The strengthening of the tax transparency regulations in Europe and the related controls by the Tax Authorities

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The year 2020 has been marked by the strengthening of European rules promoting better tax transparency in the financial sector. These regulations have significantly impacted the Luxembourg market, notably linked to the volume of complex cross-border transactions and structures.

One year later, controls carried out by the tax authorities and regulators are stricter and require Financial Institutions ("FIs") and other impacted actors to set-up an appropriate tax governance. These controls should be reinforced with the upcoming visit from the FATF.

We will detail those regulations and their obligations, the consequences of the stricter approach applied by the tax authorities and conclude with some suggested actions to define the path forward towards tax transparency compliance.

Retrospective of those regulations and the resulting obligations

The year 2020 has been marked by a regulation related to the automatic exchange of information, which has been a hot tax topic on the financial market. DAC6 came into force as from the 1st July 2020 and targets intermediaries (or under certain circumstances taxpayers) who are required to report certain cross-border transactions and arrangements to the domestic tax authorities.

DAC6 intends to capture arrangements considered as aggressive from a tax perspective by assessing the relevant key indicators covered under the notion of hallmarks and in some cases the main benefit test, i.e. whether the transaction is tax driven or supported by any other genuine reasons. It also requires reporting on arrangements whose goal is to circumvent the CRS reporting or the identification of ultimate beneficial owners.

The concerned stakeholders should have adapted their day-to-day organisation to assess if an arrangement is in scope and report it (if needed) within 30 days.

At the same time, the CSSF issued the Circular 20/744 during the summer, complementing the Circular 17/650 related to the extension of laundering offense to aggravated tax fraud and tax swindle (the "2017 Circular").

With this new Circular, the CSSF expands Annex 1 of the 2017 Circular with an additional list of 9 indicators specific to the Asset Management sector. Management companies, custodians, transfer agents are mostly concerned by the new indicators and need to consider them in their onboarding and due diligence exercises. Several of those indicia refer to CRS compliance.

The last piece of tax transparency regulation that appeared recently is the FATCA/CRS governance law which has been voted in June 2020 and came into force on the 1st of January 2021. The law imposes on FIs to establish a compliance program including written policies and procedures, systems and controls detailing how due diligence and reporting obligations are in practice dealt with and documented.

One of the salient elements of the FATCA/CRS governance law is the obligation for the FIs to exercise oversight and control on the functions (onboarding, reporting) that may have been delegated to an external service provider (transfer agent, fund administrator, other service provider). This requirement should also be reflected in the operational procedures. Moreover, another important pillar of this compliance program requires FIs to implement proportionate effective controls to comply with the reasonableness test to be formed on the FATCA and CRS documentation received from the investors to ensure satisfactory data quality in the reports to be filed to the Luxembourg Tax Authorities ("LTA"). The latter could request access to this "register of actions" for a 10-year period.

Increase level of scrutiny by the Tax Authorities and the regulators

The FATCA and CRS due diligence and reporting obligations is the cornerstone of the tax transparency framework. Therefore, the data quality of those reports is subjected to more and stricter controls by the Tax Authorities and also recently from the regulators.

As a concrete example, following some automatic controls on the 2020 FATCA reports, the US Tax Authorities, i.e. the Internal Revenue Service ("IRS"), notified the LTA for each report containing missing or invalid US Tax Identification Numbers ("TINs"). The LTA are currently sending letters to all concerned Luxembourg Reporting Financial Institutions ("FIs") including those having used the required explanation codes.

The Financial Institutions have 120 days to obtain the missing TINs from the US account holders and to file amended FATCA reports. In case of remaining invalid TINs for the accounts concerned, the IRS will assess whether it qualifies as a material non-compliance considering all facts and circumstances including the reasons of the missing TINs, the procedures and the efforts deployed to obtain them. This request is, as of today, limited to FATCA but could in the future be also requested from foreign tax authorities in the context of CRS.

We have already witnessed that foreign tax authorities are more and more requesting from FIs their written policies and procedures, details about the internal organisation for the FATCA/CRS governance covering the IT systems, client on-boarding and reporting.

It is not limited to FATCA/CRS and also concerns DAC6 for which similar requests have been addressed to some intermediaries (including ones benefiting from waiver) to provide with their set of policies and procedures and describe concretely the actions taken to comply with their obligations.The LTA have updated their tax returns to request from the taxpayer a justification of the use of the DAC6 cross-border reportable arrangement (if any).

Tax Authorities and regulators are investing to build up their workforce and system resources to efficiently deal with the volume of the reports filed, allowing them to track faster the late filers and to carry out in-depth review of the data quality of the reports by performing various reconciliations. At the same time, the cooperation between tax authorities can lead to further requests of information.

In the future, the Tax Authorities and regulators are expected to control more and more the data quality of the information received to maximise their utilisation when fighting tax fraud. We expect that the DAC6 reports, which include information related to arrangements considered as tax aggressive, should help the Tax Authorities to identify potential breaches in the local tax regulations and take corrective measures.

To manage the financial, operational and reputational risks resulting from the tax transparency regulations, the actors should have a clear understanding of their obligations and set-up a tax governance function.

Setting-up a tax governance function

The starting point for each impacted actor is to define its tax risk appetite and map its inherent tax risks arising from the type and fiscal residence of the clients/investors it serves, their reputation, the nature and localisation of the assets, to name a few. Based on such preparatory work, those actors could review their existing AML processes to leverage on what is already existing within the organisation and to consider the interactivity of the regulations to adopt an holistic approach.

