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Fiscal Compliance – It ain´t over with AEI

by Philipp Tenbieg and Achim Eckert

Not so long ago, Switzerland as one of the global leading Wealth Management centers was stigmatized by foreign governments as a Tax Haven due to the strict banking secrecy standards. In order to strengthen Switzerland´s reputation and ensure economic collaboration with international partners, several initiatives were launched.

With each introduction of a new fiscal initiative to prevent tax evasion, the framework of fiscal compliance in Switzerland got more solid, loophole after loophole got closed. Nowadays the Automatic Exchange of Information (AEI) is considered the most comprehensive approach to fiscal transparency internationally.

However, it must not be concluded that tax compliance is fully ensured for all account types subject to AEI. The new framework evidently leaves certain aspects to be addressed by subsequent measures. Even though no new major regulation regarding tax transparency is on the horizon, regulators are refining the requirements of existing regulations continuously. Rather than waiting for further rules to be imposed on them, many financial institutions have identified fiscal compliance as a strategic advantage and started to transform the various disclosure initiatives into one watertight fiscal compliance framework.

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Historic development: Swiss banking secrecy crumbling

The first major milestone towards fiscal compliance for the financial center Switzerland was the European Savings Taxation Directive (ESD) which became effective in 2005. Subsequently, bilateral agreements on exchange of fiscal relevant information with few EU states followed. In light of increasing political pressure, FINMA's expectation and the possibility of Group Requests in line with OECD standards, Swiss banks started fiscal compliance initiatives with the purpose to document tax compliance of their international clients.

While the ESD had some substantial loopholes, the Automatic Exchange of Information (AEI) which became effective in Switzerland as of 2017 is considered to be a stronger, more extensive framework. Currently, it is commonly conceived that no further fiscal compliance documentation of cross-border clients is required due to the apparently watertight AEI. This hypothesis should be challenged carefully and the introduction of a comprehensive fiscal compliance approach might be recommended taking into consideration the latest developments in international taxation.

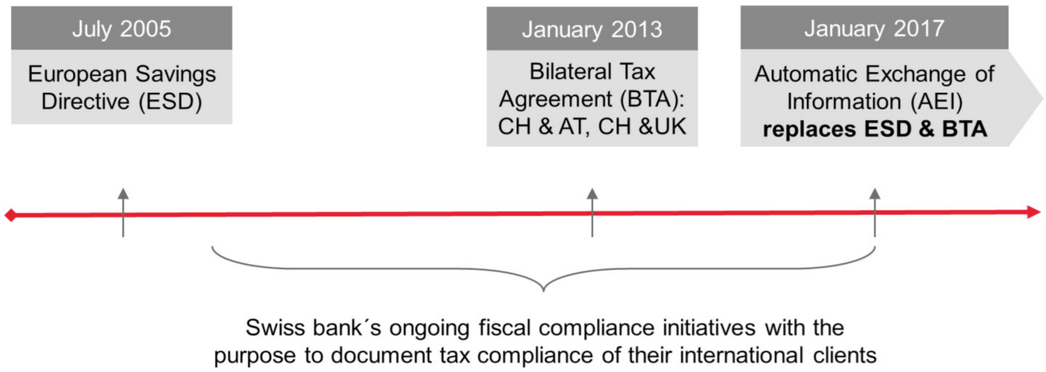

Illustration:
Historic Development
(Source: Own Illustration)

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New global standard: Automatic Exchange of Information

In an increasingly globalized financial environment where cross-border activities became the standard, international tax authorities are compelled to work together closely and exchange information in order to prevent tax evasion. As a global initiative, AEI was originated by the OECD with the aim to increase tax transparency and decrease tax evasion by introducing a worldwide standard for automatically exchanging tax related information.
Under AEI, Reporting Financial Institutions are required to widen their client identification and documentation procedures meaning that clients have to provide specific details on their tax domicile(s). In principle, AEI is based on the following approach:

1. All clients are requested to confirm their tax residence in order to determine client populations affected by respective AEI Agreements
2. The Swiss Financial Institution collects the required information on clients subject to AEI and reports the respective information to the Swiss Federal Tax Authority (FTA)
3. Subsequently, the FTA will then share this information with the tax authorities in the clients' country of residence

