The wealth management puzzle:

The customer tax integrity journey – moving from KYC to UYC

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PwC's Wealth Management Insights 2022

Deep Dive IV

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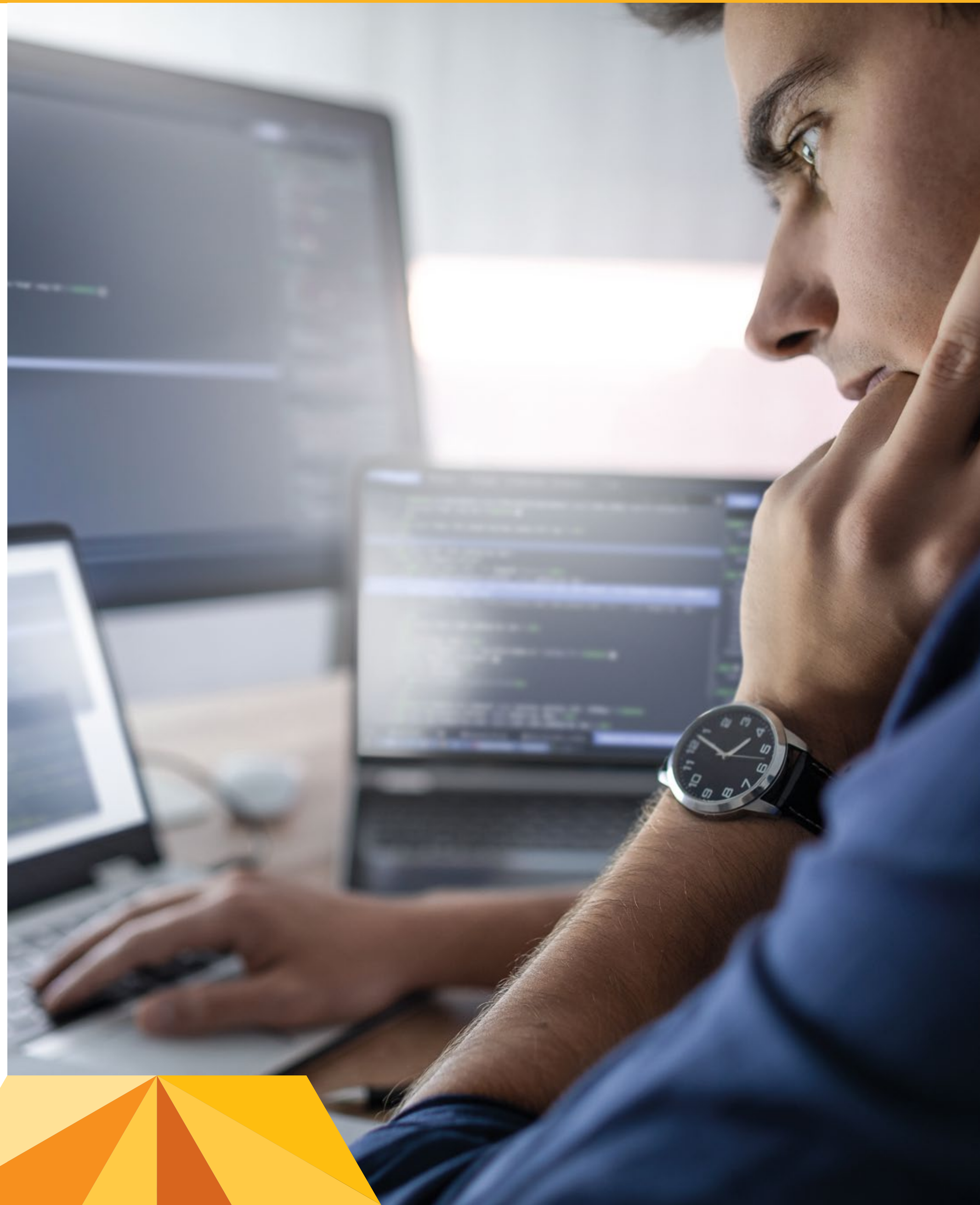
There has been a huge shift in the information that financial institutions are expected to know about their customers' tax affairs over the past decade. How to collect this data whilst managing these 'customer tax integrity' risks in a pragmatic and commercial manner is a challenge that few organisations have yet found the perfect solution for. Concurrently, individuals, families and family offices are expected to provide ever-more data without necessarily knowing why or how it will be used.

