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Tax Compliance

INSIGHT: Tax Operations: Back of Office, Front of Mind to Global Banks

Daniel Carpenter of Meritsoft discusses the increasing prominence of tax compliance in international banking operations.

BY DANIEL CARPENTER

Ask any banker on Wall Street, and they'll tell you that the compliance department of a global bank has become perhaps the most powerful decision-maker within an institution since the 2008 financial crisis. The introduction of laws like Dodd-Frank, Sarbanes Oxley, and the European Union's revised Markets in Financial Instruments Directive (MiFID II) to bring added transparency to the global banking system and to protect consumers have not only led to an uptick in compliance body count, but also to the use of automated technologies to ensure that regulations are adhered to and client risk is mitigated.

Daniel Carpenter is head of regulation at Meritsoft in London. Daniel joined the Meritsoft team in November 2014. He has over 20 years of experience in front, middle, and back office software solution provision across the financial services industry. At Meritsoft, Daniel specializes in providing regulatory technology expertise and solutions to leading global financial institutions.

Though adherence to far-encompassing trading directives like MiFID II have dominated the conversation in recent months, a lesser-discussed, but just as important component of compliance is the area of tax. As people move throughout the world, so does their money—which in turn affects the regulatory environment, especially as it pertains to the collection of taxes by national governments of its citizens living abroad.

With the Internal Revenue Service's issuance of regulations under tax code Section 871(m), which imposes a transaction tax on equity-based derivative contracts, alongside dealing with processing Section 305(c) tax levied on conversion rate adjustment (CRA) dividends and other transaction taxes like the Financial Transactions Tax (FTT)—smart institutions must weigh their compliance strategies to avoid getting lost in what may seem like a sea of transaction taxes. And as if adherence to these complex transaction taxes was not complicated enough, banks must also think about the other half of the equation: tax reclaims, or the recovery of overpaid tax from authorities. This is a step which banks championing customer service cannot afford to overlook.

Justin Walker, Head of Tax Operations at Barclays Capital, recently gave us his take on why many banks

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have undertaken the creation of a dedicated tax operations department to abide by these complex transaction tax regimes. According to Walker, ''Tax compliance is so key because it starts right at the beginning of the lifecycle with client onboarding, and continues all the way to the end of asset servicing. Understanding front to back is the only way to ensure compliance.''

When it comes to tax compliance, acquiring the most accurate, up-to-date data and then applying logic and calculation methodology to put that data to work is a huge challenge for organizations. Walker continued, ''though we've trained talent internally when building up our own tax operations department, partnering with technology vendors has been indispensable. We needed a consistent solution because tax compliance is not a competitor factor for banks, it's a hygiene factor. Everybody simply needs to do it, and having experts working with our own internal personnel dedicated to these solutions and maintaining them has been very invaluable.''

Complex Portfolios

Financial products, especially those found in the portfolios of high net worth individuals, have become significantly more complex. An investment is no longer just a simple vehicle—it is often a bundle, or a ''basket'' of several different types of uniquely structured instruments, some with layers of underlying assets—which makes the taxation of these products far from simple.

Nacera Beniken, a tax lawyer for FIDAL in France, is tasked with advising banks and brokers on achieving day-to-day compliance with transaction taxes, often from the ground up.

''Taxation has been around for hundreds of years and is not going any where it's well overdue becoming its own dedicated department,'' said Beniken.

According to Beniken, the real challenge in setting up compliance procedures and maintaining them for new transaction taxes is that there is no previous model of compliance on which to model efforts. And when noncompliance is detected by regulators, it goes from being a back-office issue to a front-office issue.

''Preventing tax evasion is clearly top of mind to banks. Reputations are at stake—banks do not want to be in the headlines for regulatory noncompliance, from overarching regulations down to these transaction taxes'' said Beniken.

Many banks have gotten caught up in a siloed approach to transaction tax compliance—using distinct systems and software providers for each and every tax, requiring repeat builds of interfaces and associated maintenance costs, with no central oversight. When considering that regulations like 871(m), 305(c) and the FTT have multiple points of crossover, taking a siloed approach simply isn't scalable. Banks taking a strategic approach to transaction tax compliance can significantly consolidate efforts to ensure smooth sailing for the tax operations department, compliance teams, vendor partners and ultimately, for its customers.

Being in the tax compliance space for over a decade now, we've seen time and again that regulations and their interpretations are constantly changing. In order to achieve successful tax compliance, the most efficient tax operations teams we've seen have established and utilized a repository for tax compliance, centrally stored and maintained to minimize interfacing costs, rather than implementing regional solutions. The correct combination of expertly trained bank personnel and technology is the perfect match in ensuring compliance for the entire lifecycle of a transaction.

Walker outlines an increasingly connected future: ''I see rules similar to 871(m) being adopted by other jurisdictions as well—not just the IRS. You can't ignore that FATCA was a U.S.-led initiative, which then led to CRS being the global standard in preventing tax evasion. This is just the same objective being achieved by a different means.'' Walker was referring to the U.S. Foreign Account Tax Compliance Act and the Organization for Economic Cooperation and Development's common reporting standard.

''The digital world has led the economy to change significantly as moving assets around the world is so much easier now. Coordinated international responses to these issues has become increasingly important. In the U.K., there's even a corporate criminal liability for tax evasion, showing how serious it's being taken by the authorities. Events like the Panama Papers and the Paradise Papers have shown us that transparency is certainly on the up and consumers are taking notice,'' said Walker.