For instance, in the context of its AML/KYC obligation, a financial institution could identify the use of a fake tax residency by one of its clients. This situation has an impact on the CRS report, which is based on the tax residency, but this also constitutes an indicia of tax fraud to be reported to the FIU and may also be considered as a cross-border reportable arrangement under DAC6.

The new/updated procedures and internal working documentation should include those interactions from an operational perspective to avoid isolated reviews of the different aspects by different teams without sharing their knowledge and findings.

This also means to ensure that the relevant employees are regularly trained and are comfortable with the principles of the most frequent cases they will face. The collaboration between the first and the second lines of defense is key to perform the expected reasonableness test on the documentation received based on the standard of knowledge of the client.

In the case of delegated functions of the onboarding or reporting obligations delegated, financial institutions cannot rely on the works performed by the service provider without any oversight or controls as ultimately they are accountable towards the tax authorities, the regulators and their clients or investors.

Those different aspects, including audit trail of the actions taken, should be covered by the tax function to have the operational team equipped to understand the difference between tax structuring, aggressive tax planning and tax fraud. It should also be under the radar of the Board of the impacted actors to ensure a good governance to avoid any remediation plan or financial sanctions from the tax authorities and regulators.

Good COP Bad COP: a critical view on governments' environmental commitments

Imagine you go to sleep and forget to blow a candle in your house. You wake up in the middle of the night and discover with astonishment that the candle set fire to the curtains. The crackling of the fire awakens your first friend who witnesses the fire and makes the following statement: "This is a risky situation, we should act before it is too late". You agree, but instead of acting you wait for five hours. Your whole living room is now on fire and it is pretty hot, so you decide to throw a glass of water on the flames. The blaze keeps growing, so much so that your second friend wakes up and declares "Let's agree that we should all put out the fire before next year or we will die. Besides, I suggest we stop lighting candles". This sounds like a reasonable statement, you cheer the speaker and sit down to set the commitment in stone.

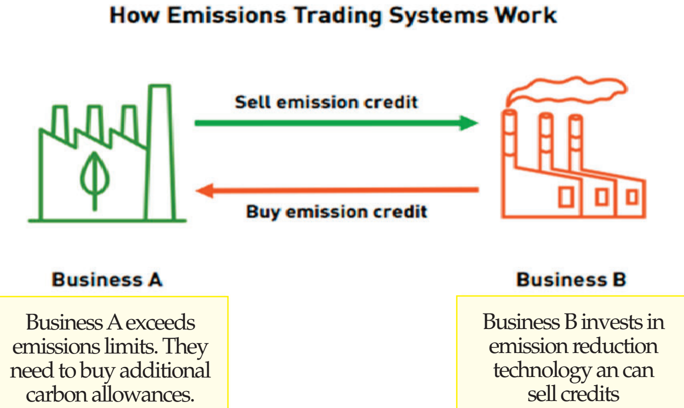
Maybe you wonder why no one ever called the fire department or maybe you wonder where I am going with this story. Consider the first protagonist being the Paris Agreement and the second one being the COP26. Now you should realize the ludicrousness of the climate change handling. Institutions should put words into action or soon enough the critical target of keeping a global temperature rise well below 2°C will be out of reach. This discourse could sound alarmist, but it reflects the magnitude of the changes every people on Earth needs to make to live, consume and invest more sustainably.

COP26 was concluded in November and achieved to gather around hundreds of countries around a common goal : Fighting Climate Change. This is a great news to see governments who usually disagree on geopolitical rhetoric finally align on their mutual enemy. However, writing "net-zero by 2050" on a piece of paper is just not enough. The world needs shorter milestones and concrete measures to cut emissions today, not in ten, twenty or thirty years' time. Money is king, so governments should give prominence to financial incentives to punish polluters and reward change makers.

In September 2021, the weighted carbon price was around $40 per ton of CO2. At this level, carbon credits are not accurately pricing the negative externalities of global warming and therefore they do not constitute a deal breaker for companies conducting due diligence on projects that are environmentally harmful, but still very profitable. The price of the right to pollute should be prohibitive to dissuade companies from financing any carbon intensive projects.

However, the issue is not only about the price, but also about the scope of the carbon Emission Trading System (ETS). According to the World Bank State of Carbon Markets, in 2019, ETS and carbon taxes covered only a fifth of global greenhouse gas emissions.

The silver lining to the toxic cloud is that China, one the largest polluters in the world, launched its carbon allowance market in 2021, but a global market for carbon allowances remains to be seen. One way to spur sustainability commitments would be to tie executives' performance reviews to ESG KPIs.



Sources: Kraneshares™, Climate Finance Partners

To end on a positive note, it is not all doom and gloom, because more than 450 major financial institutions, controlling assets of over $130 trillion, agreed to finance the investment in a net-zero economy. Besides, 80 countries adopted the "Green Grids Initiative" that aims to create a more interconnected global grid in order to enhance the development of renewable energy. This year's Nobel Prize in Physics was even awarded to climate scientists for their contribution to the IPCC (Intergovernmental Panel on Climate Change). All this demonstrates awareness, but achieving the target will require unprecedented and immediate action involving redeployment of global finance to support the United Nations' Sustainable Development Goals. Ultimately, large green inflows should be beneficial to equities and bonds participating to Clean Energy, Sustainable Cities, Circular Economy, Climate Action and Life Below Water among others (SDG 7, 8, 11, 12, 13, 14).

At FARAD I.M., we structurally favour those investments for our clients by including financial and extra-financial criteria in our due diligence process, thanks to our proprietary GreenEthica Sustainable Scoring System. We genuinely believe, to paraphrase the "TINA" equity effect, that "there is no alternative", but acting now and focusing our attention on the real drivers of the sustainable transition while avoiding the wolf in "sustainable" sheep's clothing.

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