

# Tax Reclaim, an innovative differentiator for your institution!

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Over the last few years, the Luxembourg private banking industry has been facing a series of challenges requiring a structural reshaping of its business model.

Luxembourg private bankers will have to differentiate and be innovative to maintain their attractiveness vis-à-vis clients that are—now more than ever—looking for advice to optimize their investments. In this context, efficient tax management of their clients' investments is a true value-added service that private bankers need to consider. Let's step back for a minute to understand the recent changes that have impacted the Luxembourg environment before investigating one of these new value proposition services: Tax Relief & Reclaim assistance.



### **Moving toward a fiscally transparent environment**

Since 2009, several initiatives both at the European as well as on the international level have impacted—and will continue to do so—the scope of banking secrecy, so that Luxembourg is now acting in a transparent fiscal environment full of challenges and opportunities.

This transition has been achieved with the switch to automatic exchange of information in the framework of the EU Savings Directive as from 1 January 2015, the signature of the Intergovernmental agreement Model 1 for FATCA purposes, and the implementation of the EU Directive on administrative cooperation in the field of taxation with regard to the exchange of information upon request and the spontaneous exchange of information.

The shift was further emphasized with the Common Reporting Standard (CRS). More than 80 jurisdictions will participate in this OECD initiative, more than 50 of which have already announced their intended starting date for CRS reporting. Based on the EU Directive, Luxembourg, as all other EU member states, will apply CRS reporting as from 2017.

In this new environment, the Luxembourg private banking center will not only be in direct competition with other international financial hubs like Switzerland, but also with homeland private banking players which are developing rapidly, providing services to resident clients and retaining the share of the richest individuals. In that context, there's a need for private bankers to offer innovative value proposition services: Tax Relief and Reclaim assistance is one such solution.

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## The level of automation is important to make it feasible to process high volumes, which is a necessary step to make Tax Reclaim a viable service offer within the bank's value proposition

### Tax Relief & Reclaim assistance: What is it in practice?

#### Introduction to double taxation issues

Each time an investment is realized on a cross-border basis, there is a risk that the income derived from such investment is taxed twice. One of the most common double taxation issues is the 'juridical double taxation' where the same income is being taxed twice in the hands of the same taxpayer. For example, it is rather common that a dividend payment is taxed in the country of source<sup>1</sup> by way of withholding tax in first instance and then subject to income taxation in the investor's country of residence<sup>2</sup> by way of a tax assessment. As double taxation may discourage cross-border investments and affect their financial return, countries started to enter into bilateral tax agreements whose main purpose is to eliminate or reduce double taxation.

#### Tax Reclaim

A dividend paid by a German corporation to a Luxembourg resident investor would in principle be subject to an upfront withholding tax rate of 26.375%.

The Luxembourg investor can claim the benefit of the reduced dividend withholding tax rate (15%) based on the Germany – Luxembourg tax treaty, leading to a tax refund of 11.375% of the gross dividend amount.

The remaining 15% can be credited against the investor's Luxembourg income tax.

Most of the countries hence agree to levy lower withholding tax rates on dividend and interest outbound payments than the default rate applicable based on their local domestic tax legislations. Investors are then entitled to a tax credit for the remaining withholding tax leakage. In other words, the final withholding tax charge suffered in the country of source of the income can be deducted from the income tax due in their country of residence.

The benefit of the tax treaty rate can be granted either upfront at the time of the payment (**Tax Relief or Relief at Source**) or afterwards by way of a reclaim filed with the local tax authorities (**Tax Reclaim**). While the investor immediately receives an amount of dividend or interest after deduction of the correct reduced withholding tax rate under a Tax Relief method, under the Tax Reclaim method he/she suffers the full domestic withholding tax rate in first instance and receives the tax refund after filing the reclaim.

The refund methods vary from one country to another: for example, relief at source is available for French source dividends while Germany only offers the possibility to reclaim dividend withholding tax (no relief at source).

<sup>1</sup> Country of Source can be defined as the country of the security's issuer. For example, Germany will be the Country of Source for dividend paid by a German resident corporation and for interest paid on German government bonds

<sup>2</sup> Country of Residence can be defined as the country in which a person lives i.e. the country in which he or she has a place to live where he or she normally spends the daily period of rest. The tax treaty provides for some specific criteria to determine the residence of an individual person



### A key strategic differentiator

#### For Private clients

Tax Reclaim improves the performance of clients' portfolios. There are a lot of factors putting pressure on the wealth management and private banking industry, where it is getting more and more difficult to achieve significant returns. A successful implementation of Tax Reclaim processes could enhance clients' portfolio performance by 0.10% to 0.15% (see Figure 1) and consequently increases client portfolio AuM.

