The Perfect Storm? By Ross McGill

Never, in thirteen years in this industry, would I have predicted that a US President would talk about withholding tax and use the term "QI" (qualified intermediary) in a public forum, let alone formally target foreign banks and inward investors, as well his own residents with dramatic changes to tax policy that could create a "perfect storm" for the US as an investment market.

Yet, since September 2008 there has been a steadily rising tide of concern, not to say aggravation, over the policy proposals by the US administration, together with the more procedural consequences of the IRS and US Treasury's proposed changes to the enforcement of that policy. The result we are seeing may have significant, if unintended, consequences. Already, many non-US banks are writing to their US customers telling them to close their accounts and take their money elsewhere (where I wonder?). Others, predominantly the majority of financial firms who have not so far signed up to the QI program, are having to review a massive increase in expenditure for little or no benefit, in order to comply with the potential new rules. Many of the small and medium sized firms I've spoken to are actively considering divesting from the US, whether or not they have US customers, simply because the cost of providing asset servicing for the US market is viewed as prohibitive.

To consider the effects of this "perfect storm" we have to look at the way the elements are coming together. President Obama's remarks in May this year came hard on the heels of swingeing proposals from the IRS to tighten up on the terms of the QI contract and also proposals from the US Treasury to more than double the penalties that would be applied to foreign banks for non compliance. The fact that the IRS intends to employ over 800 more enforcement staff and the US Treasury predicts penalty revenue to increase to over $300 million by 2018, is giving the community serious cause for concern. All this now puts the UBS case in perspective with the US and Switzerland battling it out over disclosure and France, Belgium and other markets adopting new "information sharing" principles, all of which sit at the heart of withholding tax.

The problem for US tax policy here is that the two main planks of the strategy - the use of the QI tax model and the underlying strength of the US economy are both fundamentally flawed individually and in concert. The QI program has not gained sufficient traction (or successful compliance) in the eight years since its inception, with only a small percentage of firms globally, usually the larger ones, having the financial resource to become and maintain QI status. This is partly due to a lack of constructive engagement with the community at a global level. The problem is compounded by the facts that the policy doesn't take account of the simple reality that, for foreign financial institutions, the number of US customers (and the value of their assets) is relatively inconsequential to their overall client base and that the trigger for compliance is receipt of US sourced income, **<u>not</u>** that of simply having US customers. This means that, even though US tax policy is ostensibly aimed at US residents and their compliance, or lack thereof, the unintended consequence of using the QI regulations at this level, is that **<u>all</u>** investors in US, as well as their intermediaries, of any flavour, are impacted potentially to the tipping point.

All this would be moot, as it was in 2001 when the regulations were implemented, if it were not for the fact that today, the US economy can ill afford a mass exodus of foreign investor's cash and has competitors waiting in the wings. And yet, that seems to be the road that US tax policy is sending the community down by targeting foreign financial institutions as well as their customers. As the industry meets in Hong Kong for its annual SIBOS conference, it'll be exactly a year to the day that Lehman Brothers hit the headlines around the world and sparked the largest and deepest global recession for many years. Today, we know that China, India and all the Asia/Pac markets are coming out of recession faster, are more nimble and can spot the opportunity to draw inward investment away from the US more easily. I've heard in several markets that people can clearly see the tipping point on the horizon now. The problem is that, if such a tipping point does occur to any significant extent, the consequences may be much larger and longer lasting than any of us think. The reality is that in tax policy, we need balance and certainty not radical swings that create uncertainty for investors and hard pressed banks.

It's seldom mentioned of course, but withholding tax is actually a key driver for the global economy. For every dollar taxed at a treaty rate or refunded to an investor after the fact, there are hundreds of thousands of dollars that enter the market concerned, precisely because of the availability of those refunds and the certainty that the treaties deliver. It would therefore seem more prudent to assess the available policy tools from both a principle and practical standpoint, engage with the community on the receiving end more extensively and constructively and make sure that the community is an early adopter of policy rather than an enemy to be defeated.

To that end, it's perhaps fortuitous that we all meet again, one year on, in the shadow of this perfect storm, at the centre of the Asian markets - at SIBOS, where the SWIFT community can reflect on a year of turmoil of one kind and try to make sure we don't end up in turmoil of an entirely different kind.

For those who are interested, I'll be speaking at an Open Theatre Presentation at SIBOS on this very issue on Tuesday September 15th. You can also see other key market figure's views at the Linkedin Withholding Tax Group. For those of you returning to Europe after SIBOS, the two-day Withholding Tax Congress in London organised by Osney Media will be solely focused on this issue and will be a "**must attend"** event for tax, compliance and operations staff. Finally, at the risk of blatant self-promotion, you can also get a broader view of this issue in my latest book "Investment Withholding Tax – Best Practice & Strategies for Intermediaries and Investors" published by Palgrave Macmillan in their Finance & Capital Markets series. You can't say no-one told you!