Issue
08
Regular journal of exploiting Common Reporting Standard weaknesses

CRS TIMES

3 August 2018

Author: Mark Morris
www.the-best-of-both-worlds.com

Issue highlights

By far the most popular way to avoid automatic exchange of information is the USA due to no reciprocal FATCA with China. Taiwan is also a popular non-participating jurisdiction to hide assets.

Another tax evasion tactic are irrevocable trusts are settled with previously **undeclared capital.** Current weak Chinese CFC rules and future CFC amendments do would not apply. Nil reporting on settlors of such trusts also inhibits investigation of undeclared capital to establish these trusts.

Other ways to evade tax and CRS reporting is the use of untaxed Active NFEs, listing companies on small exchanges such as Curacao, investment entities not reporting on equity interest if both the management and ownership are located in China, false residence by means of investment, hiding portfolios in sham Hong Kong retirement savings or using prohibited insurance wrappers, irrevocable insurance, and ignoring MDR to hold properties.

Chinese favourite tax evasion methods

this issue

How Chinese residents avoid tax

How Chinese residents avoid CRS

China's weak CFC rules on individuals make it incredibly simple to avoid tax on previously undeclared capital by setting up irrevocable trusts, especially in Singapore

Singapore investment entity irrevocable trust: Tax planners' favourite avoidance scheme for Chinese residents involves assisting establishing irrevocable trusts. Even if the trust is reported for CRS, there is no tax on the trust income due to no CFC rules for individuals. Even when CFC rules are introduced there will be no tax liability on the trust as the settlor has no control over the irrevocable trust.

Furthermore, if the trust is categorized as an investment entity, i.e. has a corporate trustee and the trust earns mostly financial income, there is no reporting on beneficiaries until a distribution is made. Trusts may instead make a loan to beneficiaries which is not reported as a distribution.

Singapore goes the extra length to ensure the Chinese authorities are not aware of the value of the trust established by the settlor by guiding the trustees to report a nil value for settlors of investment entity irrevocable trusts.

Preventing investigation and tax status of assets used to establish irrevocable trusts

When China receives from Singapore a nil value on the settlor, tax authorities will incorrectly believe the trust has no value and not investigate if the capital used to establish the trust was ever declared. Combined with no CFC rules for individuals, income and capital of irrevocable trusts may never be taxed.

THE ONLY WAY FOR CHINA TO ADDRESS THIS IS TO DEMAND THAT THE OECD CLARIFY THAT THE ENTIRE TRUST VALURE BE REPORTED FOR SETTLORS OF IRREVOCABLE INVESTMENT ENTITY TRUSTS.

Proof that Singapore is illogical and assisting CRS evaders: The CRS and the Implementation Handbook mandates that the entire account value be reported for the settlor of passive NFE trusts, whether irrevocable or not. So why does Singapore guide a nil report if the irrevocable trust is categorized as an investment entity? There is no difference in principle between investment entity and Passive NFE trust.

OECD usually wants relevant information BEPS Action Plan recognizes that one of the key challenges faced by tax authorities is a lack of timely, comprehensive and relevant information. There is no argument that a nil value is comprehensive, relevant and timely.

Growl of this issue

Most Financial Institutions wrongly accept a client's self-certification of being an Active NFE if the entity claims its income is a business or trade and the company has premises and staff.

Two issues here that are totally incorrect:

1. Banks do not study the balance sheet to determine if more than 50% assets can produce passive income. In most cases, these businesses and trade entities hold more than 50% assets in cash. Worse, many FIs are incorrectly opine cash is not a financial asset, despite the FAQ indicating cash can produce passive income in a Passive NFE test.

2. Banks do not study client's income and balance sheet

Banks are supposed to retest the asset and income test annually to determine the status of type [A] Active NFE. In practice, once a bank accepts the Active NFE categorization, it is set in stone. This is wrong.

An untaxed NFE is the most popular way to avoid the CRS

It is Nirvana for CRS evaders to have their offshore entities categorized as an Active NFE because there is no reporting on the controlling persons.