We work with organisations to understand how to better manage these customer tax integrity risks whilst enhancing the customer experience, and our deep dive covers some of our insights on how customer tax integrity is evolving as a topic across the financial sector.



1 Customer tax integrity

Global public interest in those evading and avoiding tax has never been higher. Over the past decade since the global financial crisis, floods of information have hit the public arena, from the 'P papers' trilogy (Panama, Paradise and Pandora) to various other data leaks and whistleblowers from large global financial organisations. The upshot of this has been that wealth managers, banks and other financial service providers now face severe reputational risks at best, regulatory fines and sanctions at worst if there is not clear evidence that they have acted with integrity when it comes to the question of who they are doing business with. Various financial institutions got this publicly very wrong in the past and, as such, there is huge societal expectation on these providers to ensure such risks are managed proactively.

There are ever-increasing rules, regulatory requirements and expectations around how financial institutions manage the tax risks of their customer base. This covers not only tax evasion but also tax avoidance, a nuanced area where it can be difficult to define what is 'avoidance' and what is acceptable 'planning'. At the same time, the increased focus on the ESG agenda and the broad commitments made across the financial sector to conduct their business in a socially acceptable manner makes managing customer tax integrity risks a lightning rod issue with potentially damaging ramifications for organisations that do not take them seriously.

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2 The customer tax integrity landscape

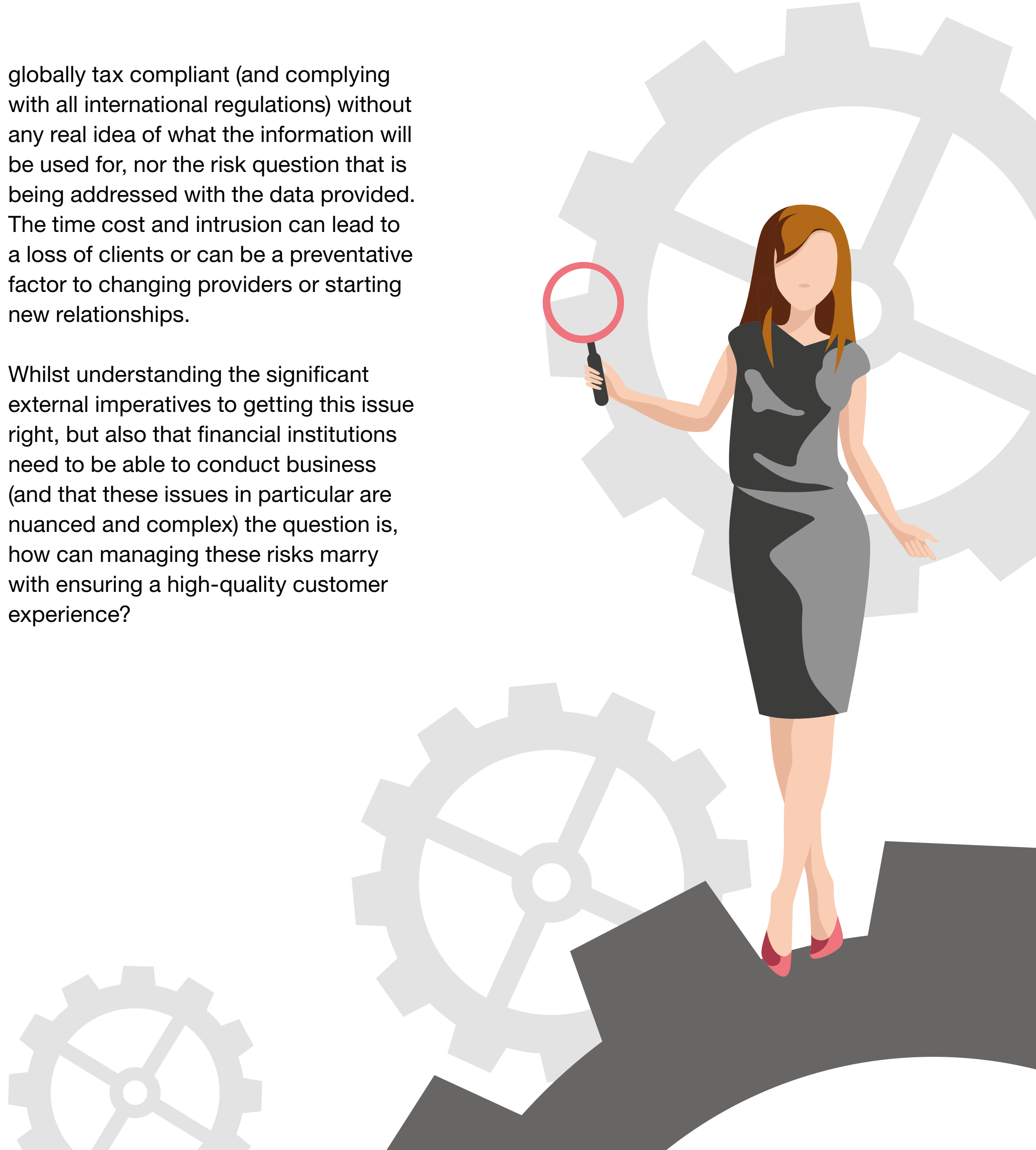
Managing customer tax integrity risks is therefore a hot topic for many financial institutions; but notwithstanding definitions for tax evasion and certain types of tax avoidance, there is no global standard for what is acceptable from a customer tax integrity perspective, i.e. the approach varies from institution to institution. The FATCA or CRS reporting requirements and guidance provide a template for requirements, but the meaning of 'customer tax integrity' will vary in different contexts and from jurisdiction to jurisdiction.

