Vivien Teu & Co LLP
張慧雯律師事務所
有限法律責任合夥

LEGAL UPDATE

Hong Kong Implementation of Common Reporting Standard and Automatic Exchange of Information

The Common Reporting Standard (**CRS**) introduced by the Organization of Economic Cooperation and Development (**OECD**) for inter-governmental automatic exchange of information (**AEOI**) is a significant initiative that could be a paradigm shift in the financial industry.

CRS will soon be implemented in Hong Kong, following the Inland Revenue (Amendment) (No.3) Ordinance 2016, published in the Gazette and which became effective on 30 June 2016. Financial institutions and intermediaries in Hong Kong will be under legal obligation to report to the Inland Revenue Department (**IRD**) on financial accounts for reportable persons, starting 2017, with first reporting to be made to IRD by 31 May the following year, ie. 31 May 2018. Hong Kong IRD will conduct the first automatic information exchange with relevant jurisdictions on a reciprocal basis by the end of 2018.

According to the IRD: *"Under the AEOI standard, a financial institution (**FI**) is required to identify financial accounts held by tax residents of reportable jurisdictions in accordance with due diligence procedures. FIs are required to collect the reportable information of these accounts and furnish such information to the Department. The Department will exchange the information with the tax authorities of the AEOI partner jurisdictions on an annual basis."*

The AEOI requirement will cover individuals who are tax residents of "reportable jurisdictions", being jurisdictions with which Hong Kong has entered into an AEOI arrangement. Financial institutions are not required to report information on accounts where the account holder is not tax resident in a jurisdiction with AEOI agreement with Hong Kong.

In general, whether or not an individual is a tax resident of a jurisdiction is determined by the tax law of the jurisdiction, and typically having regard to the person's physical presence or stay in a place (e.g. whether over 183 days or such other relevant threshold period within a tax year) or, in the case of a company, the place of incorporation or where the central management and control of the entity lies.[1] FIs may request account holders to provide self-certifications on tax residency in order to determine whether the accounts fall within scope of reporting under AEOI.

On 9 September 2016, the IRD issued the "**Guidance for Financial Institutions**" (**IRD Guidance**), with further detailed guidelines on the relevant reporting requirements and due diligence procedures, and includes clarifications with respect to collective investment schemes, and the treatment of trusts. A summary of the IRD Guidance is set out further below in this update.

---

[1] OECD has established a portal which provides information on tax residency rules in jurisdictions which have committed to implementing AEOI:
http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/tax-residency/#d.en.347760

Background

Traditionally, business owners and investors have a tendency of diversifying wealth and investments outside of the home jurisdictions. It has become common practice to establish varying holding structures including offshore accounts and offshore companies, which often carry the result, if not necessary the intent, of reducing the tax implications. This form of tax planning and at times unexpected reduced tax incidents or outright tax evasion are in recent years increasingly a subject of focus and counteractive measures by governments, and under greater public scrutiny.

Inter-governmental exercises are now underway as a coordinated effort to obtain more accurate depiction of the assets and income of their respective citizens on a global scale. At first, the US Foreign Account Tax Compliance Act (FATCA) was enacted in the US, and now the CRS follows suit as a framework for the exchange of information, bringing tax residents of more jurisdictions into the net.

With the intention to unify the exchange of information globally, CRS is a measure to improve tax transparency that has drawn upon previous information-sharing legislation of similar nature such as the EU Savings Directive (2003) and FATCA (2010). CRS provides a common global approach for establishing the types of financial information to be obtained, such as the assets and income of financial accounts, the relevant individuals/account-holders for reporting, the expectations on the roles and obligations of financial institutions, and the framework for automatic exchange of information with the respective governments of relevant individuals.

CRS: A global reporting standard

As at 26 July 2016, 101 countries have endorsed the 'Declaration on Automatic Exchange of Information in Tax Matters' released by the OECD. The declaration was drafted for countries to commit to the implementation of a single global standard for "Automatic Exchange of Financial Account Information in Tax Matter" (AEOI).

