Path to Transparency

The following summary is intended to give business advisors and business leaders an insight into the Common Reporting Standard regulations. It is based on Part 1 of the October 2014 Standard for Automatic Exchange of Financial Information and Part 1 of the August 2015 Standard for Automatic Exchange of Financial Information on Tax Matters – Implementation Handbook. As the rules are somewhat complex, I have focussed on matters that I believe to be relevant to professional advisors as well as entrepreneurs or top management working in industry and have attempted to present these in a simplified form.

BACKGROUND

Over the past few years much progress has been made by the OECD, EU and the Global Forum on Transparency and Exchange of Information for Tax Purposes in improving transparency and exchange of information on request. The international community is now making a quantum leap to automatic exchange of information.

The Common Reporting Standard (CRS), or the Standard for Automatic Exchange of Financial Account Information (AEoI), as it is also known, is an international initiative and traces its origin to the 2010 Convention on Mutual Administrative Assistance in Tax Matters (Convention). This Convention is open for adoption by countries that are member states of the Organisation for Economic Co-operation and Development (OECD) and Council of Europe. The Convention regulates information exchange between countries party to the Convention regarding tax matters. The concept is largely based on the US Foreign Account Tax Compliance Act (FATCA) implementation agreements. One of the main characteristics of the Convention is its global reach.

On the 29 October 2014 fifty one countries had signed the first ever Multilateral Competent Authority Agreement (CAA) to automatically exchange information, based on Article 6 of the Convention. By the 4 June 2015 the number of signatory countries had risen to 61 jurisdictions and as at the latest count on the 25 October 2015 this was now 74 (Click here to see signatories list). This CAA specifies the details of what information will be exchanged and when. The number of signatory countries to this multilateral CAA is expected to reach and exceed 100 over the next year with China and Hong Kong also agreeing to become signatories.

The EU has transposed the CRS by way of the amended EU Directive on Administrative Cooperation (DAC2 – Council Directive 2014/107/EU) so as to regulate EU member states as between themselves.

INTRODUCTION AND OVERVIEW

The CRS will need to be translated into domestic law either by way of Article 6 of the Convention or the equivalent Article 26 in a bilateral double taxation treaty or by an enhanced Tax Information Exchange Agreement (TIEA).

Countries translating the reporting and due diligence rules into domestic law need to take the following into consideration.
1.selecting a legal basis for the automatic exchange of information;
2.putting in place the necessary administrative and IT infrastructure; and
3.protecting confidentiality and safeguarding data.

Under the CRS, jurisdictions would obtain financial information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. The standard consists of two components:
1.the CRS, which contains the reporting and due diligence rules; and
2.the CAA, which contains the detailed rules on the exchange of information.

There are three Model CAAs contained in the standard, each developed to suit a different scenario:
1.The first Model CAA is a bilateral and reciprocal model. It is designed to be used in conjunction with Article 26 of the OECD Model Double Taxation Agreement.
2.The second Model CAA is a multilateral CAA. This could be used in conjunction with the Convention, something a very significant number of jurisdictions have already done.

3.Finally the third Model CAA is a non-reciprocal model provided for use where appropriate (e.g., where a jurisdiction does not have an income tax).

There will be Financial Institutions and Financial Accounts that present a low risk of being used for tax evasion but which the CRS does not identify as such. The CRS therefore provides for jurisdictions to identify these as Non-Reporting Financial Institutions or Excluded Accounts (i.e. non-reportable accounts) in their domestic law. This will be a key area for jurisdictions to consider during the legislative process.

Implementing the CRS effectively not only requires the reporting obligations to be translated into domestic law but the introduction of a framework to enforce compliance with those obligations. The CRS therefore specifically requires jurisdictions to ensure that it is effectively implemented and applied by financial institutions, including the introduction of provisions that:
1.prevent circumvention of the CRS (anti-abuse provisions);
2.require reporting financial institutions to keep records of the steps undertaken to comply with the CRS (record-keeping requirements); and
3.permit the effective enforcement of the obligations in the CRS (including penalties for non-compliance).