I. Erroneously categorizing entities doing business or trade as Active NFEs

Most banks in tax haven will readily accept self-certification that an entity is an Active NFE so that there is no reporting on the controlling persons. Banks invariably categorise any entity who earns most of its income from business (e.g. consulting or IP) or trade (import & export) as Active NFE. Some banks may request proof of premises and staff. However, this categorization is incorrect if more than 50% of the assets are cash. In most cases, these entities have most, if not all their assets as cash, Therefore, these entities should be correctly categorised as Passive NFEs and the controlling persons should be reported.

II- Banks make another error in favour of CRS evaders

Furthermore, banks maintaining the accounts of Active NFE ubiquitously make the error of reporting the account holder (the entity) to the place of incorporation, rather than tax residence jurisdiction. This means, that, a bank will report a BVI Active NFE to the BVI instead of China as its place of management.

For example, a Chinese tax resident owning a Hong Kong entity used to import from China and export to USA. This entity is likely tax resident in China as its place of management as well as China. Yet the bank will report only to Hong Kong.

Another example is a Chinese tax resident owning a BVI company to collect consulting fees. Even if the bank incorrectly categorises the company as an Active NFE (it should be passive NFE), the banks will invariably report the account holder (the entity) to the BVI as its place of incorporation, rather than to China, its tax residence due to place of management.

THE ONLY WAY FOR CHINA TO TACKLE THIS ABUSE OF ACTIVE NFES IS TO HAVE THE OECD REMIND FIS THAT MOST ENTITIES DOING BUSINESS AND TRADE MAY BE PASSIVE IF IT HAS MORE THAN 50% CASH. ALSO, ACTIVE NFEs SHOULD BE REPORTED TO PLACE OF MANAGEMENT AND PLACE OF INCORPORATION DEPENDING ON THE RULES OF TAX RESIDENCE.

As a side note. There is no justification for an untaxed Active NFE to be exempt from CRS reporting. There is no difference between untaxed financial income and untaxed business income.

CRS flaw enables simple conversion of Passive NFE to Active NFE

To convert a Passive Non-Financial Entity which earns mostly trading or business income (sales commissions, consulting, buying and selling profits, IP, and has mostly cash assets, form a parent company to own the entity.

Strip the cash from the subsidiary with regular interim dividends. Voila, the holding company and subsidiary will be Active NFEs.

CRSTimes
CRS Expert

List private investment company on a small stock exchange to be incorrectly classified as non-reportable, despite not meeting regularly traded criteria

Small stock exchange of choice for CRS evaders

Dutch Caribbean Securities Exchange
In Curacao

Listing on small stock exchange to avoid CRS through misapplication of CRS

Chinese resident lists his private investment company on small stock exchange and bank, in collusion, accepts that the entity is a non-reportable person because the bank misunderstands that listed equals regularly traded.

Chinese resident clients holding offshore private companies avoid the CRS by working with service providers and banks who misapply or misunderstand the CRS to list their company on a small offshore stock exchange.

The exchanges of choice for evaders are Jersey, Malta, Cyprus and primarily the Dutch Caribbean Securities Exchange in Curacao where investors of any level may use the startup exchange as there are no minimum income or investment requirements.

Critical to the avoidance of CRS, there is ubiquitous misunderstanding by banks maintaining the accounts of these listed companies to accept the self-certification that these companies are non-reportable persons.

Regularly traded requires a listed stock to satisfy four criteria to be a non-reportable person, namely

1. Meaningful volume traded of at least 10% of shares.
2. Regularly quoted where dealers buy and sell stock for sale to unrelated persons.
3. On an ongoing basis of at least 60 business days per year.
4. On an established securities market with a market cap exceeding one billion USD.

In most cases, the CRS evasion tactic does not meet the criteria to be regularly traded yet banks are treating these listings incorrectly as non-reportable regularly traded persons.

In any event, Active or Passive the implementation handbook pg. 70 par (148) says Controlling Persons do not need to be identified for listed entities, evebn if there is one owner. The term Controlling Persons corresponds to the term "beneficial owner" as described in the Financial Action Task Force Recommendations (FATF), in Recommendation 10 and the corresponding Interpretive Guidance. FATF Recommendations do not require the determination of beneficial ownership if an Entity is (or is a majority owned subsidiary of) a company that is listed on a stock exchange and is subject to market regulation and to disclosure requirements (either by stock exchange rules or through law or enforceable means) to ensure adequate transparency of beneficial ownership. Further, FATF Recommendations do not require determination of beneficial ownership of a controlling interest that is held by an Entity described in the preceding sentence. Thus, in such cases, it is accepted that a Reporting Financial Institution will not be able to determine the Controlling Persons for CRS purposes.

