

# Global Wealth Management and the Panama Papers



**Dan diBartolomeo**

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# Context

- While the wealth management communities in some countries such as the US and Australia have made meaningful progress toward managing investment in a “after-tax” framework, being concerned with taxes is almost unheard of in most countries.
- The reason this is that “after-tax” investing is a second order problem in most nations. Most of the wealth being managed has not itself been declared for tax purposes, and is routinely hidden in foreign accounts and offshore shell corporations.
- *With the recent public release of thousands of documents hacked from Panamanian law firm Mossack Fonseca, a global firestorm of both civil and criminal investigations has begun with substantial negative publicity for both financial firms and myriads of high profile clients. As we meet today, international soccer star Lionel Messi is on trial in Spain for \$4.6 million in criminal tax evasion.*

# Today's Discussion

- The first part of the presentation will review the background and common practices of offshore investing for private individuals and for collective vehicles such as hedge funds. While heavily tainted with the stain of tax evasion there are other legitimate benefits of such vehicles.
- Next we will discuss how legislation in various countries has been enacted in the wake of the of the Mossack data leak that we believe will lead to vast amounts of global wealth that has not been previously been taxed becoming “legitimized”, greatly increasing demand for tax sensitive investing.
- *The presentation will conclude with an overview of how the techniques of tax sensitive investing can be adopted quickly by non-US financial firms so as to prosper in the “post Panama papers” world of wealth management.*

# A Ticking Time Bomb

- In 2010, CFA ran a large wealth management conference in Singapore. At that conference I was one of several speakers who argued that hiding money abroad to evade taxes would eventually become an extinct practice, and wealth management firms had to be ready to manage wealth in a tax sensitive fashion.
- The key milestone in this process originally had nothing to do with taxes. The driver was increased surveillance of international financial transfers as a means to undermine the operations of terrorist groups.
- Most countries around the world have enacted “all crimes” rules against money laundering and criminal financial transfers. Financial institutions are required to report all financial transactions that have the potential to be linked to criminal activity. In most (but not all) countries tax evasion is a crime.

# A Brief History of Financial Secrecy

- In the 1700s Swiss banks started to keep the identity of clients secrets, many of whom were French Protestants. At the time, non-Catholics were subjected to higher taxes in France.
- Through the 20<sup>th</sup> century, “tax havens” like the Cayman Islands, and Lichtenstein became popular, and the practice of offshore shell companies became common place.
- In the late 1990s, Japan shut down most of the Citibank retail branches for money laundering violations.
- In 2010, the US enacted FATCA legislation requiring disclosure by financial institutions of foreign accounts held by US citizens.
  - Substantial litigation ensued with billions of dollars in fines for large international banks such as CS and HSBC
  - AML fines in other countries are still small but increasing
- Recently, Switzerland, Mauritius, Hong Kong and Singapore agreed to share account holder data for their citizens

# The Taxonomy of Anti Money Laundering

Terrorism

Criminal Proceeds

Tax Evasion on Earned Income

Tax Evasion on Investment Income

Tax Avoidance (legal)

# Splitting the Hair

- Around the world, most countries have adopted a legislated distinction between illegal “tax evasion” and legal “tax avoidance”.
- An early and widely adopted version of this standard was articulated by the US Supreme Court in Gregory versus Helvering (1935)
- Before the case got to the USSC, Second Circuit Appeals Court Judge Learned J. Hand provided the landmark ruling:

*“a transaction.... does not lose it’s immunity because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Anyone may arrange his affairs so as to make his taxes as low as possible; he is not bound to that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes”.*

# Similarity and Different Across Countries

- Most countries only tax earned income of residents.
- A few countries including the US and Libya tax the earned income of their citizens irrespective of residence. Taxes paid to country of residence are credited toward taxes of the country of citizenship.
- Many countries have no taxes on investments at all. A few have “stamp duties”, small taxes on transactions.
- Most countries have no taxes on investments by foreign entities.
- Some countries like the USA impose a withholding tax on dividends and interest remitted to foreign investors, but generally there is no capital gain tax. Australia can have negative taxes on dividends.
- Across all countries, investment taxation is quite similar. You do or don't tax trades, income or capital gains. Almost always capital gain taxes are limited to domestic taxpayers.



# Bilateral Treaties: the Offshore Shell Company

- Almost all major nations have a large number of bi-lateral treaties with other countries offering tax breaks of one sort or another to the respective citizens.
- As an example, the US has tax treaties with sixty eight other nations. Each one has different terms. They are listed in IRS publication 901.
- It is likely that each of those sixty eight nations also has treaties with many other nations, some of which do not have treaties with USA.
- The web of bi-lateral treaties creates the tax motivation for the legal formation and use of many offshore “shell companies”.
- Consider the situation where Country A has a “zero tax” treaty with Country B, and Country B has a “zero tax” treaty with Country C. Investors in Country C could create a shell company in B in order to legally invest in Country A with zero taxes, even if C has no treaty with A.
- This kind of legal activity is a huge source of revenue to many small jurisdictions such as the British Virgin Islands.
- A complex version of this process was used by the Renaissance hedge fund (with help from Deutsche Bank) to legally avoid billions in US taxes.

# Mossack Fonseca Hack

- In early April, servers at the Panamanian law firms Mossack Fonseca were hacked. Nearly 2.7 TB of data were removed, including tens of thousands of confidential documents.
- These were mostly publicly released to various websites. They showed that among 250,000 companies formed by MF, the founders included at least a dozen heads of state, including the since resigned PM of Iceland, and the father of UK PM David Cameron.
- Numerous other famous persons were identified including international sports stars such as Lionel Messi who was already under investigation in Spain for criminal tax evasion.
- The number of US persons identified in the MF hack data was very small. The US has extensive tax rules about how American's investing abroad are taxed as if the investments were domestic unless you structure very carefully.
- For US maximum advantage, you need friends. The key is to structure an offshore entity so that no five US taxpayers have a controlling interest. The UK has similar rules.