Private banks that succeed in launching these services will have a big advantage in relation to their competition. Tax Reclaim services can be a major differentiator when it comes to service offerings for U/ HNW (Ultra/High Net Worth) individuals which will not only increase client satisfaction and retention, but also attract new clients.

Figure 1: Example of potential quantitative impact of Tax Reclaim for private clients

### Enhanced client portfolio performance

Client portfolio performance is accrued by **0,10% to 0,15%**

- Increasing client retention rate
- Increasing client portfolio AuM
- Consolidating your reputation as a leading private wealth manager



### **For your institution**

#### *Customer management*

Today, we observe that Tax Reclaim is an emerging service provided by some innovative players. Nevertheless, Tax Reclaims are mainly performed on a case-by-case basis and upon request. Since Tax Reclaim is a time-consuming exercise and a long-term process, it is typically restricted to a few (Ultra) High Net Worth clients (UHNW or HNW clients). The challenge for banks is to transform the Tax Reclaim and embed this service in the banks' value proposition to be part of their overall service offering.

To do that, private banks will need to seek industrialized automated solutions. The level of automation is important to make it feasible to process high volumes, which is a necessary step to make Tax Reclaim a viable service offer within the bank's value proposition.

Tax Reclaims provide banks with strong leverage to improve client retention. In an environment where switching costs between banks are lower than ever, offering Tax Reclaims can prove to be a real asset for private banking players.

Tax Reclaim services offer the opportunity for relationship managers to get in touch with clients with good news which will not only create a 'wow effect' but also provide great opportunities for cross selling.

#### *Financial performance accelerator*

At the bank level, Tax Reclaims are a new source of revenue. The Tax Reclaims service may be easily invoiced to clients, as it brings value: "a win/win approach"—which will be perceived as offering both high-level technical expertise and innovative solutions. Currently, there are different pricing models in use on the market. The most common one combines a fixed fee for each individual claim on which a success fee (as a percentage of the recovered amount) is added.

#### *Focusing on value-added services*

More broadly, the Tax Reclaim can be part of a more general strategy—focusing on more expertise and more added-value services that enable private bankers to differentiate their value proposition. This will be a key differentiator in attracting increasingly demanding clients looking for specialized and knowledgeable advice on tax and investment optimization.

#### *Centers of excellence: Internal Tax Reclaims within a group*

Tax Reclaim can also be an opportunity for subsidiaries and branches belonging to a larger group to position themselves as a center of excellence—providing Tax Reclaim services to the whole group. Such a positioning makes sense since Tax Reclaims require fiscal expertise and can strongly benefit from economies of scale. The increasing competition between private banks calls for combination and scalability, creating strong incentives to pool services like Tax Reclaims.

For a banking group, it clearly makes sense to organize itself as a group capitalizing on centers of excellence, especially for Tax Reclaim services. Financial centers accustomed to dealing with cross-border investments—like Luxembourg and Switzerland—are advantageously positioned to provide these services which combine fiscal complexity and technical challenges.

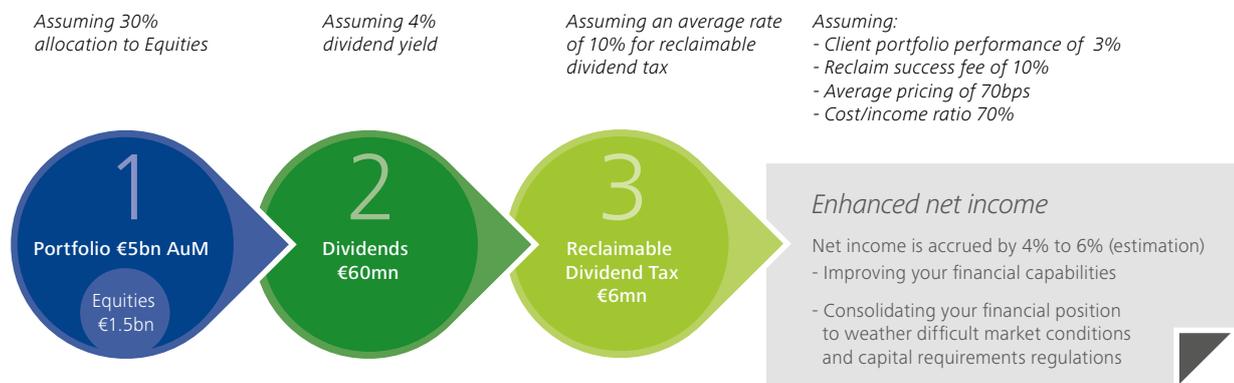
The definition of a Tax Reclaim center of excellence will offer different advantages:

