Automatic exchange of information: a global effort to combat tax evasion

Anthony Tam looks at impact of the new global initiative on financial institutions

The Organization for Economic Co-operation and Development issued the Standard for Automatic Exchange of Financial Account Information in Tax Matters on 21 July 2014, which was endorsed by the G20 in September of the same year. The AEOI calls on governments to obtain detailed account information from their financial institutions, and exchange such information automatically with other jurisdictions on an annual basis. It consists of two components:

i. The Common Reporting Standard, which sets out the reporting and due diligence rules to be imposed on the financial institutions; and
ii. The Model Competent Authority Agreement, which contains the detailed rules on the exchange of information.

Scope of the Common Reporting Standard

In order to prevent taxpayers from circumventing the CRS, it has been designed with a broad scope across three dimensions:

i. The financial information to be reported for reportable accounts includes all types of investment income (including interest, dividends, income from certain insurance contracts and other similar types of income) as well as account balances and sale proceeds from financial assets;
ii. The financial institutions that are required to report under the CRS do not only include banks and custodians but also brokers, certain collective investment vehicles and certain insurance companies; and
iii. Reportable accounts include accounts held by individuals and entities (which includes trusts and foundations), and the standard includes a requirement to look through passive entities to report on the individuals who ultimately control them.

Latest CRS development

As of today, more than 100 countries have committed to implement the CRS in their respective countries in 2018 the latest. These countries include Australia, Canada, China, Singapore, United Kingdom and Japan. The United States has implemented its own regime called Foreign Account Tax Compliance Act. Being a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes of the OECD, Hong Kong has committed to implement the new global standard on a reciprocal basis with appropriate partners who can meet the relevant requirements in terms of privacy protection, confidentiality of information exchanged and proper use of the data. The Hong Kong Inland Revenue Department has committed to implement the local CRS on 1 January this year, with the first automatic information exchanges to be made by the end of 2018. The mechanism is that the financial institutions would notify the IRD within three months from the date they commence to maintain a reportable account. The IRD would issue electronic notices to the financial institutions for filing the CRS returns through the AEOI portal, with the first reporting to be made by May 2018. The IRD would exchange information with CRS partners by September 2018. Hong Kong has agreed to implement AEOI with Japan, U.K. and Korea, and it is expected that more countries, including Canada and China, would be added soon.

Similarly, China has committed to implement the CRS by the end of 2018. On 14 October 2016, the State Administration of Taxation released the Discussion Draft on the Administrative Measures on the Due Diligence Procedures for Non-residents' Financial Account Information in Tax Matters to solicit public opinion.

Challenges ahead to financial institutions – Hong Kong CRS

The first challenge is to identify the reportable person and the reportable account. Among others, a reportable person is an individual or entity that is a tax resident of a CRS partner. A reportable account is an account that is held by (a) at least one reportable person; or (b) a passive non-financial entity such as holding company, trust or foundation, with at least one controlling person being a reportable person. Active non-financial entities will be considered as a passive non-financial entity if more than 50 percent of its income is from passive income and more than 50 percent of the assets are held for production of passive income. The threshold for defining "controlling" for this purpose is 25 percent. Financial institutions that fail to report under CRS may be subject to financial or/and criminal penalties.

Consequently, a company that is not a tax resident of a CRS partner may still have a reportable account. For example, the account of a Singapore company, Singapore not being a CRS partner, which is 30 percent owned by a tax resident of U.K., a CRS partner, would be reportable to the IRD, as long as the Singapore company is a passive non-financial entity. While the Singapore company is not a reportable person, its account would be a reportable account. The U.K. residency status of the 30 percent shareholder would be reported at the same time.

The second challenge relates to due diligence and reporting requirements. On 9 September 2016, the IRD issued the CRS guidance for financial institutions to assist them in complying with the CRS obligations. Even though the AEOI commences in January 2018, the information gathering under the CRS commenced on 1 January this year. The due diligence procedures would apply to new accounts opening on or after 1 January 2017, and due diligence procedures for pre-existing high-value individual accounts, defined to be exceeding HK$7.8 million, would be completed by 31 December 2017, with the procedures to be completed for all remaining pre-existing accounts by 31 December 2018. The guidelines clarify a number of issues on due diligence and reporting requirements, including reporting on place of birth being encouraged and the templates for self-certifications for individuals, entities and their controlling persons. The financial institutions must cross check the self-certification form with information obtained through their own "know your client" procedures.

