Treatment of wealth management structures under the AEoI - Case studies

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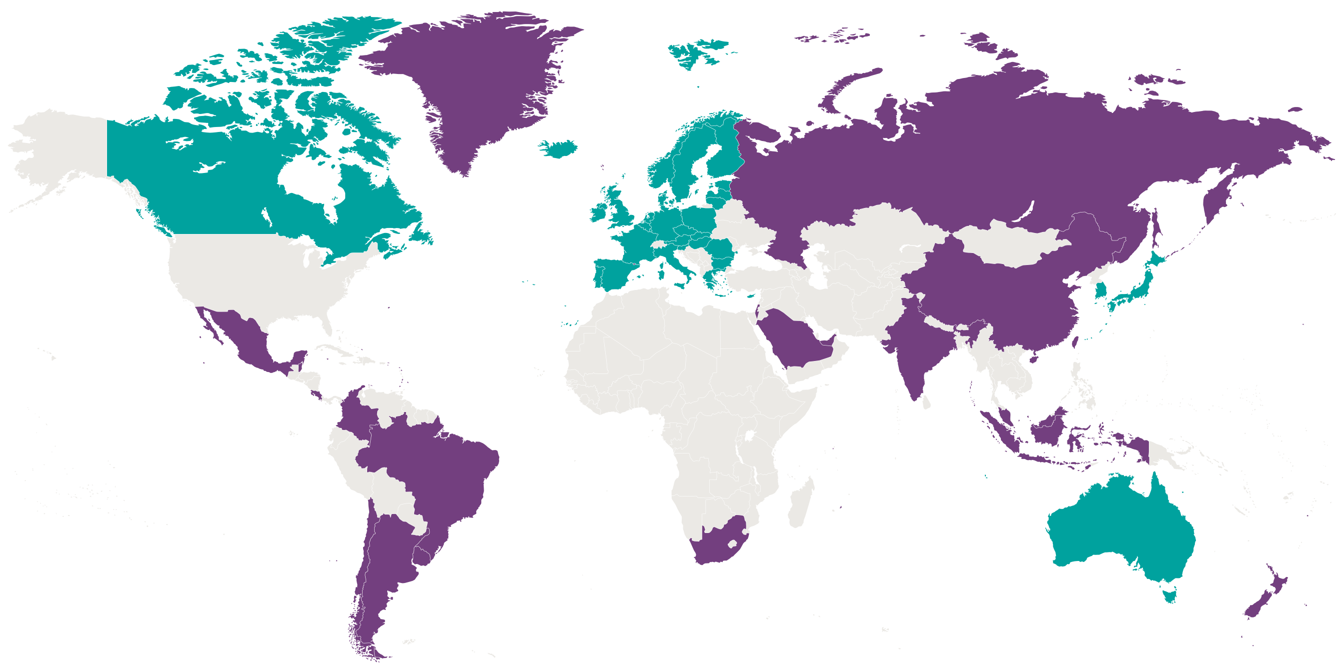
The Automatic Exchange of Information (AEoI) does not only affect individuals holding accounts with financial institutions but also controlling persons of wealth management structures such as trusts, foundations and domiciliary companies. However, depending on the individual aspects of the structure, different persons and information will need to be reported. In the following, we use case studies to explain how the AEoI affects the different wealth management structures and the individuals involved, resulting in very different outcomes.

Entry into force of the AEoI
In order for a reporting under the AEoI to take place, the AEoI has to be in force between the country of residence of the reporting financial institution and the country of residence of the reportable person.

As of December 2016, already over 1300 bilateral exchange relationships in more than 50 jurisdictions have been activated, with first exchanges scheduled to take place in September 2017 (see http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/exchange-relationships/ for the official OECD list). In September 2018, many additional countries will exchange information regarding the year 2017, including Switzerland. Switzerland will exchange information with the following countries in 2018 and 2019, respectively:



Switzerland will exchange information under the AEoI in 2018 regarding the year 2017 with the following countries:

- Australia
- Canada
- EU
- Guernsey
- Iceland
- Isle of Man
- Japan
- Jersey
- Norway
- South Korea

Switzerland will exchange information under the AEoI in 2019 regarding the year 2018 most likely with the following countries:

- Andorra
- Antigua and Barbuda
- Argentina
- Aruba
- Barbados
- Belize
- Bermuda-Islands
- Brazil
- British Virgin Islands
- Cayman Islands
- Chile
- China
- Colombia
- Cook Islands
- Costa Rica
- Curaçao
- Faroe Islands
- Greenland
- Grenada
- India
- Indonesia

Investment Entity vs. NFE

In a first step, the wealth management structure must be classified either as Investment Entity or as Non-Financial Entity (NFE).