- **Costs:** Combination and pooling enables lowering the overall costs related to such service at group level
- **Synergies:** The implementation of centers of excellence within a group enhances synergies within the group and will break silos
- **Increased net income:** Finally, the impact of such service on the bottom line can be significant. It can enhance net income by 4% to 6%. The goal is twofold:
  - Improve the financial capabilities
  - Consolidate the financial position to handle difficult market conditions and capital requirement regulations
- **Profit center:** Consequently, Tax Reclaim is far more than a new service. It offers the opportunity to shift a full area of services from being a cost center to becoming a new profit center

A lot of products and services offered by banks are currently facing an increase in costs, regulatory pressure, low profit margins, and fierce competition, which is causing their added value to decrease. To close this gap, banks need to lower the costs while increasing the perceived value of some products, and introduce innovative offerings to attract and retain clients as well as to create new revenue sources.

From this perspective, the Tax Reclaim service is a great opportunity for private banks. Although it may be difficult to invoice tax reports to clients, it is possible to bundle tax reports and Tax Reclaims, for example, and to sell a combined offer. As Tax Reclaims generate value for private clients, it is easier to justify the pricing.

Figure 2: Possible impact of tax reclaim on the net income



### **An organizational and operational challenge**

The implementation of a Tax Relief & Reclaim assistance service must be carefully prepared as it entails many operational and organizational challenges. We have highlighted some of these challenges below.

#### **Catch and keep the tax knowledge: “The withholding tax matrix”**

Before offering a Tax Relief & Reclaim service to their clients, private banking players will have to prepare a withholding tax matrix (hereafter the “matrix”) which has to contain all required information to identify Tax Reclaim opportunities for their clients and then file the request with the competent authorities.

The main challenge will be to ensure that this matrix is up-to-date and captures any changes in both domestic legislation and tax treaty networks that may affect the investors’ right of refund. Access to a large network of local tax experts is crucial, to remain abreast of any relevant developments.

#### **Client segmentation**

Another key element is determining what commercial approach to pursue: offering this assistance to top-tier clients or expanding the service to a wider client base. This decision will naturally influence the volumes to be processed and impact the (internal and/or external) resources to be dedicated to the project.

Based on client data extracted from the bank’s systems, a cost/benefit analysis should be performed in order to determine the viable claims per client i.e. the claims where the cost of pursuit is lower than the estimated tax refund. It is crucial that this cost/benefit analysis is automated allowing the bank to rapidly identify relief/reclaim opportunities, start gathering all required information and documentation to make available to the local paying agents for the Tax Relief Service, and to prepare the Tax Reclaim to be filed with the local tax authorities. Such automation is even more important when the service is offered to a large number of clients.

### **Highly secure transfer of client data and information**

A tax Relief/Reclaim service requires dealing with client data and information and sharing them with external stakeholders such as local paying agents and external tax service provider. It is therefore critical to set up a highly secure technology-backed solution that allows the bank to remain in full control of its client data at all times.

The connection between the bank and the external stakeholders will also need to be secured to offer a high level of security. Depending on the volumes to be processed, a secured data sharing platform would be essential to provide easy and centralized access to client data and information in a secure environment.

Although the private banking industry is facing challenging times, there are plenty of opportunities to successfully navigate troubled waters. A Tax Relief/reclaim assistance service requires a good understanding of the operational and organizational impacts, combined with an excellent management of tax information. But it provides clients with a distinctive value-added service where they can benefit from tax refunds, improving the return of their investment portfolio. Who said the power to tax is the power to destroy<sup>3</sup>?

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3 Chief Justice John Marshall in 1819 US Supreme Court Ruling., *McCulloch v. Maryland*.

