Financial institutions adapt to tax transparency

Tax transparency initiatives such as the CRS, AEOI and FATCA, and the upcoming mandatory disclosure rules, are having a profound impact on the operations and IT infrastructure of financial institutions (FIs) worldwide. Ronald Frey, chief product officer of the RegTech product unit within BearingPoint, discusses how these are creating trends towards data alignment and centralisation, and are changing the role of FIs and wealth managers in cross-border tax reporting.

The history of global tax transparency schemes is indeed long, but tax transparency has finally become a global reality.

With the introduction of the common reporting standard (CRS), tax transparency is now impacting FIs in a much broader and global scope than it has in the past under the US qualified intermediary (QI) reporting rules introduced in 2002, and the Foreign Account Tax Compliance Act (FATCA) that entered into effect in 2014 (see Diagram 1).

From the financial institutions' perspective, the QI rules only apply to clients investing in US securities, while FATCA only affects FIs dealing with US clients. The CRS, however, is much wider. Added to this is the voluntary disclosures and tax amnesty schemes offered by numerous countries and the increasing amount of previously untaxed offshore wealth being declared and taxed.

With all this data exchange, FIs are having to adapt quickly to meet the demands of their clients and the authorities.

Operating models

In the domain of tax reporting under QI, FATCA and CRS, there is a growing trend towards centralisation of data management and the localisation of reporting to the tax authorities.

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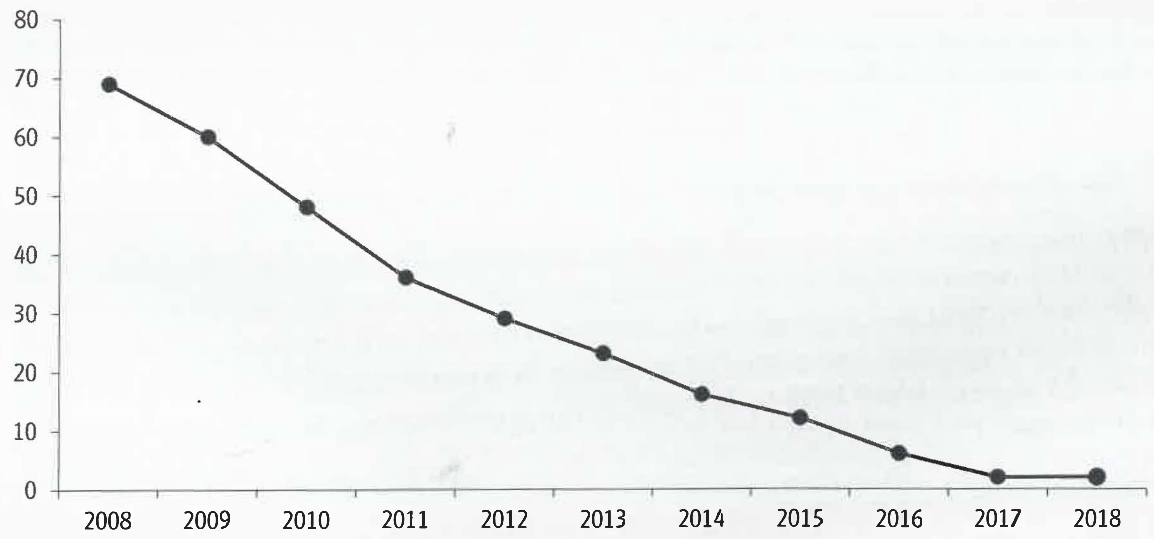
Globally operating FIs have started to implement so-called data hubs. FIs that have already consolidated their operating IT platforms will be in a better position to establish such hubs. Most larger global FIs have built their proprietary IT platforms and can now start to centralise the static and transactional data of their clients.

In line with this data centralisation, there is a trend of FIs aligning their operations. Previously, most FIs processed QI, FATCA and CRS data and subsequent reports in different organisational units, but they are realising the cost savings of harmonising these different processes within a single reporting unit. In fact, FIs that have already centralised their tax relevant data and implemented a single reporting engine, are now able to process all reporting within a single team.

Diagram 1: Jurisdictions with restrictions on access to bank information for EOI purposes



Source: OECD – Tax Transparency 2018 – Report on progress

A further trend is that FIs are changing their sourcing strategy by switching from their own proprietary built engines to vendor supplied, standard report engines.

While the technical infrastructure management cost to maintain a proprietary built solution may be more cost efficient than a vendor solution, the expense of the functional application management by far exceeds the maintenance cost paid to an all-inclusive vendor solution provider. Since FATCA and CRS reporting varies from country to country, FIs need to track and implement changes themselves. Sometimes compliance and tax departments are involved in this monitoring but often this service is bought from one of the Big 4 accounting firms. There are vendor solutions available on the market that include reporting rules for local reporting schemas in the engine, with the maintenance fee including a continuous functional update of the report engine.

The pressure to switch to a vendor solution and for the implementation of a centralised report unit and process is further exacerbated by the upcoming reporting due under the OECD's model mandatory disclosure rules (MMDR) and the EU's application of it under its DAC6 scheme. MMDR will broaden the scope of CRS reporting, and the EU has introduced an even wider scope for covering investment structures that offer a tax advantage.

The ultimate question is whether FIs will keep their reporting in-house or outsource it to a specialised service provider.