CRS Commentary on Regularly Traded criteria to be non-reportable person

Page 92 par (112) Non-reportable Person can depend on the stock of that corporation being <u>regularly traded if:</u>

a) **meaningful volume of trading** the aggregate number of shares during the prior year at least 10% of the average number of shares

b) **regularly quoted** by dealers making a market in the stock. A dealer makes a market in a stock only if the dealer regularly and actively offers to, and in fact does, purchase the stock from, and sell the stock to, customers who are not related persons with respect to the dealer in the ordinary course of a business.

c) **an on-going basis** trades in each such class are effected, *other than in de minimis quantities* on at least 60 business days during the prior calendar year

d) **traded on an established securities** market if it has an annual value of shares traded on the exchange exceeding USD one billion during each of the 3 calendar years.

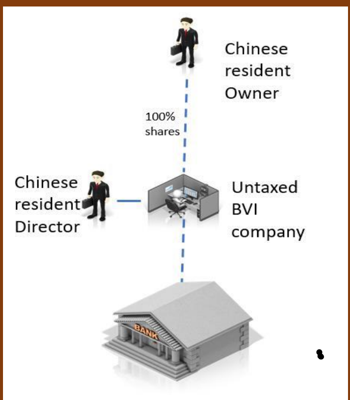
Mandatory Disclosure Rules and CRS FAQ updates – Tax haven jurisdictions laughing it off as either an option or not a minimum standard. The OECD attempts to close CRS loopholes through updates to the CRS FAQ. However, many tax havens CRS guidance state that FIs may rely on the FAQ but it is not CRS legislation. The OECD has made a valiant effort to close CRS loopholes with the Mandatory Disclosure Rules addressing CRS avoidance. Once again, most tax havens have stated the MDR is not a minimum standard and will not be adopting them. Hence, the loopholes continue. China should have the OECD ensure the FAQ and MDR is a minimum standard.

Investment entity flaw

An investment entity is located for CRS where it is incorporated if that jurisdiction's tax residence laws state so. It is also tax resident in its place of management, if the place of management tax residence laws state so.

If a Chinese-resident owner of a BVI company is also director of his investment entity, then the investment entity is located in its place of managed (because that is law of China) and it is not resident in BVI (because that is law of BVI).

In this example the Chinese director would not have to report on himself, as the entity and himself are tax-resident in China.



See how Netherlands counters this loophole

Abuse of residence by investment

For years, Chinese have been procuring St. Kitts passports and apartment, sight-unseen, without any visit ever being made, for visa-free travel.

However, the OECD encouraged residence-by-investment schemes when it made a huge error in its CRS due diligence by allowing FIs to accept jurisdiction reporting would be sent to according to account holder's government-issued identification plus utility bill. This insane mistake resulted in a huge uptick in Chinese residents procuring tax haven government issued identification (passports or residence visas) from St. Kitts, Greece UAE, Thailand, etc. Some ultra-high net worth Chinese individuals procured Singapore residency. In virtually every case of residence or citizenship by investment, the account holder is still tax resident in China, but the CRS reports are misdirected to the jurisdiction where client shows his procured residency.

The only way to address this abuse of residence by investment is to demand the OECD mandate FIs determine residency of account holders by OECD Model tax convention on residency, viz Permanent home, Centre of vital interest and habitual residence.

Trustee retirement funds

Some countries' laws provide sham retirement funds, such as Hong Kong ORSO or Singapore / Gibraltar trustee pensions. Members can contribute any asset into the retirement fund such as shares of private companies, yachts, properties, artwork, etc. Although a single fund, each member has their segregated account. Members can manage their own investment strategy and can decide to retire any time. These schemes do not tax the benefits of non-resident members

The OECD made a mistake when it allowed domestic law non-reporting FIs for savings plans equivalent to a broad participation retirement scheme.

