Clear thinking

International Tax Personal tax

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Eugene Skrynnyk explains how high net worth individuals can plan effectively in light of increasing global transparency

Key Points

What is the issue?

The wealthy have to face up to full tax transparency

What does it mean for me?

Financial information of wealthy taxpayers and their family members is now automatically reportable to tax authorities

What can I take away?

HNWIs and their families who hold financial assets in accounts outside their country of residence should review their affairs and seek tax advice to fully assess their tax dues and ensure they remain fully compliant

The financial crisis which exploded in 2008 and the subsequent impact on the global economy, particularly the cost of bailing out the major banks, left most governments with a serious imbalance between revenue and expenditure. The consequent high unemployment, which naturally hit some of the poorer members of society the hardest, drove a perception that the wealthy were in an advantageous position by being able to employ professional advisers to reduce their tax bills, or were using offshore financial centres to hide their wealth, therefore not paying their fair share of tax. Various well-publicised scandals around the use of aggressive tax avoidance schemes, together with the prosecution of a number of major banks for actively assisting tax evasion by wealthy clients, fostered this perception, thereby creating a favourable political climate for governments to seek to increase their tax take from the wealthy.

Financial institutions and family offices servicing high net worth individuals (HNWIs) have, over the course of the past two years, been expending a lot of resource, time and energy in implementing the requirements of the US Foreign Account Tax Compliance Act (FATCA). This law, enacted to help curb offshore tax evasion by US taxpayers, took effect on 1 July 2014 and has ushered in one of the most far-reaching and controversial changes in global tax transparency: the sharing of financial information about individuals between jurisdictions.

UK FATCA and OECD CRS

Following the enactment of US FATCA, the UK has used its constitutional influence over its crown dependencies and overseas territories to coerce them into an almost identical reporting regime (known as ‘UK FATCA’). This provides the same financial information to HMRC about UK tax-resident individuals who have financial assets in these jurisdictions. In turn, the OECD, a club of mostly wealthy countries, has similarly won the backing of a global FATCA-like regime called the common reporting standard (CRS). Currently, some 90 countries have signed up to implementing the CRS with more expected to follow. Signatories to the OECD initiative will annually share between them all data on financial accounts and assets of all non-residents.

Compliance approach for family offices

Every single or multi-family office, corporate trustee and fiduciary company has to, in the first instance, assess its status under FATCA and the impact on its operations. If no exemptions apply, registration with the IRS and agreeing to comply with the requirements of the legislation are a must in order to avoid punitive withholding, or being frozen completely out of financial markets. This means:

- taking on new clients in a FATCA-compliant manner as well as performing due diligence on existing clients to confirm their US and/or UK person and tax residence status;
- sponsoring client structures (such as trusts, foundations and companies) under administration by the corporate trustees and/or directors to meet the requirements on their behalf; and
- putting in place a reporting mechanism and associated processes in order to disclose the required information in respect of in-scope persons.

Smaller family offices, and similar financial firms, will likely have to outsource FATCA obligations to service providers, or refer impacted clients to bigger industry players that have the compliance capacity to carry out the FATCA obligations.

Implications for HNWIs

The advent of automatic exchange of financial information means that HNWIs will face greater scrutiny of their tax reporting by tax authorities which will now be armed with information hitherto not at their disposal. A large number of HNWIs have either inherited wealth or are entrepreneurs whose income is self-certified. The US IRS and other tax authorities estimate that these taxpayers in particular underpay their taxes by billions of dollars every year.

Further, the compliance burden placed on financial institutions advising the wealthy inevitably means that the cost of providing services has increased, leading to both a rise in fees and increasing documentation demands. Essentially, financial institutions need to establish the tax status and tax residence of each and every individual, either currently existing or new, with whom they do business and are required to undertake reporting of relevant personal and financial information.

In response to these increased requirements, and to guard against the possibility of 'getting it wrong' and incurring punitive fines, a large number of market participants have sought to minimise the risks by refusing to do business with, in particular, US persons. Many American HNWIs living, working or doing business abroad have found it extremely difficult, if not impossible, to access banking, insurance and investment management services. Where financial institutions have accepted their business, these clients are being required to provide a much greater level of information and documentary evidence with regard to their identity, tax residence and direct and indirect ownership of their businesses and assets.

More recently, HSBC has stated that it will close all bank accounts of UK-resident individuals held with its Jersey branch. Such an approach is not expected to be sustainable once the OECD CRS comes into effect. Charlie Willcox, head of compliance in Switzerland and FATCA subject matter expert for Stonehage Fleming, notes that this is likely to lead to a contraction in the number of providers of wealth management and trust and fiduciary services and thereby a diminution of client choice. Smaller players will be forced out of the market simply through an inability to absorb the costs of maintaining compliance with the various tax reporting regimes.

Taking regular tax advice

There have always been changes to tax laws but, in the aftermath of the financial crises, the extent and pace of these changes globally has markedly increased. This increase has primarily been aimed at clamping down on tax evasion and other avoidance practices now deemed inherently unfair, or even immoral; a prime example is profit diversion by the big multinational corporations. Many individuals with complex affairs have the temptation to assume, or hope, that none of the changes are relevant to them. However, what worked years ago may not work now, so how often should the wealthy take advice on their tax affairs and what kind of advice should be sought?

The big changes seen last year with the implementation of both US FATCA and UK FATCA are but the tip of the iceberg. The forthcoming implementation of the OECD CRS will take these concepts to a global level and further changes are in the pipeline, for example amendments to the European Savings Directive, possible changes to the UK residency non-dom legislation (including the possibly of abandoning it), and the implementation of the diverted profits tax.

Wealthy clients need to ensure that they receive sound professional tax and legal advice from their advisers in relation to changes in global tax legislation and how this may affect their current financial structuring, both for themselves and their wider family. Preferably, such advice should be obtained prior to the implementation of any legislative changes, so that there is sufficient time to plan any re-structuring where this is possible and desirable. Among other concerns, consideration could be given to:

- In which jurisdiction should a holding entity be located or administered?
- How are assets held when not located in the jurisdiction of the settlor’s tax residence?
- If a trust structure is in place, is the rationale for its formation, its terms, and choice of beneficiaries and excluded persons, still valid in all respects?
- Do tax rules place any practical restrictions on the way the trustees act, or the investments they can select?
- To what extent can a settlor or beneficiary influence decision making in the structure?
- Is there any need to segregate some assets from others?
- Should any assets currently in the structure be removed or further assets settled (including direct shareholdings in family-owned companies)?
- What are the implications if the settlor or beneficiaries of a trust has emigrated to, or are now resident in, a different jurisdiction for tax purposes?
- What tax is due on distributions made to, or benefits received by, beneficiaries and what is the difference between making a capital or an income distribution?
- What are the tax implications of loaning funds to, or receiving a loan from, a trust?

Conclusion

Wealthy clients’ financial affairs are no longer confidential as far as disclosure of information to tax authorities is concerned. High net worth families need to ensure that the professional advice and assistance they receive enables full tax compliance in all relevant jurisdictions and that submitted tax returns are complete and accurate in all respects. The consequences of non-compliance could result in unwelcome enquiries from revenue authorities, including costly and time-consuming, fines, interest penalties or potentially even criminal prosecutions.