

# Farewell America

Is the US, in its efforts to collect as much tax revenue as possible to manage its massive economic problems, driving away international capital? **Dr. Konrad Hummler** says yes. He also explains how institutions and investors are being forced out of that market by the sheer complexities of the country's taxation regulations.

To get some idea of how the inheritance tax of a foreign state can become a serious problem for third parties, we need to start with a fundamental difference between continental and Anglo-Saxon inheritance law. On the continent, the view prevails that the logical recipients of assets left by the deceased are their descendants. Accordingly, continental inheritance law provides for forced heirship, whereby a portion of the estate is legally required to be left to close relatives. Under such a system, it is not difficult to see where any taxation of the inheritance should occur: with these heirs.

## Liable to US inheritance tax

Things are different under Anglo-Saxon law. There is no forced heirship, so American inheritance tax is levied on the estate; that is, the physical goods, such as property, goods and chattels and securities. If they are US securities, they are liable to tax, regardless of the final domicile or main place of residence of the deceased. US securities are basically defined as securities issued in the US, such as the stock of American companies like Apple, General Electric or Pfizer, US funds and US bonds – Treasury bills in particular. American inheritance tax law makes specific reference to both US citizens (including US citizens resident abroad) and non-resident aliens. These latter are foreigners with no permanent residence in the US; in other words, all non-Americans in possession of US securities.

American inheritance tax rates are variable, with the top rate at 45 per cent. Significant exemptions of over US\$1 million are allowed for US citizens. The limit for non-Americans is US\$60,000,

unless there is a double taxation agreement setting a higher limit. To claim the allowance, the estate – that is, in continental terms, the heirs – must disclose the entire, global legacy to the Internal Revenue Service (IRS). On account of the IBM shares that he was so attached to, the children of Mr. Ruedi of Zurich must file with the IRS and present a valuation of all other family assets.

The US has a remarkable lack of double taxation agreements with Latin America, Asia and the Middle East. Mr. Abdullah of Dubai, a typical owner of treasuries, industrial bonds and GM shares, is liable to American inheritance tax on his decease. Not his problem, but it may well become one for his sons, Omar, Ali and all.

Or maybe not. For he had placed his securities in an institutional structure, a trust or a company domiciled on one of the Caribbean islands – and institutions cannot die, can they? Indeed not. However, the Americans are increasingly going over to regarding such structures as look-through entities and are trying to get access to the beneficiaries and their tax liabilities.

Another common objection: it's impossible anyway. How on Earth can the IRS make the connection between a US security and a deceased foreigner? The US is not even capable of registering its own residents, so how should it be able to control the rest of the world? Simple answer: it doesn't have to. Rather, American inheritance tax law focuses on the executor. If there is no executor, the role is fulfilled by the custodian bank, which is liable for the tax due. In order to exclude this liability, the American custodians of foreign banks will go over to requiring their partners abroad to freeze the estate when one of their clients dies.

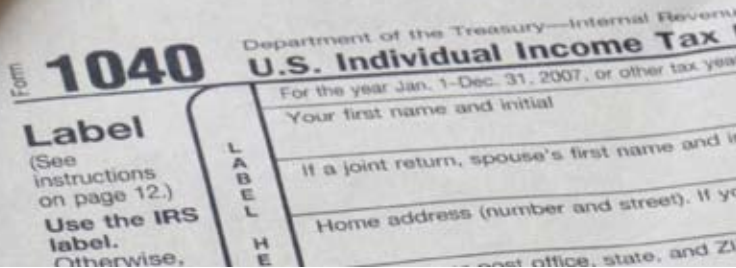
Besides, the revised provisions of the Qualified Intermediary (QI) enable an American auditor to control banks' compliance with the agreement, which entails giving such auditors access to all files, including client data. This will create the means of directly linking US securities with non-American owners.

An act passed in 2001 by President Bush envisaged a "sunset clause" for the then controversial but reintroduced inheritance tax. Unless extended, the estate tax would expire in 2010 and, if not reformed, would come into effect again on January 1, 2011. The Obama administration is currently working not merely on an extension, but also on making the law stricter with regard to recognised loopholes. The possibility of further unpleasant surprises can certainly not be ruled out.

