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SYNOPSIS SERIES

Tax in the transparent world: a review and update on the automatic exchange of information

Background

Traditionally, business owners and investors have tended to diversify wealth and investments outside of their home jurisdictions, and the use of holding structures, with offshore companies, offshore accounts and/or trusts, or a combination thereof, is relatively common place, across many jurisdictions and has been existing for a long time. It is usual to involve handing over legal ownership and responsibility for the assets and delegating control or investments to a third party trustee. The reasons for setting up a trust varies but with growing global wealth, there continues to be ever-growing needs for such arrangements for maintaining and protecting wealth for future generations, and as succession planning. In a wealth management centre like Hong Kong, for instance, we continually see increasing demands for trust set-up among high-net-worth individuals and families in China and the rest of Asia, amongst others.

Meantime, the Organisation for Economic Cooperation and Development ("OECD") has in recent years doubled up efforts of (non-US) tax authorities globally towards chasing taxpayers who are flying under the radar of their home countries' tax authorities and who do not declare their income or gains arising from assets or investments held overseas. As a responsible member of the international community and in keeping up its international reputation and competitiveness as an international financial centre, Hong Kong has also adopted automatic exchange of information between tax authorities, moving from its previous position of providing information (only) upon request.

In this synopsis, we provide an outline of the global changes that have driven the enhancement of tax transparency - more specifically, the international standard on *automatic* exchange of financial account information in tax matters, which has now been implemented by many jurisdictions globally including Hong Kong and China.

Double Tax Agreements ("DTAs") and Tax Information Exchange Agreements ("TIEAs")

Previously, it was necessary for a country to submit a request for exchange of information where a DTA or TIEA with Hong Kong has been concluded.

At present, Hong Kong has concluded 42 DTAs (of which 40 have been ratified and are in force). Hong Kong's first DTA was signed with Mainland China on 11 February 1998, the second one with Belgium on 10 December 2003 and the third one with Luxembourg on 2 July 2007, meaning that 39 more treaties had been concluded within the last 12 years. On 25 March 2014, Hong Kong signed its first TIEA (notably with the United States). So far Hong Kong has concluded TIEAs with seven jurisdictions.

China currently has DTAs with 110 jurisdictions (of which 102 are in force), which were concluded within the last 36 years (with the first one being signed with Japan on 6 September 1983 and the most recent one with Argentina on 2 December 2018). Furthermore, China has concluded TIEAs with 10 other jurisdictions so far, including the jurisdictions traditionally regarded as tax havens such as the British Virgin Islands, Cayman Islands, Isle of Man, Guernsey, Jersey, Bahamas, Bermuda, Liechtenstein, San Marino and (even though not a tax haven) Argentina.

As Hong Kong and China generally follow the OECD's Model Conventions with respect to the scope of the exchange of information, there is actually no substantive difference between a TIEA and the exchange of information article in DTAs. In terms of safeguards on confidentiality of information exchanged and taxpayers' right of privacy, a TIEA and (the exchange of information article in) a DTA generally offer the same level of protection.

Foreign Account Tax Compliance Act ("FATCA")

FATCA was a major impetus towards Hong Kong and China becoming familiar with an initiative to exchange tax information on an *automatic* basis. In brief, FATCA is US law designed to combat tax evasion, requiring financial institutions resident in cooperating jurisdictions to provide information on US taxpayers to the US Internal Revenue Service ("IRS") on an annual basis. Non-compliant countries are subject to a 30% withholding tax on US related income channeled through their domestic financial institutions.

In this connection, Hong Kong has entered into a so-called Model 2 intergovernmental agreement ("IGA") for FATCA. Under this Model 2 IGA, financial institutions in Hong Kong are obliged to report information on their US clients and relevant transactions directly to the IRS. China has agreed to FATCA under a Model 1 IGA, and as such, financial institutions in China are obliged to report information on their US clients and relevant transactions to the Chinese tax authorities which, in turn, report the relevant information to the US IRS.

The Common Reporting Standard ("CRS")

In 2014, the CRS was developed in response to the G20's request and approved by the OECD Council on 15 July 2014, calling on jurisdictions to obtain information from their financial institutions on their residents' financial account information, and automatically exchange that information on an annual basis with other CRS participating jurisdictions.