Across Europe, various regulatory requirements have been brought in to manage these risks: in the Netherlands, the Central Bank issued guidelines for financial institutions to follow; the UK has specific legislation in place focused on the failure to prevent the facilitation of tax evasion; Luxembourg and Germany have also issued various circulars and rules designed to tackle this topic. An EU consultation is underway to assess whether a directive focused on the role of financial institutions in this area should be implemented ('Tackling the role of enablers involved in facilitating tax evasion and aggressive tax planning'). Whilst Europe is leading the way in implementing specific regulations to tackle this topic, any global financial institutions with a global clientbase needs to be cognisant of the risks and expectations.

In addition to any specific regulations and legislation, each financial institution will have their own ESG commitments to tax policy and strategy, which cannot be limited to the organisation itself; these commitments will need to also cover the customer base or the organisation will lose credibility that they are genuinely committed. Acting ethically from a tax perspective will have different meanings for each organisation, but broadly equates to demonstrating that the organisation does not condone or facilitate either tax evasion or tax avoidance, and that the risk framework in place is sufficiently robust to handle the potential issues and judgements expected.

In practice, this means that individuals and family offices are often asked to provide data to 'prove' that they are globally tax compliant (and complying with all international regulations) without any real idea of what the information will be used for, nor the risk question that is being addressed with the data provided. The time cost and intrusion can lead to a loss of clients or can be a preventative factor to changing providers or starting new relationships.

Whilst understanding the significant external imperatives to getting this issue right, but also that financial institutions need to be able to conduct business (and that these issues in particular are nuanced and complex) the question is, how can managing these risks marry with ensuring a high-quality customer experience?



3 The history of customer tax integrity

The notion that a financial institution should be aware of the tax status of its customer base is a relatively new one. If we travelled back in time only a decade or so, it would have been possible in many jurisdictions to open a bank account, create a company or establish a trust with just a few basic pieces of information.

Today, the same exercise would likely involve multiple forms running into hundreds of pages and can be a multi-step process that can last months. Tax authorities, regulators, investors and clients alike expect that financial intermediaries know and understand a great deal about the individuals and corporates they work with.