According to the CRS Implementation Handbook published by the OECD in 2015, the following is a list of information to be reported and automatically exchanged between relevant countries on an annual basis:

1. the name, address, Taxpayer Identification Number (TIN) and date and place of birth (in the case of an individual) of each 'Reportable Person' that is an 'Account Holder' of the said account;

2. the account number (or functional equivalent in the absence of an actual number);

3. the name and identifying number (if any) of the 'Reporting Financial Institution';

4. the account balance or value (including in the case of a 'Cash Value Insurance Contract' or 'Annuity Contract', the Cash Value or surrender value) as of the end of the relevant calendar year or other appropriate reporting period or, if the account was closed during such year or period, the closure of the account;

5. in the case of any 'Custodial Account' (holding financial assets):

a. the total gross amount of interest, the total gross amount of dividends, and the total gross amount of other income generated with respect to the assets held in the account, in each case paid or credited to the account (or with respect to the account) during the calendar year or other appropriate reporting period; and

b. the total gross proceeds from the sale or redemption of property paid or credited to the account during the calendar year or other appropriate reporting period with respect to which the Reporting Financial Institution acted as a custodian, broker, nominee, or otherwise as an agent for the Account Holder.

6. in the case of any 'Depository Account', the total gross amount of interest paid or credited to the account during the calendar year or other appropriate reporting period; and

7. in the case of any account not described above, the total gross amount paid or credited to the Account Holder with respect to the account during the calendar year or other appropriate reporting period with respect to which the Reporting Financial Institution is the obligor or debtor, including the aggregate amount of any redemption payment made to the Account Holder during the calendar year or other appropriate reporting period.

Although OECD has issued details on CRS, information collection and reporting will need to be undertaken subject to local laws and regulations. For example, if local rules do not allow collection of certain information (such as TIN, date of birth or place of birth), such information may not be collected or reported unless otherwise authorized by local law. Accordingly, most (if not all) jurisdictions who have committed to the CRS would introduce local regulations for effecting implementation.

Early adopters of the CRS include the Crown Dependencies (Jersey, Guernsey and the Isle of Man), many British Overseas Territories (The British Virgin Islands (BVI), the Cayman Islands, Bermuda and Gibraltar) and European countries such as the United Kingdom, Luxembourg, Ireland, Malta, France, Germany and Netherlands. These countries and territories first adopted the CRS requirements for implementation from 1 January 2016 and are expected to undertake first rounds of information exchange in respect of the financial information of foreign tax residence account holders by September 2017.

Hong Kong, China, Macau, Singapore, Malaysia, Australia and New Zealand are among the jurisdictions that have pledged to adopt the standard at a later stage and so will begin to implement the requirement from 1 January 2017 (at the earliest) and to aim to commence the first rounds of information exchange by September 2018.

CRS in Hong Kong

The Inland Revenue (Amendment) (No.3) Ordinance 2016 was introduced specifically for the purpose of implementing CRS in Hong Kong. Hong Kong law on personal data privacy strictly restricts disclosure of personal data of data subject, therefore the proposed disclosure of financial information for AEOI needs to be specifically authorized by law.

Currently Hong Kong has in place a network of Comprehensive Double Taxation Agreements (CDTAs) and Tax Information Exchange Agreement (TIEA), being existing agreements for bilateral mutual cooperation and exchange of information for avoidance of double taxation and to counter tax evasion. However information exchange under CDTAs and TIEAs are not automatic, but information shall be provided to a treaty partner/counterparty to TIEA only upon its specific request. These jurisdictions with which Hong Kong has entered into CDTA and TIEA are not automatically AEOI partners. IRD has indicated that it shall identify potential AEOI partners from these jurisdictions and aim to conclude AEOI negotiations by end of 2016, to be published in a new schedule to the Inland Revenue Ordinance (subject to vetting by Legislative Council).