The OECD has tried to address these sham schemes in the June 2018 update CRS FAQ "In case the fund is compartmentalised into sub-funds that are in practice working as separated pension products, including through the segregation of the assets, risks and income attributed to such sub-funds, does the five percent test apply at the level of the fund or at the level of each sub-fund? In such cases, the test of whether a single beneficiary has a right to more than 5% of the fund's assets is to be applied at the level of each sub-fund.

Pre-existing Insurance prohibited from being sold to Chinese residents

The dumbest loophole the OECD permits is exempting insurance contracts which are not allowed to be sold, but nevertheless are sold likely through a 3rd country, or when policyholder visited insurer jurisdiction.

Accounts not required to be reviewed, identified or Paragraph A exempts from review all Preexisting Individual Accounts that are Cash Value Insurance Contracts and Annuity Contracts, provided that the Reporting Financial Institution is effectively prevented by law from selling such contracts to residents of a Reportable Jurisdiction.

Reporting Financial Institution is "effectively prevented by law" from selling Cash Value Insurance Contracts or Annuity Contracts to residents of a Reportable Jurisdiction if: a) the law of the Reporting Financial Institution's jurisdiction prohibits or otherwise effectively prevents the sale of such contracts to residents in another jurisdiction; or b) the law of a Reportable Jurisdiction prohibits or otherwise effectively prevents the Reporting Financial Institution from selling such contracts to residents of such Reportable Jurisdiction.

Where the applicable law does not prohibit Reporting Financial Institutions from selling insurance or annuity contracts outright, but requires them to fulfil certain conditions prior to being able to sell such contracts to residents of the Reportable Jurisdiction (such as obtaining a license and registering the contracts), a Reporting Financial Institution that has not fulfilled the required conditions under the applicable law will be considered to be "effectively prevented by law" from selling such contracts to residents of such Reportable Jurisdiction.

Hiding accounts in USA – MDR missed chance

Over the Counter Derivatives to avoid CRS

Originally, banks created OTC products to circumvent the definition of interest for the EU Savings tax directive. The same banks are using the same structures to avoid the definition of financial accounts.

For example, a Swiss bank wraps a client's portfolio into a forward contract, whereby the client instead of owning the portfolio, will own a derivative, which is a private contract between two parties,

The OECD has attempted to address this abuse

1. in an update to the CRS FAQ (the definition of Financial Asset does not distinguish between exchange traded or listed derivatives or over-the- counter derivatives
2. In the Mandatory Disclosure Rules

However, these banks are in tax havens which do not consider the FAQ has part of the CRS, nor will adopt the MDR. Hence this loophole will continue

The OECD continuously it is satisfactory that the USA is not a CRS participant because United States has undertaken automatic information exchanges pursuant to FATCA from 2015 and entered into Intergovernmental Agreements (IGAs) with other jurisdictions to do so. The Model 1A IGAs entered into acknowledge the need for the USA to achieve equivalent levels of reciprocal automatic information exchange with partner jurisdictions, including a political commitment to pursue the adoption of regulations and to advocate and support relevant legislation to achieve such equivalent levels of reciprocal automatic exchange.

Since FATCA was approved 8 years ago, there is no chance the US Congress will approve equivalent reciprocal automatic exchange of information. The non-existent reciprocal IGA information is restricted to depositary interest held by individuals, with no reporting on capital value. Furthermore, US banks offer CRS evaders zero interest deposits or products that simulate interest, as was done to avoid the EU Savings tax directive more than ten years ago.

Unacknowledged by the OECD, is that Congress maintains a political biased list of countries that the US regards as appropriate provide information to. This is updated annually with one or two additions. See Rev Proc 2017-46 which has only around 40 countries, compared to the 100+ IGA Model 1A. China does not receive any FATCA reciprocal information from USA.

"After how many more years of no progress on the political commitment will appeasement by the OECD no longer be acceptable?"

The Mandatory Disclosure Rules addressing circumvention of CRS, says any Financial Institution shifting accounts to USA upon clients' instruction is not a reportable arrangement.

The only way for China to address shifting of accounts to USA ask OECD to obligate reporting of any account shifted to the USA since 2014.

To Subscribe

mark.morris@the-best-of-both-worlds.com

+41 76 212 20.24

CRSTimes
CRS Expert