This can be illustrated in the following example: Mr. A was born in Hong Kong. He had migrated to Canada and lived there for a few years and has returned to Hong Kong. He is a Canadian passport holder. In the self-certification form, he fills in as a Hong Kong resident only. The question is whether he is also a Canadian tax resident, which is often determined by facts and circumstances. In order to relieve the bank from the reporting obligation for Mr. A, the bank would require to ask further questions to ascertain that Mr. A is indeed not a Canadian tax resident.

Another example relates to non-financial entity. Company D is a Hong Kong company, owned 50 percent by a Canadian tax resident and 50 percent by a Chinese tax resident. Company D declares itself as an active non-financial entity in the self-certification form. The bank would need to do its due-diligence to ensure that the company is indeed an active non-financial entity not meeting the 50 percent threshold, and similarly the residencies of the individual shareholders. If company D is a passive non-financial entity, the bank would need to report the account information as to the company as well as the individual shareholders.

Development in China

The SAT has released its discussion draft on the CRS implementation framework in China. The basic requirements generally follow the OECD standard with further clarifications on a couple of concepts. Reporting financial institutions include depository institutions, custodial institutions, specified insurance companies and their branches. Nevertheless, institutions such as financial companies, finance leasing companies and automotive finance companies are not included. Reportable information includes the balance of the account and the different types of income, e.g. interest and dividends.

For new individual accounts, the financial institution would identify the tax residency status of the account holders according to the self-certification of the individuals. For pre-existing individual accounts, the threshold for a low value individual account is set at 6 million yuan at the end of 2016. For low-value individual account, the determination of tax residency status could be based on his or her address. For high-value individual account, the financial institution would need to perform search and inquiry to identify his or her residency status. As to entity accounts, the criteria to distinguish between an active non-financial entity and a passive non-financial entity is the same as those in Hong Kong. The threshold for performing due diligence by the financial institution is set at 1.5 million yuan. The timeline for completion of due diligence for new accounts, low-value and high-value accounts are the same as that for Hong Kong.

Based on the discussion draft, Chinese tax authorities could only provide relevant advice to financial supervision bodies for reference relating to penalties on non-compliance. It remains to be seen as to how penalties would be implemented.

In one recent case, a Chinese individual transferred ownership in his Chinese enterprises to his close relatives prior to migrating to Canada. Funds from the enterprises were made via the close relatives' bank accounts in Hong Kong. Such funds had been accounted for as loan to shareholders. The Canadian tax authority sought information from the Chinese tax authority through the exchange of information provision in the China-Canada tax treaty. Upon investigation, the Chinese tax authority uncovered the arrangement and the close relatives were deemed to have received dividends from the Chinese enterprise, thus subject to individual income tax in China. As well, the Chinese individual was also deemed to have received dividend income in Canada, thus subject to Canadian income tax. While this example may not have direct relevance to CRS, it indicates that CRS can be a tool for Chinese and overseas tax authorities to catch this kind of tax avoidance arrangements.

Conclusion

It should be noted that CRS' targets are not enterprises and individuals that are tax compliant, but those tax avoidance and evasion activities via foreign accounts. Proper and legitimate tax planning is still a viable means for individuals and enterprises to minimize tax payments, in particular high-net-worth individuals.

Although the specified timeline for exchange of information has been determined, time will tell how jurisdictions involved could take advantage of the information exchanged through CRS. It may still take some time for CRS to play an important role in cracking down tax avoidance cases after its implementation. Nevertheless, the capability to make use of overseas information collected will be vigorously enhanced in the future. Taxpayers should pay more attention to their global tax compliance. If the taxpayer can be construed as having more than one tax residency, he or she should identify the circumstances and come clean in preparation for this new global initiative.

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