This change – from knowing very little to knowing a lot, has happened in a relatively short period of time and has been driven by where regulators and legislators have focused. Initially, the focus was on raising transparency – if more information is shared, tax evasion and aggressive avoidance immediately come out of the shadows and are easier for governments to tackle. And so we saw the introduction of FATCA and then CRS. This was a huge shift in the industry, requiring financial institutions to collect, verify and report information on their entire customer base.

The next step in the journey was the introduction of ‘DAC6’, which focuses on the identification of aggressive tax avoidance by requiring the assessment of planning against various hallmarks of avoidance. Again, there is the requirement for information to be assessed, verified and reported; but as the focus has shifted to an ‘avoidance’ rather than an ‘evasion’ lens, the information collected is slightly different to information already held. DAC6 also impacts a wider audience than solely Financial Services, showing the determination of the regulators to clamp down on this type of activity across the economy. Concurrently, individual jurisdictions have put pressure on the banks and other service providers to change behaviors through regulatory measures as referenced above.

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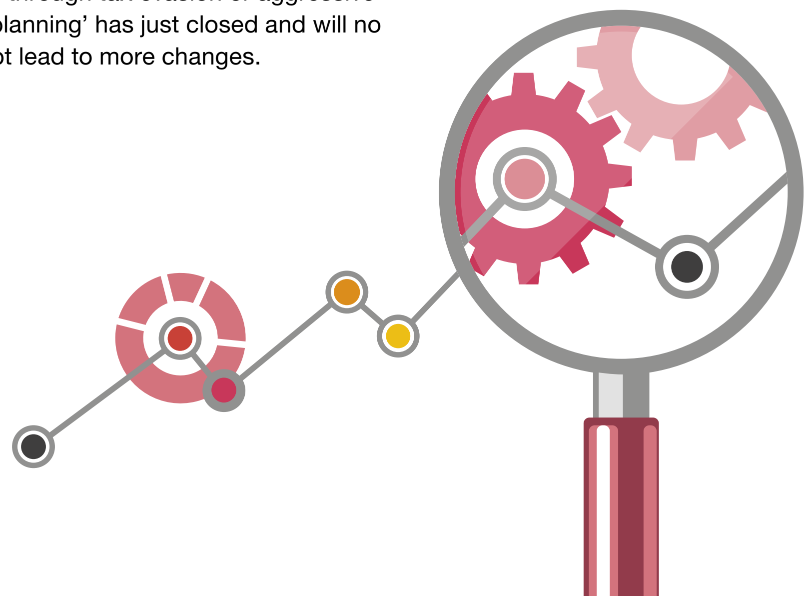
4 Where are we today?

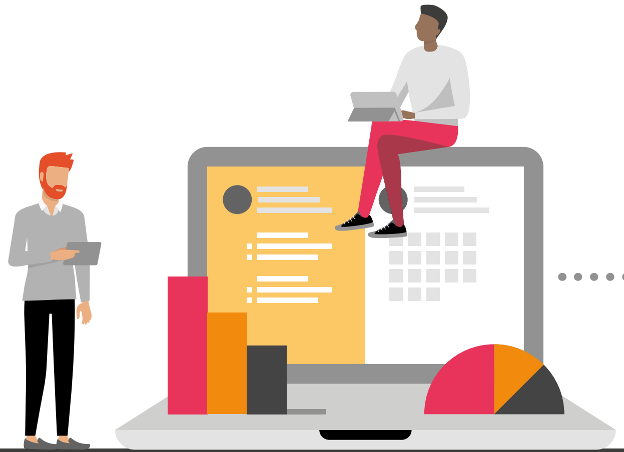
We are now in the third wave of transparency measures, with UBO registers being introduced in many jurisdictions and tax authorities taking very deliberate steps to target groups of taxpayers considered to be avoiding and/or evading taxes. There is more on the horizon with European proposals such as the 'un-shelling' initiative that will require additional compliance reporting by certain structures across the EU to demonstrate that they have sufficient substance. A consultation period on another proposed EC directive focusing on those enablers who 'design, market and help set up structures in non-EU countries that erode Member States' tax base through tax evasion or aggressive tax planning' has just closed and will no doubt lead to more changes.