## A qualified extended arm

We need to look more closely at the already-mentioned QI agreement. In 2001, the US introduced a new withholding tax system with the aim of avoiding the complicated and expensive reimbursement of tax levied on those not liable to taxation and thus to give foreigners easier access to the American capital market. The aim was also of obliging US persons with securities deposited with intermediaries whose countries had no automatic exchange of information with the US to include all their US holdings in their tax declarations. This was done by imposing a withholding tax of 30 per cent, which US persons could avoid entirely by full disclosure and non-US persons could avoid in part or entirely (depending on the double taxation agreement) by self-declaration to the QI.





The 2001 QI agreement took account of countries with banking secrecy to the extent that clients could be assigned to their individual categories by the QIs themselves. Compliance with the agreement was, though, monitored by a special audit following a process laid down by the US tax authorities.

There are three definitions in the QI agreement that are of decisive importance: that of a US person, that of a US security and that of a legal entity belonging wholly or in part to a US person. The definition of a US security is fairly unproblematic in that it is effectively determined by the retention of the withholding tax by the custodian. The other two definitions, however, have caused and continue to cause almost insurmountable problems for QIs and thus generate considerable legal uncertainty.

Sadly, it is entirely unclear who actually counts as a US person and who does not. In addition to the clear case of US citizens resident in the US, the American understanding of the category also includes foreigners living in the US, those in possession of a social security card, holders of a green card, US citizens not resident in the US and also those who pass the so-called Substantial Physical Presence Test. This presence test has a particularly delightful design: it is passed when someone has been in the US for at least 31 days in the current year and a total of 183 days over a period of three years. In the first year, the days count for one-sixth, in the second for one-third and in the third year they are counted full. By this definition, a student, perhaps Mr. Abdullah's son Omar, who is doing an MBA at Harvard, very probably counts as a US person. The problem is that the QI has to know whether he does or not, for the agreement has

turned the QI into the extended arm of the American tax authorities.

Even trickier is the question of how far the beneficiaries of legal entities are liable to withholding tax. Clearly liable, according to the text, are active businesses: an American company holding securities in Switzerland, for example. Trusts, institutions and foundations are exempt if they meet certain and naturally highly-complex conditions.

Matters become really awkward when an impeccably non-American legal entity suddenly becomes "contaminated" by a US person. Let's assume that Mr. Abdullah has named his son Omar, as well as some of his other adult sons, as a beneficiary of his trust. As American tax law has turned him into a US person, Omar renders the trust liable to tax, and when Mr. Abdullah dies, this may mean that the entire inheritance becomes liable to US estate tax, possibly at 45 per cent, for Mr. Abdullah was extremely wealthy. Perhaps, or perhaps not. But that doesn't matter – the QI should have known.

The QI agreement of 2001 already exposed all the signatory banks worldwide to significant legal risks vis-à-vis the American tax authorities. Even without actively canvassing for clients in the US, as the UBS did with Alinghi and by other means, the mere fact that someone can mutate, almost unnoticed, from a non-US person into a US person is an unacceptable situation, for the result can be an entirely innocent misdeclaration.

### Green book, red content

The Obama administration set out its intentions with regard to various tax matters in May 2009 in a green book entitled "General Explanations of the Administration's Fiscal Year 2010 Revenue

Proposals". In addition to the notion of forcing American businesses operating abroad to pay more tax in America, the focus was on the extension of the estate tax and the tightening up of the QI system. Essentially, the Obama administration is seeking to expand the application of the QI system and to plug all known and conceivable loopholes. Seven significant changes deserve comment.

One, the definition of a US security has been expanded. In the future, the QI system will also include equity swaps on US securities and on securities lending. This should prevent US persons from entirely, and non-US persons from partly, avoiding withholding tax by means of an OTC contract. According to the green book, the QI agreement is not (for the time being) being expanded to cover non-US funds or derivatives that replicate US securities.

Two, US persons are now required to report earnings and gross revenue from non-American sources. This will extend the QI agreement to cover the entire global financial universe and enforce disclosure by all US persons, in particular those who, by not holding US securities, had previously remained outside the QI agreement. Should an intermediary wish to remain outside the QI system, withholding tax at 30 per cent is levied compulsorily and may only be reclaimed by the beneficiary, not the intermediary.

Three, the green book seeks the compulsory imposition of withholding tax at 30 per cent on US securities held by non-American companies. Any reclaiming would have to be done by the company itself and involve disclosure of its ownership structure. According to the green book, exceptions would be possible for pension funds, listed public companies and the like.