Hong Kong is adopting AEOI on a 'bilateral basis' with respective partner jurisdictions, which means that Hong Kong retains a level of discretion as to the countries with which it chooses to be AEOI partner as opposed to adopting the "wider approach" multilateral instrument through the signing of the "Multilateral Convention on Mutual Administrative Assistance in Tax Matter" that will cover all participating jurisdictions in this multilateral agreement. There was some industry concern that this will lead to higher compliance costs and inefficiency of requiring review and update of due diligence procedures each time Hong Kong signs on a new AEOI jurisdiction. In this regard, the law enacted on CRS has set out the expected due diligence obligations for identifying and collecting information in reportable accounts, and specifically stipulates that a reporting financial institution may apply the required procedures to any financial account, even where the account holder is tax resident in a territory that is not a reportable jurisdiction.

The Inland Revenue (Amendment) (No.3) Ordinance 2016 introduces the legislative and operational framework for adopting CRS in Hong Kong, covering the following key areas:-

- the scope of financial institutions, non-reporting institutions, reportable and excluded accounts;
- the types of information financial institutions shall collect and report on account holders;
- the due diligence procedures and reporting requirements to be adopted by financial institutions;
- the role of the Hong Kong Inland Revenue Department (IRD) in collecting relevant information from financial institutions and the delivering of such information to designated bilateral AEOI partners;
- the penalty(s) for failure by financial institutions to comply with the AEOI requirements, and the IRD's power to enter business premises for inspection;
- the mechanism to be adopted by financial institutions to safeguard confidentiality; and
- the compliance system and process, as well as electronic data infrastructure, to record, transmit or otherwise support the implementation of such requirements.

As defined, "financial institution" (FI) means:

(a) a custodial institution;
(b) a depository institution;
(c) an investment entity; or
(d) a specified insurance company.

The range of Hong Kong FIs subject to due diligence and reporting obligations for CRS thus covers commercial and savings banks, custodian banks or other entities that hold financial assets, insurance companies, entities licensed with the Securities and Futures Commission (SFC) to conduct regulated activities of type 1 (dealing in securities), type 2 (trading in futures contracts), type 3 (leveraged foreign exchange trading) or type 9 (asset management), SFC authorized collective investment schemes (CIS) or other entities primarily engaged in the business of trading, investment, administering or managing money or financial assets (not including non-debt direct interest in real property) on behalf of others or are managed investment entities (by an FI).

However, mandatory provident fund (MPF) schemes, occupational retirement schemes (ORSO), and approved pooled investment fund (APIFs) for investment by MPF and/or ORSO only, or regulated CIS all of the interests of which are held by non-reportable persons, are "non-reporting financial institutions".

Guidance for Financial Institutions

Details on the reporting obligations and requirements on FIs are set out in the "Guidance for Financial Institutions" issued by IRD on 9 September 2016 (**IRD Guidance**).

Reporting Financial Institutions

The IRD Guidance contains clarifications on "reporting financial institutions", which cover Hong Kong incorporated "FIs", or if incorporated outside Hong Kong, where the normal management and control are in Hong Kong, or if established as a trust or other legal form, where constituted under the laws of Hong Kong or normally managed or controlled in Hong Kong. An FI in the form of a trust will also be caught where one or more of its trustees are resident in Hong Kong.

Among the categories of "reporting financial institutions", a "custodial institution" is subject to reporting obligations where it is an entity with a substantial portion of its business in the holding of financial assets for the account of others, applying a threshold of 20% gross income in determining whether a "substantial portion' of the business. Intermediaries that are "execution-only brokers" will not hold financial assets and therefore are not custodial institutions, but may be reporting FIs by virtue of other criteria, for example as an "investment entity".

Fund nominees, fund intermediaries and fund platforms engaged in fund distributions and which hold assets on behalf of clients should generally be regarded as "custodial institutions", unless there are specific factors for characterizing the business as "investment entity".

While "investment entity" is defined to include entities primarily engaged in the business of trading, investment, administering or managing money or financial assets (not including non-debt direct interest in real property), the term excludes investment holding companies or treasury centres that are members of non-financial group, start-up entities, or entities that are liquidating or emerging from bankruptcy.