Certain FIs have started to outsource this process, but given the sensitive nature of information (e.g. disclosure of name, address, date of birth, as required under CRS reporting), not many have so far chosen this option. If they have done so, then they have usually implemented internal processes complementary to the outsourcing. This has of course not resulted in significant cost savings. With the upcoming implementation of MMDR and DAC6, under which investment schemes that include tax efficient structures must be reported, the outsourcing of such data becomes ever more difficult. It is therefore rather unlikely that outsourcing of reporting under these global tax reporting schemes will become a widespread reality.

Tax report demands

With CRS in its second year of operation for the early adopter countries and for the first year for the second tranche of countries such as Singapore and Switzerland, tax transparency has also become a reality for investors.

As international tax regulations become more stringent, taxpayers face challenges in reporting their onshore and offshore assets to tax authorities, with some using the voluntary disclosure facilities offered by some governments.

As a result, financial institutions are finding that their clients are increasingly requesting the institutions to provide tax reports consisting of tax information such as income, capital gains or wealth, in order to assist in filing tax returns according to the respective tax law.

While tax reporting is typically not a core function of private banks and wealth management firms, clients often seek their help with completing tax forms. It should be noted that the vast majority of FIs do not offer tax advisory services, but, in most cases, are willing to offer some level of tax reporting service in order to keep their clients satisfied. The demand for client tax reporting services is growing and the approach from banks and wealth management firms varies widely depending on the profile, capabilities and business strategies of the FIs.

The service and advisory quality of wealth management institutions will increasingly be judged by investors (both private and institutional) based on their after-tax portfolio performance.

The following examples underline the necessity for banks and other wealth managers to consider the tax impact on their portfolio management activities, or when advising their clients on investments. Considering the tax impact before trading or investing, the tax burden on the client can be minimised and after-tax performance increased:

- Sweden: Losses cannot be carried forward. If a client has an overall loss at the end of the year (which cannot be carried forward into the next year), realised capital gains before year end up to the loss amount would be tax free. By contrast, any capital gains in the new year would be taxed at 30%. Realising gains within the same year that losses occur can improve after-tax performance by up to 43%;
- UK: Different tax rates for different kinds of income. Capital gains resulting from so called offshore-non-reporting funds qualify as interest income and are therefore taxed at up to 45%. Gains

Tax transparency generates additional tax revenues

The impact of the AEOI has already been felt. As reported by the OECD to the G20 in July 2017, in response to disclosure initiatives and similar measures put in place prior to the start of exchanges approximately 500 000 individuals have already disclosed offshore assets worldwide, and some EUR 93 billion in additional tax revenue has been collected.[15] The gains which have been publicly reported by the governments around the world include:

Wealth managers hold the key to the future tax success of their clients with more bespoke services

from other types of funds are taxed at 20%. Investing in the right instrument can increase the after-tax performance by up to 45%;
- Australia: The discount method is applied. For Australian clients, taxes can be halved if positions are held longer than 12 months. Holding a position for a short additional period can increase the after-tax performance by up to 40% (assuming a personal tax rate of 45%).

Banks, asset managers, trust managers and family offices are advised to implement a tax calculation engine that is fed by market data as well as by internal transaction data, and which is connected to their portfolio management solution.

Many wealth managers have already started to implement such tax reporting solutions that go beyond that which is normally available from core banking systems. Yet many banks are still far away from being able to provide their clients with an annual, country-specific tax report, simply continuing to offer a generic tax report. This is essentially a list of taxable transactions that were executed during the tax calendar year. Sometimes, this report is enriched by adding a generic rule engine for capital gain/loss tax calculations based on either first-in, first-out (FIFO), last-in, first-out (LIFO) or an average of either FIFO or LIFO. While this may satisfy a wealth manager's needs, it certainly does not do the same for investors. The following simple example illustrates this:
- Purchase of an investment fund in 2008 (at €10.92 ($12.42)) and again in 2016 (at €10.95).

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- The position is then sold in 2017 for a price of €16.58.

Applying a generic FIFO rule, the taxable gain on this sale would amount to €9,899.34. If the investor is a German, French or Austrian individual, and the wealth manager was working with a country-specific tax calculation engine, which takes into account the complete tax rulings of the country of tax residency of the investor, the German taxable gain would be €1,050.25, the French would be €9,887.23 and finally the Austrian would be €826.48, after taking into account the special tax rules and exemptions in their respective home countries.

In our example, both the German and Austrian investor would be given unfairly high capital gain tax figures if the generic tax rule engine was used. The result would be that both investors would need to hire a tax lawyer to complete their tax return according to the demanding tax rules in their resident countries. Neither investor would receive an accurate after-tax portfolio performance report from their wealth manager.

In summary, all FIs will be challenged because of the growth in worldwide tax transparency combined with clients' focus on after-tax performance. The outcome will probably be the following:
- Wealth managers will start to offer after-tax portfolio performance reports using tax simulation engines capable of running pre-trade tax impact calculations; and
- Wealth managers will offer an increasing number of country specific, rather than generic, tax reports.

Is the glass half empty or half full?

In common with many other compliance requirements imposed on companies and individual taxpayers, tax transparency schemes place a high level of implementation costs on the FIs, but at the same time offer the potential for cost savings from data and process centralisation, along with new value adding services to their clients.

Some of the larger FIs have already benefited from centralised tax reporting across all transparency schemes and put the provision of client tax reports at the core of their customer management. At the same time, many FIs now need to catch up on this opportunity in order to not lose out.