



Automatic Exchange of Information (AEI) Reporting Method II – A regulatory optional obligation?

by Johannes Ebe and Achim Eckert

In recent years, tax transparency regulation has increased on a global scale. The OECD standard, established via the Automatic Exchange of Information (AEI), is the most comprehensive set of rules. It aims at improving global tax co-operation and tackling international tax evasion. Thus, it in particular takes a close look at complex wealth management structures such as trusts and foundations.

Whereas every Beneficial Owner (BO) in a banking relationship is subject to reporting, not every beneficiary of a trust or foundation necessarily is. Beneficiaries with no claiming rights that did not receive a distribution in the relevant reporting period can be excluded based on the Swiss AEI Guidance. Offering this service to trust and foundation clients is crucial given the negative consequences the alternative of reporting all beneficiaries might entail.

However, to be able to offer Reporting Method II, Swiss Financial Institutions (FIs) must timely have the appropriate measures and processes in place. As latest by the end of 2018, entity clients are generally in-scope of reporting, it is time to act.

Short Recap AEI

With the implementation of the AEI in Switzerland in 2017, the international framework established by the OECD sets a new standard in the fields of tax transparency and tax fraud prevention. It defines the automatic exchange of tax information between states that agreed to take part (participating jurisdictions).

As stated in one of our recent publications (Fiscal Compliance – It ain't over with AEI), the AEI is considered to be a major milestone in global tax transparency, and along with its implementation, several significant loopholes of previous fiscal compliance initiatives were closed. For example, the possibility to circumvent the European Savings Directive (ESD) which was only targeting natural person clients, but not Beneficial Owners (BOs) or Controlling Persons (CPs)¹ of specific wealth management structures, e.g. trusts & foundations.

Despite the fact that the first AEI reporting of Swiss FI to the Swiss Federal Tax Administration (FTA) already took place mid-2018 for the reporting year 2017, for the majority of entity accounts established before 2017, initial reporting will commence only in 2019 for the reporting year 2018.

In the case of entity clients, CPs are reportable under AEI depending on the entity's AEI classification² in conjunction with the country of incorporation. This, in particular, affects entity clients related to trusts and foundations which are often characterized by having multiple CPs.

Footnotes:

1. Controlling Persons under AEI are defined as the natural persons who exercise control over an entity. In Switzerland this definition is largely aligned with the BO definition according to the "Agreement on the Swiss banks' code of conduct with regard to the exercise of due diligence" (CDB16)

2. The term 'AEI Classification' in general means the categorization of an entity for the purposes of the AEI. It defines how an entity relationship and, if applicable, how the CPs behind the entity relationships are being reported under the AEI.

Treatment of Trusts & Foundations under AEI in Switzerland

AEI classification for Trusts & Foundations

Contrary to a shoe manufacturing company or the bakery around the corner, entity clients related to trusts and foundations are considered to be non-operating entities, for which two AEI classifications come into question. Either it is the classification as Passive Non-Financial Entity (Passive NFE) or the classification as Professionally Managed Investment Entity (PMIE). To understand how the reporting of CPs behind such a structure works, one needs to have a look at the different AEI classifications applicable to entity clients related to trust and foundations:

- **PMIE in a participating jurisdiction**
As a PMIE is considered a FI, it has its own reporting obligations under AEI in its country of incorporation. This implies that the reporting is performed by the PMIE itself and no look through to the CPs needs to be performed by the Swiss Reporting FI.
- **PMIE in a non-participating jurisdiction**
Same classification as above, but in this case, the country of incorporation of the PMIE does not participate in the AEI. The Swiss Reporting FI has to perform a look through to the CPs determining who is reportable. The PMIE itself is not reported.
- **Passive NFE**
Different from a PMIE, a Passive NFE is not considered an FI. Hence, the entity itself, if incorporated in a reportable jurisdiction, and its CPs, if tax residents in a reportable jurisdiction, will be reported by the Reporting FI.

Being obliged to perform the AEI reporting is therefore commonly associated with high operational costs and endeavor which can be avoided by the client by opting for the classification Passive NFE where the FI conducts the reporting. This is particularly favorable for fiduciaries acting as trustees that do not have adequate reporting procedures in place.

