

## Issue highlights

Exploiting non-reporting of investment entity if it is located in the same jurisdiction as its equity interest account holders



## this issue

Investment entity  
loophole as wide as  
mountain and simple  
as that!

## Exploiting a serious structural flaw of Common Reporting Standard

**There is no account review if reportable person is in the same jurisdiction of FI**

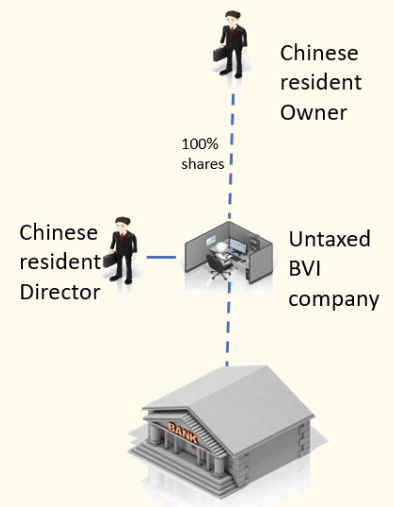
Simple to ensure an investment entity FI, is in same jurisdiction as the reportable person

**A single-individual or restricted number of same family member owning an untaxed investment entity is invariably tax-resident in the jurisdiction of the owners. Jackpot, no CRS reporting!**

For CRS purposes an entity is located where it is incorporated if that jurisdiction's tax residence laws state so. It is also tax resident in the jurisdiction of its place of management, if that jurisdiction tax residence laws state so. In virtually every case except Dubai, a tax haven entity is not tax resident in its place of incorporation, e.g. BVI, Cayman, Bahamas, Seychelles, Marshal islands, etc. Dubai's sham of untaxed entities being tax resident in UAE is covered in previous issues. So, besides Dubai, a tax haven entity is exclusively tax resident in its place of management. Dual residency of entities is covered in CRS Times issue 13 page 03.

For example, 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 management (because that is law of China) and it is not resident in BVI (because that is law of BVI).

Thus, the Chinese director would not have to report on himself, as the entity and himself are tax-resident in China. A significant structural CRS flaw.

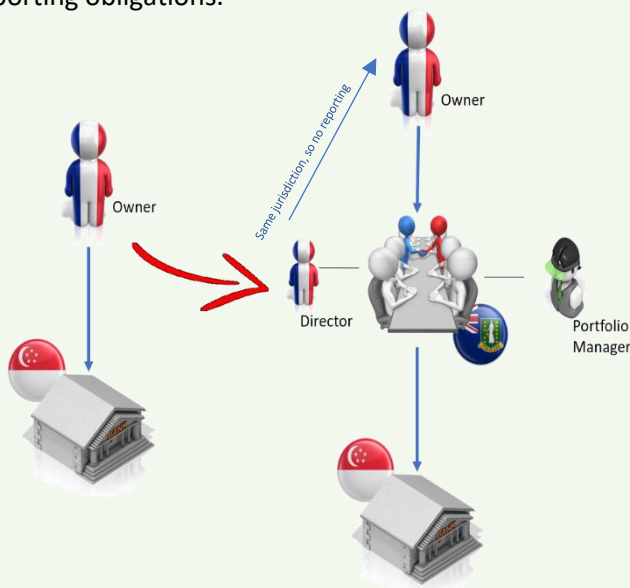


## Variations of exploiting the investment entity loophole



### A Transfer an individual's account into a non-reporting investment entity

French individual has a Singapore bank account. He establishes a BVI company for which he is the director. He shifts his individual account to the entity. He appoints an FI to manage some of the entity account assets on a discretionary basis. The entity is thus an investment entity, responsible for CRS reporting. The bank has no CRS reporting obligations.



The French resident is director and owner of entity. The entity is therefore tax resident in France, the place of management. The investment entity should report on the equity interest account holders of the entity if they are reportable jurisdiction persons.

As the equity interest account holder is resident in same jurisdiction as the investment entity (both France) the account holder is not in a reportable jurisdiction. CRS applies only when FI is in different jurisdiction from reportable person. Bingo. No CRS reporting.

### B Convert a Passive NFE into an investment entity

Assume entity earns non-passive income, e.g. consulting or commissions but most of its assets are financial assets, usually cash. It is impossible to categorize this entity as an investment entity CRS Pg. 44 par (6)(b) the gross income of which is primarily attributable to investing, reinvesting, or trading in Financial Assets. This entity will be a Passive NFE (unless FI colludes with client to categorize it incorrectly as an Active NFE type [A], see CRS Times issue 17.

However, it is possible to restructure it so that the entity becomes an Active NFE and an investment entity holding company. Simply form a new parent company to hold the existing Passive NFE. Then the parent strips the subsidiary entity of all its cash on a regular basis via dividend payments. Also, the existing entity procures some real assets such as computers.



- i. The existing entity will become an Active NFE type [A] as CRS Page 58 par (9)(a) calendar year or other appropriate reporting period is passive income and less than 50% of the assets held by the NFE during the preceding calendar year or other appropriate reporting period are assets that produce or are held for the production of passive income. No reporting on controlling person
- ii. The holding company, earns most of its income from investments (dividends) and appoints an FI to manage some of its financial assets on a discretionary basis The investment entity can thus exploit the structural flaw if owner and manager are the same jurisdiction.

## How Netherlands tackles this flaw

### Customer-definition

#### *Investment entity - Sole Shareholder*

In line with the Financial Action Task Force (“FATF”) recommendations, the Leidraad clarifies that there is no client relationship between an entity and the sole director/shareholder. In case of an entity that has more than one shareholder or if the investment activities of the entity are performed by a professional third party, a client relationship exists, and the entity is regarded as Investment Entity.

#### *Very limited group of family members*

As an exception, the Leidraad clarifies that if an entity has assets that consist of cash or investments, it should not qualify as an Investment Entity Financial Institution if (i) the entity has a *very limited* group of shareholders or participants that are part of the same family and that (ii) do not present themselves as an investment fund on the market and (iii) have neither raised nor will raise capital in the market. Even if these entities are professionally managed by a Financial Institution they should still not qualify as an Investment Entity, but as a Passive Non-Financial Entity.

### Observation

The Leidraad contains a clarification on the scope of the customer definition. By excluding sole shareholders and entities held by a very limited group of shareholders that are members of the same family, the Netherlands aligns with the FATF Recommendations as well as the approach that is taken by several other CRS and IGA countries.

## How OED can address this flaw



- Adapt the Netherlands view of not allowing an entity ultimately owned by a single individual or restricted to a few family members to be an investment entity  *recommended*
- or
- If equity interest account holders in same jurisdiction as entity, then cannot be an investment entity
- or
- Unregulated entity cannot be an investment entity, unless owned by a fund



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