To date, more than 100 jurisdictions have adopted this standard and implemented this mechanism. In this connection, exchange relationships between jurisdictions are typically based on the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the CRS Multilateral Competent Authority Agreement ("MCAA"). The MCAA is a multilateral framework agreement, specifying what information shall be exchanged and when. As such, jurisdictions no longer have to rely on a bilateral CAA, TIEA or DTA.

(a) Current position on Hong Kong's adoption of the CRS

As a responsible member of the international community and in order to maintain its international reputation and competitiveness as an international financial and business centre, Hong Kong has kept up efforts to adopt the latest global standards on tax transparency. On 30 June 2016, the tax legislation implementing the CRS in Hong Kong was published in the Gazette, as a result of which the CRS was applied as of 1 January 2017. In this connection, financial institutions in Hong Kong had to collect information as of 2017 and report this to the Inland Revenue Department ("IRD") in May 2018. The first exchange of this information by the IRD with the tax authorities of other (CRS) participating jurisdictions, including Mainland China, became a fact in late 2018. Obviously the IRD will continue doing so in 2019 onwards, and vice versa. A similar mechanism has been (or shall be) adopted in respect of tax authorities of other participating jurisdictions, with varying timeframes depending on when the relevant jurisdictions signed up to the agreement.

Since the Convention on Mutual Administrative Assistance in Tax Matters came into force in Hong Kong on 1 September 2018, Hong Kong's network for tax information exchange has been expanded significantly. The Inland Revenue (Amendment) (No. 2) Ordinance 2019, published in the Gazette on 1 March 2019, has added 51 jurisdictions to the list of reportable jurisdictions (in addition to the 75 jurisdictions that were already included in the current list), resulting in 126 reportable jurisdictions with effect from 1 January 2020.

(b) Mainland China's adoption of the CRS

As a G20 member, China has consistently supported the OECD's initiatives for the automatic exchange of information to combat cross-border tax evasion in light of improving tax transparency. In December 2015, the State Administration of Taxation ("SAT") signed the MCAA which allowed it to progress with the automatic exchange of information under the CRS. On 19 May 2017, the SAT, Ministry of Finance, People's Bank of China and the China Insurance Regulatory Commission jointly issued administrative measures for due diligence on non-resident financial account information, in accordance with the CRS, which came into effect on 1 July 2017. As a result, financial institutions in China are also required to comply with due diligence procedures to identify the tax residency of the financial account holders and to collect and record the reportable information.

Conversely, Chinese authorities are similarly able to obtain reportable information on Chinese taxpayers holding assets or investments overseas.

(c) Who are reported and what is exchanged under the CRS?

In essence, identification and reporting has to be carried out by financial institutions including banks, insurers, custodians, trustees, brokers, asset managers, intermediaries and certain collective investment vehicles (hereinafter referred to as "reporting financial institutions") on an annual basis. Typically, the information (to be) reported in respect of reportable persons includes personal details of the account holder, information relating to the investment income, account balances and sales proceeds from financial assets associated with the relevant account(s), amongst others.

In particular, trusts are flagged at the very outset in the introduction to the CRS. Emphasis is put on the fact that reportable accounts include accounts maintained or held by entities or trusts. The financial institutions (often including the trustee itself) responsible for reporting on these accounts are also required to look through passive entities to report on individuals that ultimately control these entities. Obviously, the OECD had an agenda in the CRS to ensure that trusts cannot be used by individuals as a shield against reporting requirements.

One of the noteworthy differences compared to FATCA is the scope and volume of reporting. Amongst others, the CRS does not provide the option of electing a *de minimis* threshold for individual account holders unless the account (other than an annuity contract) has a balance that does not exceed HK$7,800 (approximately US$1,000). Therefore, reporting financial institutions in Hong Kong collect information from all of their account holders, and they furnish the information in respect of each reportable account to the IRD as they consider necessary to be compliant.

For non-compliance, the Hong Kong Inland Revenue Ordinance contains various provisions imposing sanctions on the reporting financial institutions; service providers to reporting financial institutions; employees, directors and other officers of financial institutions; employees, directors and other officers of service providers to financial intuitions; and the account holders themselves.

