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Dealing with tax risks in the financial sector

Tax compliance in the light of cum/ex and cum/cum

One of the key tax issues of 2023 for banks and financial service providers operating in Germany is the realisation that the requirements for the compliance organisation of institutions in dealing with tax risks (tax compliance) have changed fundamentally as a result of the current cum/ex and cum/cum investigations. Similar developments were also observed last year in other EU countries, such as France and the Netherlands. While the legislator took the current cum/ex proceedings as an opportunity to further tighten German criminal tax law in 2020, three developments in the area of withholding tax in particular highlighted the new framework conditions last year.

Cross-border investigations in the area of withholding tax

The high-profile searches of five banks in Paris by the French financial prosecutor's office with the participation of German prosecutors on allegations of money laundering and tax fraud in connection with allegedly criminal cum/cum arrangements under French law in spring 2023 have shown that abusive tax arrangements in the financial sector are being prosecuted across borders and in other EU states. This involves the use of investigation methods that were previously only used in other areas of international criminal prosecution.

Tax compliance in the focus of supervision

As a result of the investigations, the tax compliance organisation of banks has become the focus of the supervisory authorities (BaFin). BaFin's requirements for the effectiveness of tax compliance management systems (tax CMS) with regard to the governance structure of the tax compliance organisation and the design of suitable strategies and safeguards go well beyond the requirements of the financial authorities and the leading auditing standard for tax CMS (IDW PS 980). Tax compliance in the financial sector is therefore no longer an isolated task of the tax department, but part of the general compliance organisation of the institutions as part of their NFR (non-financial risk) management and is subject to the legal requirements for a proper business organisation.

New procedures for withholding tax relief for foreign investors

In the area of tax legislation, the Deduction Tax Relief Modernisation Act ("AbzStEntModG") and the EU's FASTER initiative are two legislative initiatives that, as a direct response to the investigations, aim to better prevent abuse in the area of withholding tax in the future. Both provide for a fundamental reform of the withholding tax relief procedure for non-residents. While the FASTER initiative is still at the draft stage, the Deduction Tax Relief Modernisation Act has already come into force in Germany. It poses considerable challenges for the tax compliance organisation due to extensive disclosure and reporting obligations and greatly increased liability for issuers of incorrect withholding tax certificates.

Further challenges

There are a number of other challenges to overcome, as many tax transparency laws to combat tax fraud and tax evasion apply exclusively to financial service providers worldwide. This has resulted in completely new tax regimes and reporting obligations that place entirely new demands on the compliance organisation of banks. The sustainability reporting demanded by investors offers banks the opportunity to revisit the topic of taxes in a new and positive light as part of their ESG strategy, but this requires adjustments to governance structures in the area of tax compliance.

Realignment of tax compliance

For banks in Germany, this raises the question of how they need to respond to these new framework conditions. This must be done against the backdrop of the fact that Germany has been experiencing a continuous tightening of the climate in criminal tax law for years, which affects companies and individuals alike. This has already made it necessary to protect the company, its management and employees from tax (criminal) law risks with a tax CMS. The IDW PS 980 auditing standard has also established itself as the industry standard for the design and auditing of tax CMS in the financial sector. In view of the changed framework conditions, however, "classic" tax CMS must fulfil new requirements in order to offer effective protection. In practice, the main challenge is to ensure the effectiveness of the tax CMS for all the bank's material tax risks in such a way that it offers protection against criminal law risks and also meets the regulatory requirements for proper business organisation. To this end, the Tax CMS must be expanded to include new types of tax risks due to current legislative initiatives and measures to combat tax fraud and tax evasion in the financial sector. In addition, tax risk management must be integrated into the bank's compliance organisation for regulatory purposes. The requirements of the legislator and BaFin regarding the governance structure of the compliance organisation and the design of suitable strategies and security measures to avoid tax risks must be observed.

Practical implementation in the "4 pillar model"

Adapting tax risk management is a challenge due to the complexity of the topic. For practical implementation, banks can draw on the "4 pillar model" developed by the author, a consulting approach for holistic tax risk management in the financial sector. The model serves as a regulatory framework and takes account of the fact that the requirements for tax risk management in the financial sector differ significantly from those of other sectors of the economy.

The 4-pillar model enables banks, insurance companies and asset managers alike to define a customised and systematic approach to dealing with tax risks in order to adapt their tax CMS and tax governance accordingly. The model works with four tax risk areas (pillars) specific to the financial sector, each of which requires different approaches in order to ensure liability is minimised. All conceivable tax obligations and risks that can affect a company in the financial sector in Germany and abroad can be individually assigned to the four pillars and mitigated.

Conclusion

The requirements for tax compliance in the financial sector have changed fundamentally as a result of current measures and legislative initiatives in the area of tax transparency and to combat tax evasion and tax fraud. Tax compliance in the financial sector is not an isolated task of the tax department but is the responsibility of the institutions' general compliance organisation as part of their NFR management. It requires close cooperation between the compliance department and the legal and tax departments, as well as the business units of the first line of defence within the framework of the governance structures prescribed by supervisory law. The "4 pillar model" developed by the author offers a systematic approach for sophisticated implementation in practice.

prevent | detect | respond

1

Own tax obligations

- Risks due to non-compliance with tax declaration obligations (failure to file or late, incorrect or incomplete tax returns)
- e.g. Tax CMS (IDW PS 980, etc.)

2

Third-party tax fraud risks

- Risks due to tax fraud from/with business partners/third parties
- e.g. Cum/Ex, VAT Carousels, UK CCO

3

Tax transparency regimes

- Risks due to non-compliance with tax transparency reporting obligations
- e.g. FATCA/QI, DAC6, Sec. 138b German Fiscal Code (AO)

4

Tax KYC obligations

- Risks due to violation of tax KYC obligations (e.g. Sec. 154 AO)
- e.g. BaFin order to prevent money laundering and terrorist financing

1st LoD | 2nd LoD | 3rd LoD

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