As such, whilst the term 'customer tax integrity' is a relatively new one, understanding what it means in the context of global legislative and regulatory requirements has shifted in meaning multiple times. Tax integrity is a subjective topic, concerning not only what is legally possible and what is a regulatory requirement, but also comprising the spirit and intent of law; and trying to second-guess what the court of public opinion could think. For financial institutions this represents a dynamic and ongoing risk that has to be carefully managed.



What does it mean for wealth managers?

The problem facing all wealth managers is how to manage customer tax integrity risks robustly but commercially. A new customer onboarding could take many months and entail a long process with huge quantities of information required over time. This can result in multiple requests to the client, decision-making by committee and a multi-step internal process before starting to do any business at all.

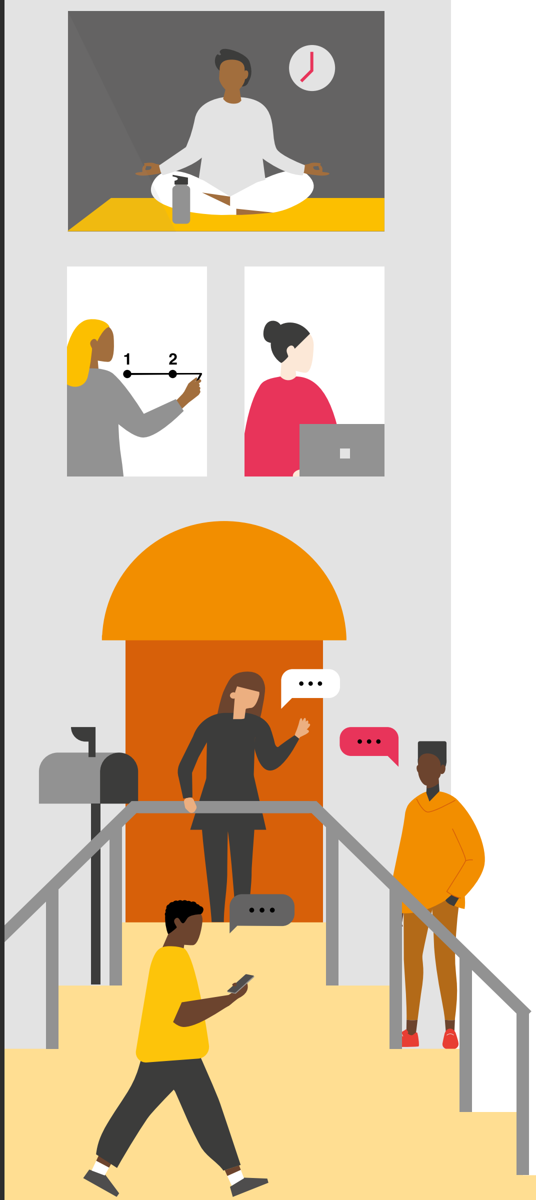


The key ingredients to manage customer tax integrity risks can be summarised as:

- Clear and consistent articulation of the organisation's 'customer tax' risk appetite
- Regular risk assessments to ensure a consistent approach, along with clearly defined roles and responsibilities within the organisation
- Streamlined, digitally-powered decision-making process and empowered staff to assess risks against clear guidance
- Sophisticated and regularly reviewed product offering
- Robust technology-enabled transaction monitoring
- Well-informed, well-trained customer advisers who understand their clients well
- Strong and knowledgeable second line of defence, supported where required by third parties to address market-specific risks
- Clear process for external disclosures to ensure data is not shared unnecessarily
- Automated internal control system ensure that regulatory risks, tax and ESG requirements, are under control, avoiding human bias and ensuring consistency

If all of these factors are in place, the organisation will have a differentiator in the market when it comes to on-boarding clients and will have vast quantities of customer data to hand that will enable the development of better customer tax reporting, more tailored tax appropriate products and enable the customer adviser teams to have more sophisticated and detailed conversations with their clients.

6 UYC is the new KYC when it comes to customer taxes



Customer tax integrity must be handled prima facie as a risk topic and embedded in the organisation's existing policies. The challenge is how to manage this pragmatically. The good news is that integrating the approach to customer tax integrity into your existing processes and procedures, and having a robust but commercial approach will protect the organisation – and in the current environment if you can make this a smooth process for a customer (the 'secret sauce' to any new relationship) it does equate to a differentiator in the market.

