Editorial

Global trading – a worldwide tax headache

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Investing across national borders is back in vogue. A recent study by Salomon Brothers Inc. estimated that, after the drop caused by 'Black Monday' international equity investment – investors in one country buying stock in another – will grow to about US$ 1,40 trillion in 1989 and will expand almost three-fold to US$ 3,90 trillion by the year 2000 and to US$ 12,85 trillion by 2010.[1]

This flow of investment has led to the phenomenon of 'global trading', i.e. trading the same stock and securities continuously around the world across all time zones. The trading can be either in one particular instrument (e.g. US Treasuries) or in one particular market (e.g. foreign exchange). It can involve trading from one book (i.e. the transfer of a book of securities such as US Treasuries, Eurobonds, etc.) or from one location but using overseas brokers or agents. New technology has ensured that different financial centres can take over trading positions instantaneously at the end of the first centre's trading period.

The regulatory framework for global trading has only recently started to develop. The International Organisation of Security Commissions (IOSCO), the leading international body of security regulators, discussed at its September meeting in Venice a supranational approach to securities markets, parallelling that used by banking supervisors. There is already some concern that the IOSCO will re-regulate globally in the 1990s what was laboriously deregulated nationally in the 1980s.[2]

There is no such risk of over-regulation in the tax area, although global trading is fast becoming one of the biggest problems for tax authorities – and, consequently, for the financial industry – in every leading financial centre.

Until now, it has been relatively easy to pin down profits earned by banks or financial institutions in particular jurisdictions – and to identify where they have made tax-allowable losses. That is likely to change when a bank's entire portfolio moves from its offices in one financial centre to the next in an endless circle.

There is no doubt that the extent of each dealing room's authority to deal in the portfolio of an overseas associate will be crucial to a reasonable apportionment of profits or losses. If the authority is restrictive, it can justifiably claim to be acting as a broker, and take commissions on transactions it carries out. However, where the authority is genuinely shared and each centre has the capability of trading the book under its own initiative, the profits must somehow be apportioned to contributing centres. It is at this point that the real problems surface.

The determination of the market value of the book of securities when they are transferred (electronically) to each selling location may, of course, go some way towards solving the problem. As the market value, however, can (and does) fluctuate from centre to centre, this could produce some interesting results. Furthermore, what happens if the book arrives with a loss in New York and a gain in Tokyo, but no overall net gain or loss?[3] The parent of such a group could end up with a strange tax charge. A number of possible alternative solutions involving the application of the so-called 'indirect method' of profit allocation have been proposed. Usually these alternatives would focus on either the value or the volume of security transactions conducted by each centre as a basis for a profit split. These methods are, however, by no means generally accepted, least of all by the tax authorities.

[1] *See* 'Stock Buying Across Borders Is Resurging', *Wall Street Journal*, 1 September 1989.
[2] *See* 'Hang loose, Mr. Regulator', *The Economist*, 30 September 1989.
[3] *See* 'A taxing problem for global trading', *The Financial Times*, 18 September 1987.

It has all the ingredients of a classical tax confrontation – financial institutions, claiming their accounting systems reflect commercial reality, versus local revenue authorities anxious to maximize their own tax take; and overseas tax authorities equally anxious to make sure they are not losing out.

The tax authorities of the largest financial centers have yet to get together to discuss the problems. When they do, the political machinations could be intense; after all, the authorities are in competition with each other to tax the same items. Perhaps the Committee on Fiscal Affairs of the OECD may provide a suitable platform to agree on a generally accepted basis of allocation, but past experience with OECD reports suggests that, at best, vague guidelines of little practical value can be expected. Perhaps it is time that the financial industry itself takes the initiative and comes up with a consistent approach to the problem which can serve as the basis for a discussion which has been postponed too long already.