Treatment of Trusts & Foundations under AEI in Switzerland (continued)

Reporting obligations with regards to related persons

The question which has to be raised now is who is assessed as being a CP of an entity related to a trust or foundation? As noted earlier, the Common Reporting Standard (CRS)³, which also applies to the reporting under the AEI, defines the term 'Controlling Persons' as the natural persons who exercise control over an entity. In the case of a trust, such term refers to the settlor, the trustees, the protector (if any), the beneficiaries or the class of beneficiaries.

While trustee(s) and protector(s) are usually determined when the settlor 'settles' the trust, beneficiaries are defined within the 'letter of wishes' that can be subject to change over time.

As an example, the beneficiaries might be defined in the letter of wishes as follows:

"All my lawful, direct descendants (Fred and Meggie) reaching the age of 18 including their spouses shall benefit from the trust as mandatory beneficiaries. Their descendants below the age of 18 may only be considered discretionary beneficiaries, but mandatory beneficiaries once they have reached legal age. In addition, my unlawful son Andy (who is not aware of the trust) shall be considered a discretionary beneficiary."

This example demonstrates the feasibility to differentiate between two types of beneficiaries. While mandatory beneficiaries have the right to claim distribution, discretionary beneficiaries do not. Nevertheless, both types of beneficiaries are considered CPs under the CRS and are generally subject to reporting. This implies that information of discretionary beneficiaries is unveiled to the tax authorities of their country of tax residence, irrespective of whether the beneficiary of a trust or foundation is aware of it (in the example above – the unlawful son Andy) and having adverse effects for the client relationship.

Reporting Method I vs. II

Fortunately, in this particular matter, the Swiss AEI Guidance offers the Reporting FI two different methods for the reporting of beneficiaries. The two reporting methods differ in the way the beneficiaries of the trust or the foundation are assessed, which in turn determines whom of the beneficiaries is reported and who is not. Whereas mandatory beneficiaries are reportable under Reporting Method I and II, discretionary beneficiaries are only reportable under Reporting Method I. Under Reporting Method II, a discretionary beneficiary is only deemed reportable if a distribution has been received during the relevant reporting period.

Footnotes:

3. CRS: Common Reporting Standard (Section VII.D.6). Sets out the financial account information to be exchanged, the FIs required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by FIs.

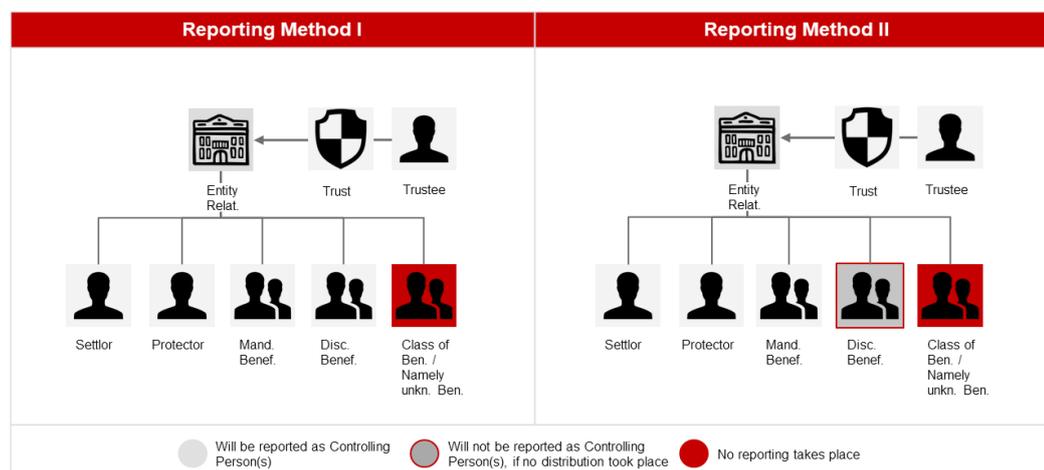


Illustration:
Reporting Method I vs.
Reporting Method II
(Source: Own Illustration)

Treatment of Trusts & Foundations under AEI in Switzerland (continued)

This opportunity allows entity clients related to trusts or foundations and classified as Passive NFEs or PMIEs in non-participating jurisdictions to exclude discretionary beneficiaries from the AEI reporting, given that they did not receive a distribution in the relevant reporting period.

