The power to tax is not the power to destroy!

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Over the last few years, the Luxembourg private banking industry has faced a series of challenges that require a structural reshaping of its business model. Luxembourg private bankers will definitively have to differentiate and innovate in order to maintain their attractiveness vis-à-vis clients who are increasingly on the look-out for advice to optimise their investments.

In this context, an 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 describing one of these new value proposition services: Tax Relief & Reclaim assistance.

Moving toward a fiscally transparent environment

Since 2009, several initiatives at both European and international level have impacted and are going to further affect the scope of banking secrecy so that Luxembourg can gradually enter a fiscally transparent environment bursting with challenges and opportunities:

1 2003/48/EC
2 The automatic exchange of information under the EUSD is broadly applicable to interest paid to individuals resident in an EU Member State other than the one where interest is paid.
3 2011/16/EU
4 Article 26(5) of the OECD Model Tax Convention (exchange of information provision)
5 http://www.impotsdirects.public.lu/conventions/conv_vig/index.html

- In the 2013 State of the Nation speech, the former Prime Minister Jean-Claude Juncker announced that Luxembourg will apply the automatic exchange of information as provided by the EU Savings Directive[1] with effect from 1 January 2015 (hereafter the 'EUSD'). Luxembourg banks will therefore have to transmit the information foreseen in the EUSD to the Luxembourg tax authorities, which will then confidentially transmit the information to the corresponding revenue service in the EU Member State in which the beneficial owner is a resident[2]. The new Finance Minister Pierre Gramegna confirmed Luxembourg's commitment to move forward towards automatic exchange of information at the ECOFIN meeting on 10 December 2013.

- In May 2013, the former Finance Minister Luc Frieden announced that Luxembourg will sign a Model 1 Intergovernmental Agreement (hereafter the 'Model 1 IGA') providing for the automatic exchange of information between the Luxembourg and US tax authorities on bank accounts held in Luxembourg by citizens and residents of the United States. Even if the IGA between Luxembourg and the US has not yet been executed, it is foreseen that Luxembourg banks will report tax information to the Luxembourg tax authorities, which will then automatically transmit the information to the US tax authorities.

- In 2013, Luxembourg also adopted a law effective from 1 January 2013 that implements the EU Directive on administrative cooperation in the field of taxation[3] as regards the exchange of information upon request and the spontaneous exchange of information. At the end of last year, a bill was submitted to the Luxembourg Parliament to implement the remaining part of this EU Directive in connection with the automatic exchange of information limited to the following categories of income: salaries, directors' fees and pensions and annuities.

- Last but not least, following the G20 Meeting held in London in April 2009, Luxembourg has amended existing tax treaties and signed new tax treaties where, except in the case of fishing expeditions, a request for information cannot be denied solely because it is held by a bank or another financial institution[4]. As of today, 37 tax treaties signed by Luxembourg are compliant with the exchange of information provision enacted in the OECD Model Tax Convention[5].

In this new environment, the Luxembourg Private Banking centre will not only be in direct competition with other international financial markets like Switzerland, but also with rapidly developing homeland private banking players, which provide services to resident clients and retain the share of the richest individuals. There is a definitive need for private bankers to develop innovative value proposition services.

Tax Relief & Reclaim assistance: how can tax create value for clients?

Introduction to double taxation issues

Each time a cross-border investment is made, there is a risk that the income derived from such investment may be taxed twice. One of the most common double taxation issues is 'juridical double taxation' where the same income is taxed twice in the hands of the same taxpayer. For example, it is fairly common for a dividend payment to be taxed in the country of source[6] by way of withholding tax in a first instance and then to be subject to income taxation in the investor's country of residence[7] by way of a tax assessment.

Tax Reclaim

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

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 their Luxembourg income tax.

Relief at Source

A dividend paid by a French resident company to a Luxembourg resident investor is, in principle, subject to an upfront 30% withholding tax rate.

A Luxembourg resident investor is in principle eligible for relief at source from withholding tax on dividends based on the France–Luxembourg tax treaty, leading to a reduced final withholding tax of 15%.

The net dividend received by the Luxembourg resident investor at the time of the dividend payment will therefore amount to the gross dividend amount less the final withholding tax of 15%.

As double taxation may discourage cross-border investments and affect their financial return, countries have started to enter into bilateral tax agreements whose main purpose is to eliminate or reduce double taxation.

Hence, most countries agree to levy withholding tax rates on outbound dividend and interest payments that are lower than the default rate applicable according to domestic tax legislation. Investors are then entitled to a tax credit for the remaining withholding tax leakage. In other words, the final withholding tax charge incurred 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 to the local tax authorities (Tax Reclaim). While the investor immediately receives an amount of dividend or interest after deduction of the relevant reduced withholding tax rate under a tax relief method, they initially incur the full domestic withholding tax rate under the tax reclaim method and receive the tax refund after the reclaim is filled.