Trusts, foundations and domiciliary companies qualify as an Investment Entity

- if their assets are «managed» by another entity that qualifies as Financial Institution (Managed By Test), and
- provided that the gross income of the wealth management structure is primarily (to at least 50%) attributable to investing, reinvesting, or trading in financial assets («Gross Income Test»). Financial Assets are all kind of bankable assets, including participations in underlying companies, but not for example, direct interests in real estate.

With respect to the Managed By Test, it is furthermore required that the other Financial Institution (e.g. the asset manager or a bank) has discretionary authority to manage the assets of the wealth management structure. This is generally given if there is a discretionary asset management mandate with a bank/asset manager or if there is a corporate board member, director or trustee that qualifies as Financial Institution (including an Investment Entity). If employees of a fiduciary/trust company act in their own name as trustee/director, for AEoI purposes, it is still assumed that the fiduciary/trust company acts as trustee/director, unless the employees act at their own risk.

Active NFE vs. Passive NFE

If a wealth management structure does not qualify as Financial Institution, it qualifies as a Non-Financial Entity (NFE). Therefore, if the Gross Income and the Managed By Tests are not cumulatively given with respect to a wealth management structure, the entity qualifies as an NFE.

According to the Common Reporting Standard (CRS), any NFE that is not an Active NFE qualifies as Passive NFE.

An Active NFE is in particular any NFE that meets the following criteria (section VIII.D.9.a/d CRS):

- [Operating Active NFE] less than 50% of the NFE's gross income (…) is passive income and less than 50% of the assets held by the NFE (…) are assets that produce or are held for the production of passive income; or

- [Holding Active NFE] substantially (to at least 80%) all of the activities of the NFE consist of holding (in whole or in part) the outstanding stock of, or providing financing and services to, one or more subsidiaries that engage in trades or businesses other than the business of a Financial Institution, except that an Entity does not qualify for this status if the Entity functions (or holds itself out) as an investment fund (…);"

Reporting obligations

A wealth management structure that qualifies as Investment Entity needs to report its Equity and Debt Interest Holders by itself.

With respect to a domiciliary company, generally all shareholders must be reported as Equity Interest Holders. With respect to a trust/foundation, an Equity Interest is considered to be held by any person treated as a settlor/founder or beneficiary of all or a portion of the trust/foundation, or any other natural person exercising ultimate effective control over the trust/foundation.

A Debt Interest is held by any person that granted a loan to an Investment Entity.

If, however, an entity qualifies as Passive NFE, the bank has to report the controlling persons of the entity. In Switzerland, the controlling persons of a Passive NFE are all individuals listed in the forms A, S, T or K (e.g. the shareholders, settlors, beneficiaries, protectors). As a consequence, a Swiss bank must treat all shareholders of domiciliary companies (beneficial owners documented with form A), including shareholders holding equity interests of less than 25% that cannot control the entity, as controlling persons.