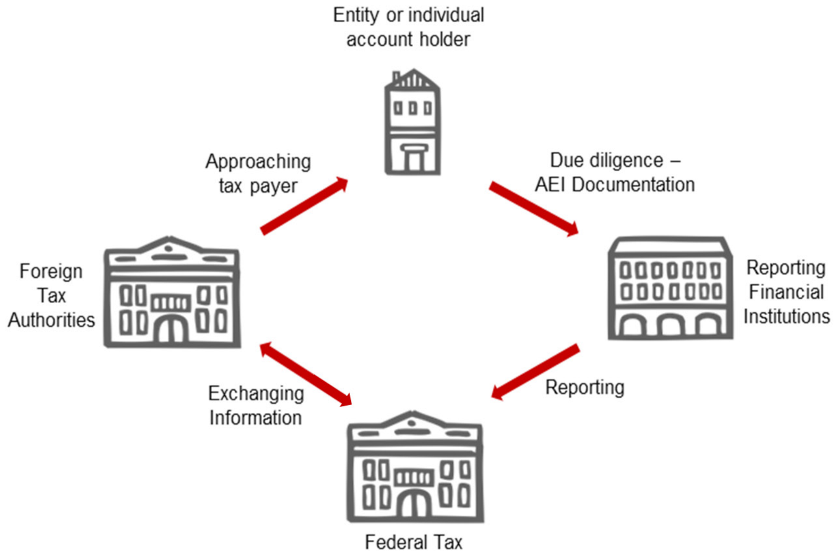

Illustration:
Automated Exchange of Information (AEI)
(Source: Own Illustration)

The reporting is based on the OECD Common Reporting Standard (CRS) and includes in addition to the client's personal details, account balances, interest and dividend payments as well as sale and redemption proceeds from financial assets.

Each financial institution has the obligation to ensure proper information exchange. Hence it is required to obtain the relevant information ("AEI self-certification") from existing clients during the so called "remediation phase" as well as from new clients as part of the account opening process. In addition, it is required to continuously monitor all relationships for potential indicia of changes of a client's tax residencies such as changes of the account holder´s address, phone number or any other relevant indication of a new tax domicile. Such new indicia are considered a "Change in circumstances" and trigger the requirement to provide a new AEI self-certification from the client.

New global standard: Automatic Exchange of Information (continued)

In terms of fiscal compliance, the AEI framework can be considered a stronger framework in comparison to its immediate predecessor, the European Savings Taxation Directive (ESD). While ESD had several limitations, and reporting to tax authorities could easily be circumvent, AEI is set up in broader way and some gaps have been closed:

Participants:
As of 1 January 2018, Switzerland has AEI agreements with more than 75 jurisdictions and additional countries are expected to join the global framework. This is a massive extension compared to ESD which was limited to the 28 EU countries

Scope:
While ESD was limited to bank accounts held by natural persons, the AEI framework applies in principle to any account – regardless whether it is held by a private individual, a company, a trust, a foundation or a life insurance company

Reporting:
One of the major weaknesses of ESD were the limited reporting details. Besides the personal information of the account holder / beneficial owner, only interest income was reported. The amount of the assets held with a Swiss bank was not included. Furthermore, annual reporting took only place in case relevant interest income occurred. Since under AEI, reporting takes place according to OECD CRS, the account balance and other details are included in the reporting. Hence, circumventing reporting to tax authorities by structuring investments in a way that avoids interest payments is not possible.

Gap assessment: AEI's loophole

Although the introduction of AEI was a major milestone in global tax transparency, it cannot be concluded that tax compliance is ensured for all accounts. There are weaknesses too:

Self-certification
In principle, a client's tax residency is determined based on a client's self-attestation. It is not required to proof the domicile by means of a tax residence certificate or another official document.

3rd party structures
In case an account is held by company, reporting of tax relevant information might not take place by a Swiss bank itself. In cases where a company or structure classifies itself as e.g. a "Passive non-financial entity", the custody bank is in charge of disclosing AEI data to the tax authorities. For other types of entity classification such as "Professionally Managed Investment Entity", the contracting party itself is in charge of AEI reporting. Hence, a bank does not always know whether an account has actually been reported

3rd party jurisdictions
The AEI framework is based on bilateral agreements between each participating jurisdiction. In case of company accounts where the beneficial owner is not resident in the company's country of incorporation, a complex triangle situation might occur for specific constellations:

Example
If Switzerland has AEI agreements with the company's country of incorporation and the beneficial owner's country of tax residence but those two countries have no AEI agreement with each other in place, no information exchange to the tax authorities in the beneficial owner's country of residence will take place.