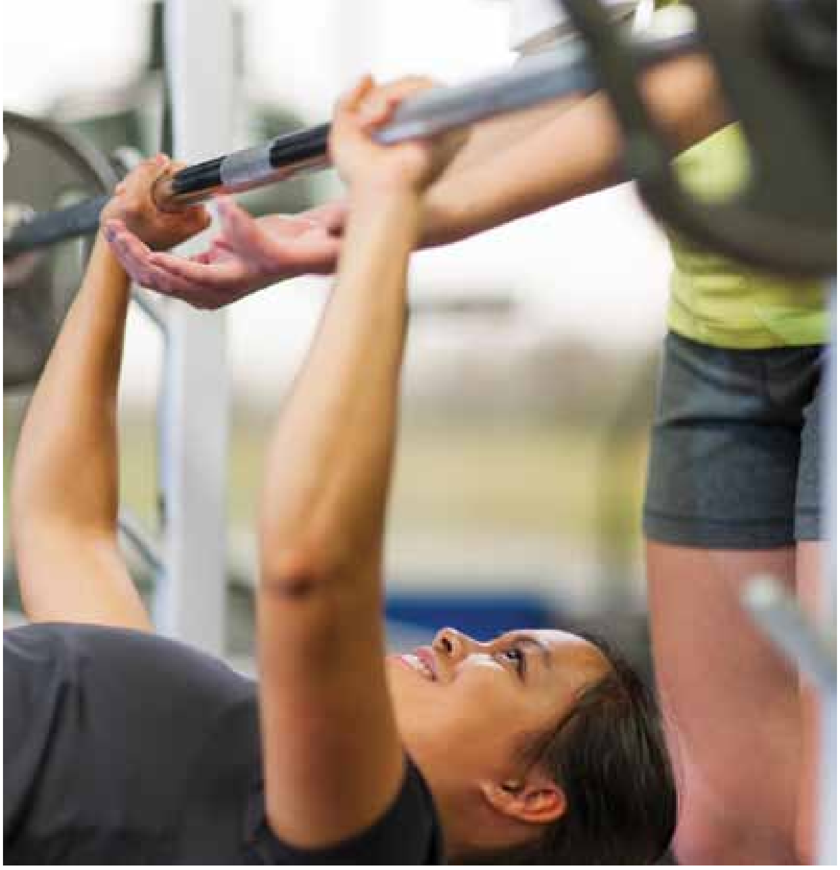
Refund methods vary from one country to another. For example, relief at source is available for French source dividends while Germany only offers the possibility to reclaim dividend withholding tax (no relief at source).

An operational and organisational challenge

The implementation of a Tax Relief/Reclaim Service must be carefully prepared as it poses many operational and organisational challenges. We have highlighted some of these challenges below.

Withholding Tax Matrix

Before offering a Tax Relief Service to their clients, private banking players will have to prepare a Withholding Tax Matrix (hereafter the 'Matrix'), which must contain all information required to apply for either the Relief at Source or a Tax Reclaim.



This should include the following information for each country of investment:

- Domestic withholding tax rates per type of security foreseen
- Tax treaty rates applicable depending on the investor's country of residence
- Possibility to get tax relief at source
- Claiming period
- Copy of the tax reclaim forms
- List of all supporting documentation required for the relief at source and tax reclaim

The main challenge here will be to keep this Matrix up-to-date and capture 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 remaining abreast of any relevant developments.

Client segmentation

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

On the basis of client data extracted from the bank's systems, a Cost/Benefit analysis needs to be undertaken to determine the viable claims per client, i.e. the claims where the cost of pursuit is lower than the estimated tax refund. The automation of this Cost/Benefit analysis is crucial to enabling the bank to rapidly identify relief/reclaim opportunities, to start gathering all information and documentation required by local paying agents for the Tax Relief Service and to prepare the Tax Reclaim for filing with the local tax authorities. Such automation is even more important when the service is offered to a large number of clients.

Highly secured transfer of client data and information

A Tax Relief/Reclaim Service requires client data and information to be handled by and shared with external stakeholders, such as local paying agents and external tax service providers. It is therefore critical to set up a highly secured technology-backed solution that allows the Bank to remain in full control of its client data at any given time.

For example, the use of encryption software[8] will be necessary to protect such data. The connection between the bank and the external stakeholders will also need to be secured to ensure a high level of security. Depending on the volumes to be processed, a secured data sharing platform would be essential to provide easy and centralised access to client data and information in a secured environment.

Although the private banking industry is facing challenging times, there are plenty of opportunities to successfully navigate troubled waters. Tax Relief/Reclaim assistance requires a good understanding of the operational and organisational impacts, combined with excellent management of tax information. However, it provides clients with a distinctive value-added service where they can benefit from tax refunds, thereby improving the return of their investment portfolio.

Who said the power to tax is the power to destroy[9]?

6 Country of Source can be defined as the country of the security's issuer. For example, Germany will be the Country of Source for dividends paid by a German resident corporation and for interest paid on German government bonds.
7 Country of Residence can be defined as the country in which a person lives i.e. the country in which they have a place to live and where they normally spend daily rest periods. The tax treaty provides for some specific criteria to determine the residence of an individual.
8 e.g. Pretty Good Privacy (PGP)
9 Chief Justice John Marshall in 1819 US Supreme Court Ruling., McCulloch v. Maryland.