Four, also stipulated is the introduction of withholding tax at 20 per cent on all gross revenue from transactions via a non-QI intermediary and in a country with no double taxation agreement or inadequate exchange of information.

Five, the green book envisages compulsory declaration of transactions over US\$10,000 involving US persons via a non-QI intermediary.

Six, notification to or recording by the IRS of the acquisition or foundation of an

offshore entity on behalf of a US person is now also prescribed.

Seven, the involvement of an American auditor to monitor compliance with the QI agreement is envisaged. The report will have to be signed by this auditor.

This list of the intended amendments is not necessarily complete and may also contain minor inaccuracies. What is clear, though, is that the US is attempting to exploit its almost unlimited position of strength with regard to the international transaction systems (swift, clearing systems, custodians) and the fundamental attractiveness of its capital market to impose its ideas on the rest of the world. There is no question that signatories to this new version of the QI agreement will need to revise their business models for cross-border wealth management, at least as far as US persons are concerned. Both Swiss-style banking secrecy and the Austrian and Luxembourg versions, and indeed all Anglo-Saxon-style structures (whether managed from London, Dubai, Singapore or Hong Kong), are called into question. As far as US persons are concerned, the US aims to abolish cross-border business.

It might reasonably be observed that as long as this really only affects its own citizens, the US is absolutely entitled to do this. And to the extent that it can exploit its position of power in the world to enforce its intentions, we must – as we have decided on as non-judgmental an analysis as possible – take note of this and adapt, or possibly re-dimension our own business activities. The concept of the green book is extraordinarily intelligent. The aim must have been “no way out” – no loopholes. Sadly, however, the matter has not been properly thought through. The real problem lies not in the rigour of the law, but in the lack of clarity about actual tax liability and the resulting disproportionate effort required for monitoring and management. The enormously expansive view of what constitutes a US person and the potential imperialist expansion of inheritance tax liability to cover the whole world substantially increase the risk of investing in the US and thus in the US capital market.



This applies to investors, but even more so to intermediaries. While the old QI agreement put the thumbscrews on them, the intended agreement will crush them in a vice. It is becoming clear that it will simply be too dangerous to own US securities, to hold them as a custodian for third parties or to trade them as a bank.

### Unattractive anyway

The financial crisis has given momentum to anti-capitalist, and thus anti-market, forces in the US (and elsewhere). That promises little good for this part of the world, but it makes it somewhat easier for investors to take their leave. There are institutions that are already in the process of recommending that their clients exit from all direct investments in US securities. This, on the grounds of the threat of inheritance tax, coupled with the uncertainty as to whether one might not, one way or another, is to be turned into a US person.

There is no denying that by doing this, institutions hope to significantly reduce their risk as intermediaries. Should these institutions maintain QI status under the new, more rigorous conditions, they will have so far reduced their holding of US securities and are spared from dealings with these cumbersome foreign authorities. Investors that need US exposure on diversification grounds can obtain it via non-US securities. The green book explicitly excludes derivatives and non-US funds from withholding tax. And it can only be expected that the range of non-US securities with American exposure will expand significantly in the near future.

But then again, it may not. If this picture

of a tautologous construct around the US Treasury is correct, then we must at the very least be extremely cautious about nominal values, for Treasury bonds and bills would then be seriously overvalued, as would the US dollar itself, which would naturally argue against all other US bonds. In our view, not even an engagement in US stocks is really worthwhile. Despite depreciation in the financial crisis, according to our calculations they are still valued at around 12 per cent above the long-term fair price, whereas European stocks are undervalued by almost 17 per cent. And these calculations do not include the impact of any future increases in taxation or interest rates.

We live at a time of shifting power and influence in the world. Asia is on the rise, and probably Brazil. Australia will catch on to their coattails, and Europe may once more be able to position itself within these countries' recoveries. The US will remain the unquestioned military power and also an enormous repository of debt and other problems. Because they are painful, and there is always an inclination to shift the blame for them onto third parties, re-dimensioning processes always harbour the potential for aggression. Switzerland is currently experiencing this. But it won't end there. Potential aggression and economic progress are mutually exclusive, which is why we are well advised to say a general farewell to the US. This will be painful, for the US was once the most vital market economy in the world. But for now, it's time to say goodbye.

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