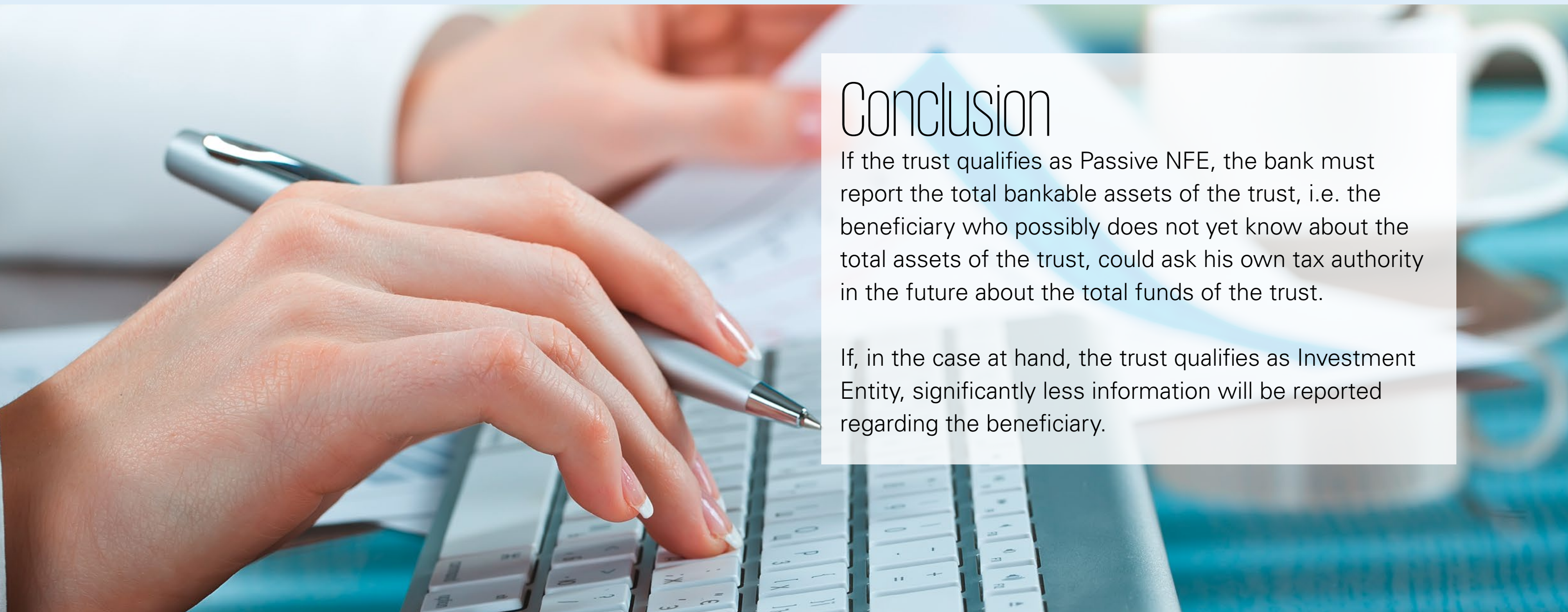
Case study 1 – Investment Entity vs. Passive NFE

Background

- A trust under the laws of the BVI was settled by Mr. Smith, resident in the UK.
- The trustee (individual) is a resident in Switzerland.
- The discretionary beneficiary is his 18-year-old son (resident in Canada), who receives a first distribution of CHF 10'000 in 2017.
- The assets of the trust consist of a Swiss bank account (CHF 10m) and an art collection (CHF 20m).
- The income of the trust consists of interest/dividends/gross proceeds of CHF 1m.
- Alternative A: There is no discretionary asset management mandate with a Financial Institution.
- Alternative B: There is a discretionary asset management mandate with a Financial Institution.

AEoI analysis

	Status of trust	Reporting of settlor	Reporting of beneficiary
Alternative A	• The trust qualifies as Passive NFE, as the Gross Income Test but not the Managed By Test is given. • Therefore, the Swiss bank is required to report the controlling persons of the trust.	• The bank must report the total bank account balance of CHF 10m and the total income of CHF 1m.	• The bank must report both, the total bank account balance of CHF 10m and the total income of CHF 1m. • As the son receives a distribution, the bank has to report the discretionary beneficiary. Regarding years where there is no distribution, he will not be reported.
Alternative B	• The trust qualifies as Investment Entity, as both the Gross Income and the Managed By Tests are cumulatively given. • Therefore, the trust itself is required to report its Equity Interest Holders to the Swiss Federal Tax Administration (for AEoI purposes, a trust is resident wherever its trustee is resident).	• The settlor must be reported as Equity Interest Holder by the trust, generally with the total assets of CHF 30m (i.e., Investment Entities are required to report non-bankable assets too). • It might be argued that the value of the assets is not reportable if the settlor cannot control the trust.	• Only the amount of the distribution of CHF 10'000 will be reported.



Conclusion

If the trust qualifies as Passive NFE, the bank must report the total bankable assets of the trust, i.e. the beneficiary who possibly does not yet know about the total assets of the trust, could ask his own tax authority in the future about the total funds of the trust.

