

Foreword – Tax compliance of clients is now a reality... but caring for cross-border customers will be an even bigger challenge!

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In these times of crisis, the best option for wealth managers and private banks to grow, is often to provide multi-market, multi-product and multi-currency services to non-resident clients. In other words, domestic private banks should look to go cross-border, and those who are already doing so, should focus on selected key markets where they want particularly to succeed. But that is not necessarily simple: the difficulty is not only in the “cross-border” regulations. It is also in the national tax systems.

As we all know, taxation of financial assets is a field where several major projects of political and diplomatic transformation are in progress. It was prompted by the evolution of the marketplace toward tax compliance. In particular, Automatic Exchange of Information (AEI) in tax matters has become a fashionable subject of conversation of this year.

It is, however, important to keep in mind that AEI is just a preliminary step in a major process of a broader *aggiornamento* of the financial industry. If financial intermediaries are to retain their clients who are residents in OECD countries, they will have to face three challenges: (i) achieving the tax suitability/efficiency of their clients’ portfolios; (ii) providing country-specific tax reports (or at least generic reports of sufficient quality); and (iii) recovering the withholding taxes on dividends and interests. And for those client services, AEI will unfortunately be of no assistance whatsoever.

Particularly in the EU, the anarchy of taxation is such that any project of creating a pan-European market for private banking is, for all purposes, at square one. Despite AEI, tax agencies of several Member States will continue to create hurdles for clients who have bank accounts outside of the country. Certainly, the principle of subsidiarity would suggest that matters of financial markets should be decided at the level of the EU so that unfair practices cannot occur. Unfortunately, this is an area where unanimity rule is still in force and any state can veto common decisions. As a consequence, national tax administrations will continue to give a competitive edge to their domestic financial industry.

Furthermore, investment funds will continue to be subjected to different tax requirements in each country where they are distributed (and often provide specific tax reporting). For lack of standardisation of procedures, this situation will keep wasting billions of euros in redundant or overcomplicated tax reporting, which would be much needed by the national economies themselves, especially in a time of debt crisis.

Four governing principles for client service

The take-away of these considerations is that until some harmonisation takes place in tax matters under the guidance of the OECD, or the EU adopts majority rule in tax matters (supposing once it does), the burden of caring for the needs of cross-border clients will remain in a great part a burden of private enterprise. It will remain a contest between the services provided by private banks to their clients, and the red tape generated by the various national tax systems.

One aspect will be paramount, which should concern the Boards of banks even more than regulation: the requirement to provide clients with a tax-compliant service that is both high-quality and reliable. In fact, it is the clients themselves who are now *demanding* from the banks that they manage their assets according to the constraints of taxation. The change in the business model is so profound that in a few years, we will no longer speak about services “in the field of taxation”, but simply of banking services. This will also create a strong push for creating a level playing field of financial services in Europe, especially now that AEI has entered into force.

But precisely because private banks offer such a wide selection of financial instruments to clients of many countries, the complexity of their challenge is several orders of magnitude greater than for banks that are mostly serving domestic clients. Nevertheless, a small circle of private banks has already succeeded, in just a few years, in positioning themselves as global leaders in that field. For the others, it is only up to them to commit the necessary effort in order to exploit this business opportunity.

To succeed, they will have to answer four governing principles, all related to tax issues:

1. **Tax compliance:** To understand the fiscal principles of clients’ countries of residence and identify the tax subject (beneficiary) of the financial assets under custody or managed. AEI is one of the tools that will ensure tax compliance.

2. **Performance after tax:** As provider of financial service, the fundamental purpose of a bank is to produce value for clients, while taking account of the tax impact of investments. At its most basic level, it implies to consider the tax suitability of financial investments. Here, we are bound to see a growth in discretionary management mandates or specific advice, and a corresponding decline of execution-only services, where clients are left to their own devices with the tax impact of their financial investments.
3. **Suitable tax reporting:** A bank will have to provide their clients with the necessary reports so that they can fill their tax returns, within the prescribed deadlines, and preferably in the format of country of residence.
4. **Recovery of withholding tax:** On behalf of their clients, banks must obtain reimbursement or relief for tax withheld at source on dividends or interests. This process must be industrialised, since too much recoverable taxes are simply evaporating (at a high cost for the performance of the client's portfolio).

As the reader can immediately notice, AEI will be of no assistance for the application of points 2, 3 and 4.

If banks want to improve their offering in the new cross-border context while remaining profitable, they have no choice but to review and re-engineer the industrial basis on which they operate. At the same time, this also requires the complexity to be reduced by working with a list of target countries, and by excluding unsuitable products from their offering.

Developing services that take into account the domestic tax systems of their clients will require considerable investment in infrastructure, both at the level of the banks and of the marketplace. Even though this could be painful for smaller financial institutions whose profit margins have shrunk, this is the only realistic way to bring about a return to growth. It is also necessary to accept the fact that financial intermediaries that do not wish to engage into this *aggiornamento* (or that cannot do so) are bound to eventually disappear or be taken over.

The financial industry has a brief window of opportunity to undertake the dynamic and profound operational reforms required by tax transparency, and to step in before competitors. Realising the urgency of the situation should however not lead to precipitation. Faced with all the challenges around the tax transparency of their clients, the boards of private banks have sometimes been tempted to make snap decisions, such as closing the accounts of tax-compliant clients that could have still been profitable, dismantling their internal back office (even though only a subset of its activities can be outsourced, for legal and practical reasons), selling part of their client base, or even the whole institution.

A first step to return to a more serene outlook is to overcome the fixation on tax regulations themselves, particularly AEI, and to focus again on the service to clients, particularly cross-border clients. The four principles above (tax compliance, performance after tax, tax reporting, and recovery of withholding tax) should provide guidelines on how to define policy at corporate level. They should also help in the design and application of new tax regulations for the financial sector. But in order for banks to face the challenge of client service in the new context, they will have to re-engineer their industrial infrastructure.

As already mentioned, this should not only help private banks retain non-resident clients. It is also the prerequisite for the next challenge and the "new frontier": access to the markets worldwide. Such as for example in the European Union (EU), a large bank that re-engineers itself to cope with the (sometimes complex) tax prerequisites of the 28 EU member states could find itself in a much better position indeed in front of the EU Commission, i.e. in a position of trust. Another avenue is to become "collaborating entities" so as to obtain relief of foreign source taxes on dividends and interests for their clients. This is not a vague theory: this concept is described in EU Commission report on workable solutions for removing tax barriers within the EU.¹ Once the foundations of tax compliance are in place, these considerations of client service (with their corollary of market access), should take priority above all others.

Everything rests, however on one cornerstone: people. In order for this *aggiornamento* to take place, and to have the best chances of succeeding, the necessary skills will have to be distributed and assimilated at all levels. This will also require a new approach to the design and application of training in the field of cross-border taxation, as well as a new way of teaching asset allocation. In order to bring "tax chaos" back under control, it is now necessary to create a common corpus of procedures, understood and shared by all, and particularly by wealth managers.

Notes:

BRP Tax SA, December 21, 2015.

¹ http://ec.europa.eu/internal_market/financial-markets/docs/clearing/tbag/130524_tbag-report-2013_en.pdf

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