To manage these risks effectively, the KYC approach taken by wealth managers with respect to a customer's tax position needs updating. We believe that a more dynamic, qualitative, digitally-enabled approach to customer tax risks is required, an approach that we call 'UYC' – 'understanding your client'. If the effort and time is taken at the start of a relationship or at the start of a transaction, to really understand what a customer is looking to achieve, the ability to correctly manage the customer transaction through the risk process will be a much smoother process in the long-run and enhance customer experience along defined customer journeys. From a customer perspective, anticipating the questions that may arise and actively considering how to share information with third-party service providers is also time well spent.

Having customer tax risks embedded into how the organisation does business requires ongoing monitoring to ensure the right risk areas are being flagged – which is especially challenging as rules change so regularly in this space. The customer-facing teams need to understand their market well, and whilst they will not be giving tax advice, they need to have at least a basic understanding of what can/cannot work in their own jurisdiction. Understanding what the customer is doing, has done and is looking to achieve must be at the front and centre of initial conversations with the client. To enable front office staff to achieve this requires a balance of robust and ongoing training, aligned KPIs to ensure the right business is being sought and identifying the appropriate third-party providers to work with front office staff, both to advise the clients and the wealth managers, topped by state of the art CRM tools.

This is helped by having strong and visible leads in the relevant risk management areas, who can articulate the tax risk appetite of the organisation clearly; this may mean additional training for the second line, or working hand-in-glove with third-party advisers to provide support as is required. But it also means that from an organisational perspective, there should be senior and visible support for ensuring customer tax risks are managed appropriately.

For wealth managers working with multiple custodian banks, the requirements could vary dramatically from one custodian to another. We suggest working with the clients from an early stage (and this is where a family office or other trusted adviser can really add value) to help them develop and maintain a pack of customer tax information that is standardised, to try to ensure that at least 'standard' risks can be addressed head on. Managing this data in as efficient a manner as possible – for example, making use of digital data management should also increase the efficiency of the process.

7 The use of data

The data collected to demonstrate the customer's tax position should be limited to what is most necessary and dealt with in a timely manner. This means continually reviewing the list of acceptable documents, relying on qualitative as well as quantitative information and working together as far as possible across the first and second line to ensure that every piece of data requested really adds a clear value. A digitally-enabled process is key to ensuring as efficient a process as possible.

Consider a customer resident in one jurisdiction with his assets structured in a holding company in another jurisdiction – a common scenario. The organisation is likely to seek to understand various tax elements; first, how the tax rules interact; and where (or to whom) the tax liability arises; then to understand that all relevant taxes have been paid. But the story does not end there – it is also necessary to understand if there is proper substance in the company, and that all corporate and UBO filings are up to date – and the question of how to address these points can vary wildly from one jurisdiction to another. However, if as a starting point, the customer adviser understands why the customer is using the structure, what they hope to achieve and what their longer-term aims are, the context of all of the information makes much more sense than simply receiving an extract from a tax return.

In fact, collecting static pieces of data without this holistic understanding is totally useless. We have worked with private clients who have had requests from their financial institution for everything from the annual tax return to sight of global transfer pricing advice in place for a particular structure. Whilst this information might be helpful, experience tells us that advice provided without context or wider narrative will generally raise more questions than it solves. It is very difficult to assess in isolation whether a piece of tax planning is evasive, aggressive or plain vanilla without significant supporting information. This argues not only for greater contextual awareness of each client's needs and objectives, but for greater specialism within markets or working alongside external providers who can provide an independent assessment of whether the client/their planning matches the organisation's tax risk appetite.

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This need for greater awareness of what works or does not is critical. With individuals, families and family offices, no two cases will be the same, so a dynamic and regularly-reviewed approach to identifying key tax risk flags per jurisdiction is also required. Standardised processes and procedures will deal with 80% of the customer tax risks encountered. But it is the 20% that will cause the bulk of the work and bears the most risk.