For more background and details on CRS and FATCA, see our previous legal update on Hong Kong implementation of CRS: http://www.vteu.co/2016/09/12/hong-kong-implementation-of-common-reporting-standards-and-automatic-exchange-of-information/

Further measures on tax transparency

(a) Mandatory disclosure rules ("MDR") for CRS avoidance arrangements and opaque offshore structures

On 9 March 2018, the OECD issued disclosure rules which are in line with the principles contained in its position countering Base Erosion and Profit Shifting ("BEPS"), with a view to further enhancing tax transparency globally. In principle, once implemented into domestic law in the participating jurisdictions, an intermediary shall be required to provide tax authorities with information on the steps and transactions that form part of an arrangement that (purports to) circumvent the CRS ("CRS Avoidance Arrangement") or a structure that disguises the beneficial owners of assets held offshore ("Opaque Offshore Structure").

Intermediaries refer to persons responsible for the design or marketing of such arrangement or structure ("Promotors") and also persons that provide assistance or advice with respect to the design, marketing, implementation or organization of such arrangement or structure and who can reasonably be expected to know it is a CRS Avoidance Arrangement or Opaque Offshore Structure ("Service Providers").

The MDR shall apply to a broad range of intermediaries such as banks, trustees, financial advisors, lawyers, tax advisors, accountants, and so forth, although is not expected to diminish or require a solicitor, attorney or other admitted legal representative to disclose information that is protected by legal professional privilege or equivalent professional secrecy obligations insofar that an information request for the same information could be denied under the (exchange of information articles of the) OECD Model Tax Convention and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, respectively.

Penalties and other mechanisms for non-compliance are recommended in the model rules. As with the other requirements and obligations in the model rules, individual jurisdictions will have to choose the nature and extent to which penalties should apply for non-compliance.

(b) EU

Parallel with the above, in May 2018, the EU issued Directive 2018/822 (known as "DAC6") regarding the mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements. In essence, this framework is designed to require persons involved in either the promotion, design, marketing, implementation or management of a relevant arrangement or structure in the relevant jurisdiction, to be legally obligated to report the existence of the arrangement or structure and the users of it to the relevant tax authority which, in turn, shall exchange the relevant information to those jurisdictions in which the users are resident, subject to the relevant international exchange relationships being in place. Although there are differences between the reporting requirements under the EU's DAC6 and the OECD's MDR, particularly with respect to the circumstances where a requirement to make a disclosure would be triggered, DAC6 seems to cover a part that is the equivalent of the MDR published by the OECD.

The EU Member States are working towards a 31 December 2019 timescale. For non-EU jurisdictions in Europe, such as Guernsey, as at 31 October 2019, it is intended to implement the MDR, which is also expected to be the preference of the other Crown Dependencies. Although it remains to be seen we understand there is a presumption that the United Kingdom will also adopt the MDR rather than the DAC6 in light of Brexit.

The takeaway

Clearly, the Hong Kong SAR and Mainland China governments have been active in adopting the measures to tackle cross-border tax evasion and fraud, as demonstrated by the implementation of the CRS after the conclusion of numerous DTAs and TIEAs. Although Hong Kong and China have not implemented the OECD's MDR, the OECD's CRS frameworks should continue to contribute further to the tax transparency on structures and potentially bring to light those not having been subject to a material level of scrutiny yet.

Service Providers should also carefully consider the implications of the CRS and the MDR, and seek advice from appropriate advisors in the relevant jurisdictions on the implications for themselves and/or their clients. On a cautious note, if caught within the scope of the MDR, any schemes (deemed to be) put in place for their clients that avoid reporting under the CRS, or preventing the identification of the beneficial owners of entities or trusts, may trigger new reporting obligations on their part.

Given the exposure to penalties and possibly even criminal prosecution in home jurisdictions, it is advisable that families and individuals who have established or are users or beneficiaries of offshore trust and/or company structures should evaluate the tax and legal implications or their structures, preparing for the scrutiny that is expected to arise or has already arisen in respect of themselves as individuals, entities and controlling persons of certain entity accounts on an annual basis.

In essence, trusts remain as a useful instrument for reasons including asset protection, succession planning and confidentiality, but in particular settlors and beneficiaries of trust structures should seek advice while establishing offshore trusts and any underlying holding companies so as to be clear on the information that is likely to be made available to the tax authorities of the jurisdiction(s) where they are resident, review whether their tax matters are in order, and resolve issues in case there are any issues to be resolved. Likewise for offshore structures that no doubt continue to offer advantages that retain their usefulness, but again, the need for a proper review and analysis of the use of offshore structures in the new global environment of tax transparency and fiscal responsibility cannot be over-emphasized.

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