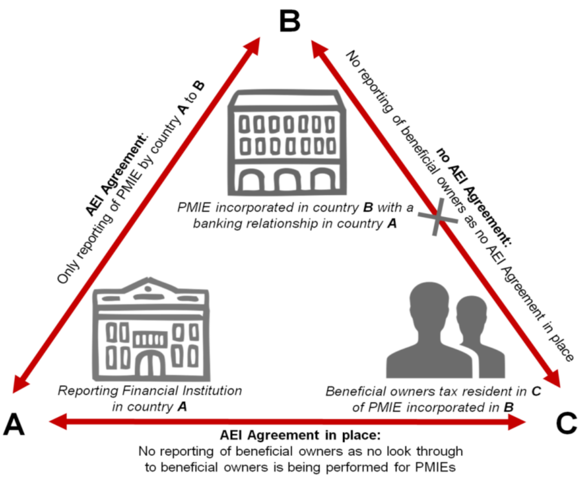

Illustration:
AEI framework loopholes
(Source: Own Illustration)

Account closure:
Under the current setup, a client might close an account prior to the end of the remediation period without triggering any AEI reporting to the tax authorities (exception: if client has a so called "super indicia" on file meaning that the client's tax residence has been formally documented under BTA, ESD, QI etc., he will be reported for the respective period).

Considering the gaps under AEI and the fact that Swiss banks might face further group / bulk requests, implementing an integrated fiscal compliance approach is advisable.

Integrated Approach

An integrated Fiscal Compliance approach based on risk clustering of the client population is key in order to address the residual risks of AEI´s gaps comprehensively.

As part of the AEI remediation and as well in line with Swiss KYC requirements, all Swiss financial institutions are obliged to formally document their clients' (tax) residency. Onshore clients and clients subject to AEI reporting induced by the bank itself can be considered tax compliant.

For the remaining client population, a Wealth Manager can initiate of a legacy book review and obtain additional documentation as proof of fiscal compliance. These documentation requirements may differ for each country. On the one hand, the documentation principles must provide sufficient comfort of the clients' tax compliance in the country of residence. On the other hand, clients shall be able to provide a form of documentation that is easy to obtain. For new clients, the fiscal compliance confirmation must be provided as part of the account opening process.

Communication is key during such a business transformation initiative – both internally to relationship managers and externally to affected clients. A comprehensive communication concept that includes a broad range of supporting materials and training sessions guarantees that relationship managers are well prepared for approaching clients on such a sensitive matter. The communication approach to clients is tailored to the specific needs and may differ for each client segment and between different market regions.

Furthermore, a risk management framework is required to mitigate operational risks and ensure long-term success in the Run-the-bank phase, including certain documentation and approval

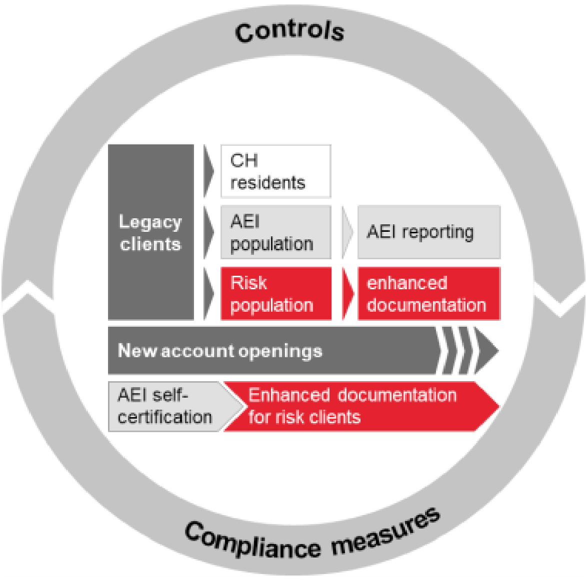

Illustration:
Integrated Approach
(Source: Own Illustration)

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Founded by experienced management consultants in 2008, we have grown since then to a renowned consulting company with a complementary service offering across various disciplines. **2018, we are celebrating our 10th anniversary.**

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Zurich
TALOS Management Consultants
Bleicherweg 45
CH-8002 Zurich

Luxembourg
TALOS Management Consultants
5, Rue Heienhaff | 2nd floor (Wing E – Suite 2E)
L-1736, Senningerberg

www.talos-consultants.com
www.shapenewstandards.com

Your Contact

Philipp is co-founder and Managing Partner at TALOS. His industry focus is on Wealth Management / Private Banking and his primary areas of expertise are managing complex Programs, ensuring Regulatory Compliance and developing Digital Banking.

Philipp Tenbieg
Managing Partner
+41 44 380 14 40
philipp.tengbieg@talos-consultants.ch

Achim Eckert
Consultant
+41 44 380 14 40
achim.eckert@talos-consultants.ch