Implementing the processes and procedures designed to manage this tax risk is not always smooth. Whilst there are similar structures in place for wealthy individuals to hold their wealth (and this is particularly the case when reviewing a particular jurisdiction) the nuance of why a structure is how it is, why it was set up and what it is doing on a daily basis, varies with every customer case. This shift therefore from simply knowing your customer (KYC) to understanding your customer (UYC) is where the future of customer tax risk management lies.

For the more intricate and specialised arrangements, a heavier reliance on third-party support (whether the client's adviser or an adviser to the wealth manager) is needed. Examples that often cause difficulties from a customer tax compliance perspective are so-called tax nomads or those with a tax residence in a no-tax jurisdiction who travel extensively. Some organisations have already decided that their tax reputational risk appetite is that they do not deal with a tax nomad at all; but for those who are happy to proceed, what is sufficient proof? These are a higher risk category of customer, so is a tax adviser signed document in the 'home' country sufficient? Or do you need a tax adviser who has a global overview and can assess where the customer is everywhere? From a CRS perspective, indicia for another jurisdiction causes alarm; from a tax perspective, what is the trigger point for concern in your organisation?

The final overlay is reviewing how this experience feels to the end client. Generally, clients will understand the need to provide information as long as it is handled in an efficient and thoughtful manner.

For many financial institutions, there is neither the appetite, experience nor resource to handle these highly complex and specific issues within a dedicated team in-house; this is especially the case for large global organisations dealing with hundreds of jurisdictions, each with their own rules and regulations. This is leading to a shift in financial institutions seeking to partner with third parties more proactively to properly manage customer tax integrity risks. At PwC, we can help share the load, by bringing our experiences of working with global financial institutions and also our insights from working with impacted customers to help understand even the most nuanced tax risks. We can partner with organisations to understand where you sit relative to your peers, to implement and update your customer tax integrity risk framework, to understand how technology can help in this process, to train staff, to assess transactions and in a way that will enhance the customer experience going forward.

The future

The level of scrutiny on financial institutions by regulators, shareholders, customers and society at large in managing customer tax risks will remain high; this is not only a tax risk topic, but connects into the wider ESG agenda, which will become increasingly more important. Individuals and families will continue to come under close public scrutiny in respect of their personal tax planning and asset holding arrangements, and we foresee that this will lead to an increased focus on how the internationally wealthy define and approach their own tax reputational risk appetite. This means that customers will correspondingly value working with organisations who have a robust and commercial approach to onboarding (that can be undertaken promptly) and ongoing compliance topics and their expectations will shift. Wealth managers will be able to use the data provided by their clients to trend-spot opportunities or themes amongst their customer base and to better tailor products and services to specific markets.

Investors will look ever more closely into the tax practices of the businesses they invest into, which will impact both the financial institutions themselves but also the investments offered to their clients. Finally, the number of the players in the market will continue to consolidate as it becomes harder to manage regulatory and tax risks in a pragmatic but cost-efficient manner.

Summary

Wealth managers must find ways of meeting their tax related KYC requirements without alienating their customers.

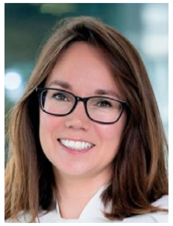
Any wealth manager that asks their clients to provide the same information more than once, especially if it's not clear why they're being asked for it in the first place, risks souring the relationship – in some cases before it's even started. By moving from 'knowing your customer' to 'understanding your customer' and embedding a robust, rational and commercial approach to onboarding and ongoing customer tax risk management, wealth managers can turn a liability into a differentiating factor in the marketplace.

Feel free to contact us if you're seeking ways of getting your relationships off to the best possible start – and keeping them that way by gaining an even better understanding of your customers.

Customer tax integrity is just one piece of the KYC story, so for more detailed information on the Future of Compliance, please visit our website.

www.pwc.ch/future-of-compliance

About PwC Switzerland – Authors



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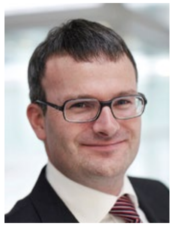

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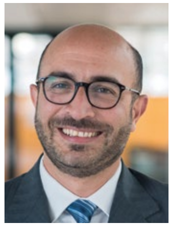

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