"Investment entity" will cover investment funds that are managed by a financial institution, say an investment manager licensed by the SFC to conduct type 9 regulated activity (asset management), with at least 50% of its income attributable to investing, reinvesting or trading in financial assets. Additional guidance is also provided with respect to trusts, charities, partnerships, personal investment companies and securitization vehicles, as to the situations or conditions in which these may or may not be regarded as "investment entity", and how the reporting obligations apply.

The IRD Guidance specifically indicates that an entity would generally fall to be an "investment entity" if it functions or holds itself out as a collective investment vehicle, mutual fund, exchange traded fund, private equity fund, hedge fund, venture capital fund, leveraged buy-out fund or any similar investment vehicle established with an investment strategy of investment, reinvestment or trading in financial assets.

The reporting obligations of a CIS apply only to registered account holders, and in this regard, it mainly applies to individual direct holders. For interests of the CIS held by fund distributors (nominees, platform or intermediaries), these are FIs subject to their own obligation to report their account holders.

Obligations on FI maintaining financial accounts

It is note-worthy that the IRD Guidance sets down an expectation that generally, for authorized CIS or investment entity such as private equity fund, hedge fund or similar investment vehicle that are not SFC authorized and which are in non-corporate legal form, the fund manager as the one with responsibility with fulfilling anti-money laundering obligations or having most in-depth knowledge of equity or debt interest holders shall be considered as having the obligation to maintain financial accounts and perform the CRS reporting requirements, although a service provider may be appointed to carry out the due diligence and reporting obligations. An entity involved in investing, administering or managing financial assets of a CIS but which is not obliged to maintain financial accounts is not subject to the reporting obligations.

Pre-existing Accounts and New Accounts

Accounts that exist as at 31 December 2016 are reportable accounts, however a distinction is drawn between high value and low value accounts in applying the manner and timeframe for due diligence requirements. High value accounts for individuals are those with an aggregate balance or value that exceeds an amount equivalent to HK$7.8million, whereas for entity accounts, the threshold value is HK$1.95 million. In any case, pursuant to the "wide approach", reporting financial institutions shall identify the tax residency status of the account holders of all pre-existing accounts as at 31 December 2016, in order to determine accounts of reportable jurisdictions.

Tax residency of low value accounts for individuals may be identified through residence address or electronic record search, while enhanced due diligence procedures or self-certification by the account holders shall be required for high value accounts. For pre-existing entity accounts, an account is a reportable account if it is identified as being held by one or more entities that are reportable persons or which are passive NFE (non-financial entities) with one or more controlling persons that are reportable persons.

New accounts that are opened on or after 1 January 2017 are subject to specific due diligence requirements upon account opening, including a form of self-certification from the account holder to establish the tax residency.

The IRD Guidance also describes circumstances where reporting financial institutions may not rely on self-certification by account holders, such as where there is reason to know that the self-certification or other documentation of an account is unreliable or incorrect, based on the standard of a reasonably prudent person.

FATCA: Comparison and Contrast

Quite naturally, comparisons can be drawn between FATCA reporting obligations imposed by the US on foreign financial institutions (FFIs) and the requirements for CRS under the OECD AEOI framework. One should also be aware of the key features that differentiate the two. Where under FATCA FFIs would primarily identify clients as US or non-US, CRS is based on the specific tax residency of account-holders which could extend to 101 jurisdictions based on current commitments made to OECD. Through CRS, financial institutions are required to report account information held by overseas tax residents to their local tax authorities, who will in turn engage in automatic information exchange with relevant foreign tax authorities based on the tax residencies of reported accounts. As a result of the need to identify and manage information relating to clients of multiple respective tax residency jurisdictions, the sheer scope and volume of reporting obligations under CRS should far exceed those required by FATCA. A common approach adopted by financial institutions of limiting accounts with US clients is clearly not feasible in this context. Another distinction lies that, unlike FATCA, there are no withholding obligations under CRS, with penalty for tax non-compliance on the account holder as determined by relevant government under the law of the home jurisdiction. However FIs may commit an offence for failing to report as required under local law where the accounts sit.