If, in the case at hand, the trust qualifies as Investment Entity, significantly less information will be reported regarding the beneficiary.

Case study 2 – Holding Company

Background

- A holding company is domiciled in Luxembourg, with the sole shareholder being a resident in France.
- The holding company holds several equity interests of 25% each in operating companies (total value of CHF 20m).
- It holds an account with a Swiss bank with a value of CHF 10m.
- Managed By Test is not given.
- Alternative A: Dividends from equity interests of CHF 500'000 and income on bank account of CHF 200'000.
- Alternative B: Dividends from equity interests of CHF 1m and income on bank account of CHF 200'000.

AEoI analysis

	Status of Holding Company	Reporting obligations
Alternative A	• The company does not qualify as Holding Active NFE, as the dividends of the holding company only amount to approx. 70% of the total income (CHF 500'000 of total income of CHF 700'000). • As the Gross Income and Managed By Tests are not given cumulatively, the holding company qualifies as Passive NFE.	• As the holding company qualifies as a Passive NFE, the Swiss bank has to report the value of the bank account of 10m and the income on the bank account of CHF 200'000 for the company itself and the shareholder as controlling person.
Alternative B	• Assuming that the other conditions for qualifying as Active NFE (see definition above) apply, the holding company qualifies as an Active NFE, as the dividends of the holding company amount to approx. 83% of the total income (CHF 1m of total income of CHF 1.2m).	• As the holding company qualifies as Active NFE, the Swiss bank only has to report the value of the bank account of 10m and the income on the bank account of CHF 200'000 for the company through the Swiss Federal Tax Administration to Luxembourg.

Conclusion

Depending on the income of a holding company, it will qualify as a Passive NFE or Active NFE with completely different reporting consequences. If the holding company qualifies as Passive NFE, the total balance/income of the bank account will be reported regarding the controlling persons, despite the fact that such income may not have to be declared in the shareholders' country of residence. Such a reporting could lead to a tax audit as the receiving tax authority may all of a sudden think that the shareholder has not truthfully fulfilled his declaration obligations.

Case study 3 – Swiss domiciliary company

Background

- A domiciliary company domiciled in Zug has an account with a Swiss bank.
- The total balance of the account amounts to CHF 2m; the interest/dividend income is CHF 50’000.
- The Managed By Test is not given.
- Alternative A: The two shareholders are residents in Spain (each holding 50%).
- Alternative B: Five shareholders are residents in Italy and five in Greece (each holding 10%).

AEoI analysis

	Status of the domiciliary company	Reporting obligations
Alternatives A and B	• The domiciliary company qualifies as Passive NFE, as the Gross Income Test but not the Managed By Test is given. • Therefore, the Swiss bank is required to report the controlling persons of the domiciliary company.	• As the domiciliary company qualifies as a Passive NFE, the Swiss bank is required to report the value of the bank account of 2m and the income on the bank account of CHF 50’000 for all controlling persons, i.e. the total amounts must be reported for each controlling person. • In Switzerland, all individuals listed on form A must be reported as controlling persons. As even shareholders holding only 10% are documented in form A, all shareholders must be reported under both alternatives A and B.

Conclusion

Even if the equity interest of each shareholder under Alternative B is only 10%, the bank must report the total value and income of the bank account. Consequently, the shareholders should consider proactively informing the tax authorities receiving the data from Switzerland that the AEoI reporting differs from the income taxable in their country of residence.

Summary

The AEoI affects all controlling persons of wealth management structures, such as trusts, foundations and domiciliary companies, not only the beneficial owners. Depending on the specifics of a wealth management structure, either the structure itself (Investment Entity) or the bank holding the account (Passive NFE) must report different information/persons.

It is therefore even more important that all of the parties involved in structures (for instance, the account-keeping bank, an asset manager or the trustee) grapple with the details of who needs to be reported under the AEoI regime.

Specifically, it must also be clarified whether it might not be better if the wealth management structure itself reports under the AEoI regime instead of the account-keeping bank (or vice-versa).

And finally, it must be ensured that all of the reported persons are fully tax compliant. This is also important because certain countries have on-going voluntary tax disclosures in place, which may end soon and because there is already tax transparency today, specifically in the form of group requests (for more details see https://home.kpmg.com/ch/en/home/insights/2016/06/tax-transparency.html).

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