CROSS BORDER TRADING

This article, written by Anthony J Smith, FCII, Head of Risk & Compliance, Risk Reward Ltd, focuses on why, for a financial services firm working across different jurisdictions, it is imperative to manage its regulatory footprint.

Many investors consider putting their nest egg savings into offshore investment bonds to take advantage of 'tax free' roll up and protection from inheritance tax through trusts. However local tax requirements will still apply and there may be other restrictions on the way the policy is sold depending on the residency of the policyholder.

The impact of the global recession has brought increasing attention to the offshore financial services industry and brought greater attention by governments on the retention of precious tax revenues as the impact of the credit crunch reduces the amount of revenue through regular sources. Turning a blind eye is no longer an option and the chances of loopholes being closed have never been greater.

The 3rd Life Directive in the European Economic Area (EEA) covers 30 countries (EU member states, Norway, Liechtenstein and Iceland) and is designed to allow cross border trading of life assurance enabling firms to sell policies in other EEA countries without establishing a branch on what is known as a 'freedom of services' basis. Unfortunately tax rules and other local requirements have not been harmonised and insurers must abide by the 'general good' in each country where the policyholder is habitually resident. It makes no difference where the sale takes place e.g. a life company based in the Isle of Man sells a policy through an intermediary in Jersey to a Spanish resident (Spanish general good requirements apply).

To sell life policies to Spanish residents requires a tax representative based in Spain and translation of policy documents into Spanish. Just to complicate matters the policyholder will soon be able to select the contract law of their native state e.g. a UK ex pat resident in Spain could have a UK contract however all other general good requirements including taxation still apply.

General good also applies to other local requirements. Belgium in particular lays out whole areas of Belgian law in Royal Decrees that must be compliant with for its residents. Germany does not allow illustrations of with profit policies, Portugal requires a contribution to its insurance institute and Latvia expects firms to participate in its insurance guarantee scheme (IGS) or plan.

Policyholders also expect an insurance guarantee scheme (or plan) to be in place but only 8 EEA countries offer such schemes for life assurance with very restrictive cross border coverage. A German policyholder with a UK policy is not covered by the UK Financial Services Compensation Scheme (plan) and even if the UK firm had a German branch it would not be allowed to participate in the German scheme. This is probably in breach of Article 12 of the EC Treaty but so far has remained unchallenged. In Spain branches of EEA offices must contribute to the Spanish IGS but their policyholders are not covered. Many compensation schemes also fail to recognise individual policyholders with investments in life policies and treat the insurer as an investor with limited or no recognition by the scheme. France allows foreign branches to participate in its IGS but so far no EU branches participate in the French Insurance Guarantee Scheme (FGAP).

When you multiply these scenarios across many different countries it soon becomes uneconomic to sell across the EEA without focusing on key markets and imposing strict residency restrictions on intermediaries. The new Payment Services Directive will also restrict recognition of life policies cross border to those providing 110% life cover unlike the 101% currently offered by many UK life bonds.

Of course the difficulties of the 3rd Life Directive only apply in the EEA but countries outside the EEA have their own requirements. Switzerland imposes stamp duty on policies for Swiss citizens and the multiplicity of regimes and requirements worldwide would require a large team of regulatory and tax experts to manage effectively. The offshore life industry in Europe has some very difficult questions to consider if it is to continue to trade compliantly. The recent G20 conference also focused attention on offshore tax havens where tax rates are often considerably less than developed countries.

Of course the life industry is not the only one affected by the dangers of cross border trading. In one Canadian province additional taxes are charged for non licensed brokers and unauthorised insurers. Whilst they allow them to operate for non standard risks the costs can be considerable with taxes as much as 10% and 20% respectively. The impact of failing to be aware of these local difficulties can amount to a considerable back tax bill to pay and a possible fine when the authorities find out making it essential to fully investigate the local market before going on risk.

For a financial services firm working across different jurisdictions, it is imperative to manage its regulatory footprint. This will begin with identifying where business is taking place and to whom services are being sold. Just because a sale takes place in one jurisdiction does not necessarily prevent it from being subject to the requirements of another. Often a deep understanding of the requirements of local law and taxation is essential to avoid the pitfalls of penalties and prosecutions for tax violations. As countries become even more sensitive about avoiding tax leakage the control of such risks will become much greater.