Example: *Gotham Family Trust is incorporated according to Jersey law and holds a financial account at a Swiss Reporting FI.*

Background information:

- The **settlor** is tax resident in UK
- The **protector** is tax resident in Switzerland
- The **trustee** is tax resident in Jersey
- The **mandatory beneficiaries**: Children of the Settlor and their spouses, Fred and his wife, Meggie and her husband, all tax resident in Germany.
- The **discretionary beneficiaries**: Unlawful son of the Settlor, Andy, who is tax resident in Italy and the settlor's namely known grandchildren having various tax residences.
- In 2017, the regular distribution to the mandatory beneficiaries took place, and also a one-off distribution to the namely known grandchildren. Andy, the unlawful son of the settlor, did not receive a distribution.
- The annual gross income amounts to CHFm 0.5 and the year end balance to CHFm 10

Reporting implications:

Settlor: According to the CRS, the settlor is considered a CP and with his tax residency in the United Kingdom, he is also considered reportable. Therefore, the data of the settlor is reported to the FTA and subsequently exchanged with the United Kingdom's tax authorities.

Protector: The protector is also considered a CP. As he is tax resident in Switzerland, no reporting will take place.

Trustee: Also the trustee is deemed being a CP. As he is tax resident in Jersey, which has an AEI Agreement in place with Switzerland, reporting will take place.

Mandatory beneficiaries: Fred and Meggie, the mandatory beneficiaries, are both deemed CPs. Irrespective of them having received a distribution in the past, a reporting will take place.

Discretionary beneficiaries: When Reporting Method I is applied, all the discretionary beneficiaries are assessed as CPs and subject to reporting. When Reporting Method II is applied, only the namely known grandchildren of the Settlor will be reported as they received a distribution in the relevant period. Andy, the unlawful son (who is not aware of the trust), will not be reported as he did not receive a distribution in the relevant period.

General: For all natural persons mentioned above, for whom reporting will be conducted, the set of reported information will include the gross income of CHF 500'000 and the year end's balance of CHF 10m. Further personal and account-related information are part of the data transmission.

Thus, the potential impact for the client can be significant and the ability of a Swiss Reporting FI to offer Reporting Method II to attract and retain entity clients related to trusts and foundations is indispensable.

Impact for Reporting FIs

As just illustrated in the example, it is crucial for the client to offer Reporting Method II. However, for the application of this Swiss-specific Reporting Method the regulator requires the FI to apply appropriate efforts and measures to identify the discretionary beneficiaries who have received a distribution in the relevant period.

Such efforts and measures may be interpreted as following.

The Reporting FI:

- trains its employees on obtaining relevant information on the beneficiaries
- and**
- informs trustees about their responsibility to proactively inform the Reporting FI about whom of the discretionary beneficiaries received a distribution in the relevant period
- and**
- performs a transaction monitoring. Basically, a tracking of payments on the related account(s) and whether a distribution to one or more discretionary beneficiaries took place
- or**
- obtains a yearly confirmation by the client listing all discretionary beneficiaries who did receive a distribution in the relevant period.

Given the potentially high costs related to the fulfillment of the requirements, different options are worth evaluating, in particular considering the size and the respective reporting procedures already in place. While for smaller FIs, the option of yearly obtaining a confirmation by the client might be the most appropriate solution, Global Banks often have integrated transaction monitoring

Impact for Reporting FIs

Despite the fact that additional regulatory requirements are generally perceived as a necessary evil, the AEI provides leading FIs the chance to set themselves apart from their competitors by offering Reporting Method II for entity clients related to trusts and foundations.

Whilst doing so, it is important to find and implement a solution that is both, regulatory compliant (effective) and cost efficient.

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