REPORTING ENTITIES

The entities obliged to report and the reportable accounts are defined broadly in order to avoid an abusive interpretation of the rules:
1.The financial information to be reported with respect to reportable accounts includes all types of investment income (including interest, dividends, income from certain insurance contracts and other similar types of income) but also account balances and sales proceeds from financial assets and other income generated with respect to assets held in the account or payments made with respect to the account;
2.The financial institutions that are required to report under the CRS do not only include banks and custodians but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance companies;
3.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 that ultimately control these entities.

The CRS also describes the due diligence procedures that must be followed by financial institutions to identify reportable accounts.

This new global standard does not, nor is it intended to, restrict other types or categories of automatic exchange of information. It intends to set out a minimum standard in the field of information exchange. Moreover Jurisdictions may choose to exchange information beyond the minimum standard set out in the CRS.

ANTI ABUSE AND DUE DILIGENCE

In order to limit the opportunities for taxpayers to circumvent the reporting by shifting assets to institutions or investing in products not covered by the CRS, the reporting regime:
1.contemplates situations where a taxpayer seeks to hide capital that itself represents income or assets on which tax has been evaded (e.g. by requiring information on account balances);
2.requires reporting not only with respect to individuals, but also limits opportunities for taxpayers to circumvent reporting by using interposed legal entities or arrangements. Financial institutions are required to look through shell companies, trusts or similar arrangements, including taxable entities to cover situations where a taxpayer seeks to hide the principal but is willing to pay tax on the income;
3.covers not only banks but also other financial institutions such as brokers, certain collective investment vehicles and certain insurance companies.

In addition to a common standard on the scope of the information to be collected and exchanged, the standard imposes a comprehensive set of due diligence procedures to be followed by financial institutions in order to identify reportable accounts and obtain the account holder’s and/or ultimate controlling party’s identifying information. The due diligence procedures are critical to the integrity of the information that is reported and exchanged.

ACCOUNTS TO BE REPORTED

The due diligence procedures to be performed by reporting financial institutions in relation to the identification of reportable accounts distinguish between individual accounts and entity accounts. They also make a distinction between pre-existing and new accounts.

Pre-existing Individual Accounts – Financial Institutions are required to review accounts without application of any de minimis threshold. The rules distinguish between Higher and Lower Value Accounts (more or less than US$1m). Enhanced due diligence procedures for identifying the country of tax residence of the account holder apply for Higher Value Accounts.

New Individual Accounts – the CRS here contemplates self-certification of the country of tax residence by the account holder and/or the ultimate controlling party (and the confirmation of its reasonableness) without a de minimis threshold.

Pre-existing Entity Accounts – Financial Institutions are required to determine:
•whether the entity itself is a Reportable Person,
•whether the entity is a passive Non Financial Entity and, if so, the residency of controlling persons. Pre-existing Entity Accounts below 250,000 USD (or local currency equivalent) are not subject to reporting.

New Entity Accounts – the same assessments need to be made as for Pre-existing Accounts. However, for new accounts, the 250,000 USD (or local currency equivalent) threshold does not apply.

CONCLUSION

It is important to note that the standard is a minimum standard and that there is a large degree of flexibility for jurisdictions to adopt broader and stricter regulation (e.g. such as for compliance requirements between new and pre-existing accounts). The same discretion cannot however be exercised by jurisdictions in the direction of making disclosure less onerous.

The regulation speaks of reportable accounts and reporting entities being financial institutions. This does not necessarily mean that all other entities are exempt. The CRS is modelled on FATCA and, if that is anything to go by, non financial institutions as well as asset holding arrangements that are not technically speaking normally considered to be 'accounts' could well be brought into the definitions and made reportable.

Moreover financial institutions will no doubt request information from account holders or the advisors of account holders as they strive to comply with CRS or FATCA rules. In this scenario financial institutions will certainly favour account holders or introducers of business who assist them to comply with CRS (or FATCA). By consequence financial institutions may close their doors to clients or introducers of business who are perceived to be uncooperative.

The Common Reporting Standard needs to be transposed into local legislation and, as always, the devil is in the detail. What is unfolding is a global comprehensive conceptual overhaul of cross border information exchange and in my opinion it would be a mistake to think that one can perform regulatory arbitrage in order to limit the impact of these rules. When it comes to CRS it will certainly be the spirit of the law, rather than the letter of the law, that is likely to have the last say.

PLEASE FEEL FREE TO CONTACT US WITH ANY QUESTIONS OR QUERIES.

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