# The Legislative Way Forward

- Since the MF hack, several countries have announced “tax amnesty” periods when taxpayers who have previously not reported taxable funds will be able to do so with minimal taxes.
- In Indonesia, the normal maximum tax rate is 30%. Any money surfaced during the nine month amnesty period will be taxed at between 1% and 6% (the sooner you act, the lower the tax).
- Indonesia estimates that as much as \$900 Billion may turn up. Argentina is estimating \$500 Billion for their program. In each case, this figure is approximately equal to one year of GDP.
- Given that world GDP is estimated at \$75 Trillion, it is plausible that if other countries follow suit tens of trillions of dollars will surface in the years ahead: a sum greater than the currently recognized “wealth management” AUM.
- Obviously, this is a huge opportunity for asset management organizations that are prepared to manage on a tax aware basis.

# Choices to Be Made

- Many financial service organizations are still trying to see their world in a “business as usual way”.
  - Before the MF hack, Credit Suisse announced the intent to vastly expand the wealth management operations, particularly in Asia, while abandoning the USA as being too “restrictive”.
  - In a recent CFA conference call on performance reporting standards, European representatives showed little interest in the concept of more detailed standards for “after tax” investment performance calculations.
- Some jurisdictions with little other economic activity such as the Cayman Islands are expected to continue current practices despite international pressure.
- Anonymous assets such as Bitcoin or gold may gain popularity. A recent Ernst and Young press release indicated they believe that 95% of global Bitcoin demand is from China. For a great discussion see Erb and Harvey (FAJ, 2013).

# Basics of Tax Sensitive Asset Management

- All the basic concepts are covered in Investment Management for Private, Taxable Investors (J. Horvitz, J. Wilcox and D. diBartolomeo, CFA Research Foundation, 2006).
  - The simplest way to think about taxable investing, is to think about an effective tax rate for each asset class. For example, you could think about owning a *passive* portfolio that has an expected return of 8%, with 2% coming from dividends and 6% to come from capital appreciation.
  - Let's assume I will hold the portfolio for 10 years then liquidate it. It's simple arithmetic to take the taxes out of the dividends, and calculate the one time capital gain tax payment at liquidation to get an after tax rate of capital appreciation. The after tax yield plus the after tax capital growth is the after tax expected return.
  - We then compare the after tax expected return to my original 8% to get the effective tax rate, which will be lower than the nominal rate.
  - We can then run our asset allocation based on after tax return and risk. Similar procedures can handle tax deferred structures such as 401K

# Tax Cognizant Asset Allocation

- A recent paper by Markowitz and Blay (JOIM, 2016) addresses asset allocation in an after tax framework.
  - The key concept here is that as an asset class has experienced gains or losses in the past that have not yet been taxed, the embedded capital gain or loss impacts the “after tax” expected return causing the optimal allocation to be path dependent across time.
  - The downside of this analysis is that investors aren’t taxed at the asset class level, they are taxed at the individual security level, and often down to the granularity of individual tax lots.

# Tax Aware Portfolio Management

- Many wealth management organizations (Fidelity, Citibank, UBS USA, Macquarie) now offer various forms of “tax aware” portfolio management that incorporates active management with such practices as actively harvesting tax losses to offset tax gains resulting from desired transactions.
  - The most sophisticated process is to build the tax costs into an optimization objective function much like a large, but complex trading cost. This is what is built into the Northfield process in our Optimizer and MARS wealth management platform.
  - A less efficient process is to optimize the portfolio pre-tax, while setting a constraint on “tax dollars to be paid out”.
  - Even less effective would be a series of fixed rules like “don’t sell a stock at a short term capital gain if it will go to long term in 90 days or less”. Obviously, this can lead to really bad outcomes in certain cases.

# Centralized Portfolio Management

- Based on diBartolomeo (1999) several firms in Australia including Vanguard have created after tax multi-manager products. In Australia, even pension funds pay capital gain tax.
- This process involves allowing multiple managers to run “paper” portfolios routing trades through a central agent who merges the various holdings and transactions into a single central portfolio that is run in an optimal tax aware fashion.
- CPM has been shown to improve alpha, reduce trading and realized taxes.
- It also allows the investor to make efficient tradeoffs relating to taxes which are levied on absolute returns, while allowing managers to concentrate their attention on benchmark relative returns.



# What Would Yale Do?

- Geddes, Goldberg and Bianchi (FAJ, 2015) ask how would the famously successful Yale endowment change their investing practices if they were suddenly taxable.
  - This seems to be very akin to what investors surfacing previously undeclared wealth would face.
  - Their extensive simulations show that the since hedge funds and other investments in which Yale has invested heavily produce mostly short term capital gains (heavily taxed), the key would be to also employ tax aware equity asset managers that could carry out tax loss harvesting to offset the otherwise heavily taxed gains.
  - Kalotay (FAJ, 2016) extends the analysis to include tax beneficial fixed income holdings such as municipal bonds in the US and their equivalents in many countries.

# Conclusions

The reality of the modern world is that international financial transactions come under a great deal of scrutiny from regulators and law enforcement, irrespective of the motivation.

In response to the Mossack Fonseca hacking event and the legal aftermath, there is a clear trend for countries to encourage the surfacing of previously undisclosed wealth in the tens of trillions of dollars by offering big discounts on taxes due.

Once large amounts of this money surfaces, global wealth management firms will have no choice but to become tax aware in their investing practices, or no longer be in a competitive position with the numerous large firms that are pioneering this process in the USA and Australia.