Hong Kong

Hong Kong and the US signed a Model 2 Inter-Governmental Agreement (IGA) on 13 November 2014 pursuant to which foreign financial institutions in Hong Kong are required to provide all relevant account information of US account holders directly to the US Internal Revenue Service (IRS). Financial institutions in Hong Kong would have since put in place necessary due diligence procedures for screening and identifying US clients, and obtaining "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting" forms for either individuals or entities (also known as the W-8BEN and W-8BEN-e forms, respectively).

Hong Kong financial institutions caught as "reporting FIs" under CRS would no doubt need to engage in reviews and implementation of new client due diligence procedures for identifying reportable accounts, collecting and reporting required account holder information and financial information in order to comply with the reporting requirements effective 2017.

CRS in China:

As China is yet to finalize terms of the IGA for FATCA, CRS may yet to be the main focus for the Chinese government. Being one of the later adopters of the standard, China will need to aim to comply with its first round for exchange of information in 2018. However, there is some speculation as to whether China will be able to meet this global deadline.

Registered FFIs with approved FATCA registration (as of 25 June 2016):

Hong Kong – 4,033
China – 1,297
(extracted from the IRS Foreign Financial Institution List (*FATCA Registered) database*)

China

In contrast to the Model 2 IGA applicable to Hong Kong with direct reporting to the US, China has entered into an "agreement in substance" with the US under Model 1 IGA. While the Chinese government has yet to produce or publish any local legislation directly addressing the reporting requirements to take place in light of the IGA, it is reported that Chinese banks and FFIs have begun and continue to actively report US taxpayers information present within the jurisdiction. As of the date of this article, no local guidance has been issued as to how FATCA reporting should be carried out.

While China's "agreement in substance" status remains unchanged, it is clear that the approach adopted by Chinese institutions is drastically different from what is required in Hong Kong. Considering the sheer size of the Chinese market compared to Hong Kong, it is note-worthy that the number of registered Hong Kong FFIs vastly outnumbers its Chinese counterparts by almost four folds. This may be indicative of Chinese institutions taking a measured stance awaiting final instruction to be set by the Chinese government.

By virtue of being a Model 1 IGA, China financial institutions have no obligation to report account details and information to the IRS, but instead report to the relevant China authority, who shall in turn would provide such information to the IRS. While this may relieve some domestic stress involved with sending such information abroad, there remains concern and uncertainty around how the Chinese government will enforce these reporting policies and the standard to adopt. On the other hand, the adoption of FATCA reporting in China could at the same time lay groundwork for CRS reporting, in view of the committed timeline of reporting by 2017 and automatic intergovernmental information exchange by September 2018.

Reflection

Considering the large number of jurisdictions that have committed to CRS and AEOI globally, the extensive scope of financial assets and reportable accounts, and the range of financial institutions that will be subject to reporting requirements, tax evasion through hiding of assets in a foreign jurisdiction should become impossible and a thing of the past. It will, and has already begun to, drive the re-ordering of financial assets and investment holdings into more transparency and legitimacy. As an example of the shape of things to come, the Indonesia government announced a tax amnesty program on 28 June 2016, providing a limited time within which Indonesia tax residents may pay a specific defined tax charge in exchange for forgiveness of outstanding tax liabilities, under which declaration of offshore assets shall be made with or without repatriation.

The CRS framework no doubt introduces significant increased compliance burden and costs across the financial industry, and the AEOI reporting requirements cover all accounts without a need for any suspicion of tax foul play. The reach could extend to all individuals with personal connections and assets in multiple jurisdictions.

The full effects of this broad and new global initiative remain to be seen, and the requirements shall soon be implemented to a schedule, not just in Hong Kong, but throughout the entire global financial network.

Contact Details

If you have any question or require advice on the subject matters covered in this publication, please feel free to contact the following people or your usual contact at our firm.

Vivien Teu
Managing Partner
Vivien Teu & Co
Tel: (852) 2969 5316
vivien.teu@vteu.co