USA, who have clients who may be US tax payers, either declare these persons, or companies if US controlled, to the US tax authorities. If these clients cannot show that they are paying their US taxes, then the institutions that hold their accounts or assets must deduct a 30% withholding tax and send it to Uncle Sam.

If you, the financial institution, do not do this, then the US authorities will place obstacles in the way of any payments from legitimate US business reaching you. So effectively, the USA is asking overseas companies who may have no US presence to act as unpaid tax collectors on the behalf of the US government. The only way out is to stop taking on client business with any US individuals, or US-owned firms, and to ensure that you do not have any counterparties who are US-controlled.

This is probably not feasible and certainly commercial suicide so you have to start introducing processes to check clients, decide whether they are American and discuss the practicality of getting them to agree that they disclose their affairs to the US taxman, or deducting 30% straight off the top. Neither option makes the salesman's life any easier, and the increase in process and reporting complexity is significant. And, by the way, this becomes effective at the end of this year, despite the fact that the details were only finalised this February.

Unsurprisingly there was a lot of protest at these rules and one of the issues was that it just was not legal in many countries to send personal financial details to a foreign organisation. Rather than back down, the US have reached agreements with their foreign tax counterparts so that the overseas firm will divulge the necessary information to their own national tax authorities who will then pass it to the US. Currently the UK, Italy (this is amazing seeing they seem to have trouble collecting taxes from their own citizens), France, Germany and Spain have signed up and we assume that the Americans are in negotiation with other countries to achieve this.

Apart from the amount of effort involved in setting up and running this, the operational risks in this process will have many and varied impacts – fines, loss of business, reputational risk – and these will, I believe, be a key issue for risk management in the year to come. Every client, subsidiary and counterparty will have to be evaluated for its US liabilities and processes set up to monitor future business. Any attempts by clients at hiding their status will have to be tracked down. New business will have an extra risk issue on which to be assessed. The operations will be complex and the new risks are many.

And believe me this operation will not be easy. Every client will have to be looked at and that alone is complex. Is he an American citizen, yes or no? But what about those with dual nationalities? I personally carry two passports. And what about those who are entitled to US citizenship but have never taken up a passport? Most of us in this multicultural world have multiple entitlements descending from parents or grandparents. I can come up with two more from my grandparents. US tax requirements cover all of the above cases. And it is not just individuals that have to be checked; one must also look at beneficial ownership of companies that are clients.

Every financial institution that pays interests, holds assets, or manages funds will be effected. Only those who have no US offices, no US-based counterparties and make a positive decision not to take on any US clients (and close down all their existing ones) can escape the dreaded FATCA. The Empire strikes back, FATCA is the sword and the financial institutions of the world are being made its agents. You are to become an unpaid tax collector, your government is becoming an unpaid tax collector so that unemployed Americans in Detroit can receive their benefits.

Having filled you all with gloom at all the extra effort that will be required of you, I was going to finish this article at this point. But I just wanted to throw in an extra thought.

All governments need extra funds and all are concerned that their citizens may be less that squeaky clean about what is tucked away overseas. What will happen if other governments move to a citizenship-based taxation system and equally start demanding that financial institutions start reporting and withholding taxes from their own citizens? Could that be why the FATCA agreements with foreign tax authorities are said to be reciprocal? Apart from the effort on your firm, think of the impact on trade, investing and travel!

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