

Reporting by Trust companies and Trusts under the HK CRS Rules [1]

{An article published in "Tax Notes International" under Outside Author Agreement}

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Hong Kong has made amendments to the Inland Revenue Ordinance in 2016 and 2017, which translates the OECD common reporting standard (CRS) into domestic laws. The two amendments became effective June 30, 2016 and 1st July 2017 respectively. This article compares Hong Kong's CRS rules with other versions and raises some questions that the authorities should consider.

Definitions

The HKCRS rules provide that a trust is regarded as an entity, and a trust can be classified as either a financial institution (FI) or a non-financial entity (NFE). The HK CRS rules further provide that:

1. An investment entity is a financial institution (FIs);
2. An investment entity is further divided into five sub-categories of entities, including trust companies (corporate trustees) or fund managers, denoted as Type A IEFI, and trusts or mutual funds, denoted as Type B IEFI [note];
3. An entity is treated as an FI trust company (Type A INFI) if 50% or more of its gross income is earned from investing, administering, or managing financial assets or money on behalf of other entity or individual during a specified period;
4. An entity is treated as an FI trust (Type B IEFI) if it is managed by any specified entity, and 50% or more of its gross income is earned from investing, re-investing and trading in financial assets during a specified period;
5. An NFE is further classified into active NFE and passive NFE;
6. There is a closed list of categories of active NFEs;
7. An NFE trust is a passive NFE if it does not fall into one of the specific categories of active NFE.

[note] Type A and Type B Investment Entity Financial Institutions are used for easy references only.

Investment Entity

Under section 50A(1) of the Hong Kong Inland Revenue Ordinance (the HK CRS Rules), investment entity means:

(a) a corporation licensed under the Hong Kong Securities and Futures Ordinance (SFO) to carry out one or more of the following regulated activities (i) dealing in securities; (ii) trading in futures contracts; (iii) leveraged foreign exchange trading; (iv) asset management;

(b) an institution registered under the SFO to carry out one or more of the following regulated activities (i) dealing in securities; (ii) trading in futures contracts; (iii) asset management;

(c) a collective investment scheme authorized under the SFO;

(d) an entity that primarily conducts as its business one or more of the following activities or operations for its customers (i) trading in (A) money market instruments, including cheques, bills, certificates of deposit, and derivatives; (B) foreign exchange; (C) exchange, interest rate and index instruments; (D) transferable securities; or (E) commodity futures; (ii) individual and collective portfolio management; (iii) otherwise investing, administering, or managing financial assets or money on behalf of other entity or individual; or

(e) an entity (i) that is managed by a custodial institution, a depository institution, a specified insurance company, or an entity mentioned in paragraph (a), (b), (c) or (d); and (ii) whose gross income is primarily attributable to investing, reinvesting, or trading in financial assets.

The entities under paragraphs (a), (b) and (c) are subject to regulation under SFO while the entities under paragraphs (d) and (e) are not. A trust company (or a fund manager) acting for many customers, meets the income test, it will be classified as an investment entity under paragraph (d) (Type A IEFI).^[2] A trust can be treated as a financial institution (FI) or a non-financial entity (NFE). If a trust meets both the income test and the managed-by test, the trust is classified as an investment entity under paragraph (e) (Type B IEFI).^[3]

Comparing with US-HK Model II-IGA

The Model II intergovernmental agreement concluded between Hong Kong and the U.S. on 13th November 2014 states:^[4]

The term “Investment Entity” means any Entity that conducts as a business (or is managed by an (k) entity that conducts as a business) one or more of the following activities or operations for or on behalf of a customer:

- 1) trading in money market instruments (cheques, bills, certificates of deposit, derivatives, etc.); foreign exchange; exchange, interest rate and index instruments; transferable securities; or commodity futures trading;
- 2) individual and collective portfolio management; or
- 3) otherwise investing, administering, or managing funds or money on behalf of other persons.

The term “investment entity” appears in the OECD guidance for the common reporting standard, the U.S. FATCA Regulations, IGAs, and HK CRS rules. Both the OECD and the HK CRS versions are based on the U.S. Regs.^[5] The Model II IGA definition is much less restrictive. It only specifies one condition rather than two and has a lower threshold for defining investment entity. Nonetheless, the US-HK Model II-IGA provides that the Hong Kong reporting financial institution may adopt the definition in the Treasury Regulations.

The Model II-IGA and HK CRS rules both have two categories of IEFI: managing and managed. But there are significant differences in the scope of trustee companies (managing IEFIs) and trusts (managed IEFIs), which will affect the classification of an entity as a financial institution (FI) or a non-financial entity (NFE).

Type A

In respect of investment entity financial institution under paragraph (d) (Type A IEFI), the HK CRS rule imposes a requirement that Type A IEFI *primarily* (emphasis added) conducts as its business the activities as prescribed under the paragraph (d). It requires that “the entity’s gross income attributable to the relevant activities equals or exceeds 50% of the entity’s gross income for the shorter of either the 3-year period ending on 31st December before the year in which the determination is made as to whether the entity is an investment entity, or the period during which the entity has been in existence. Those that cannot meet the gross-income condition will be classified as NFEs automatically. Because of those rules, a lesser number of entities will meet the Type A IEFI requirement than that under Model II-IGA.

A Type A investment entity (i.e. a trust company) may act as trustees for a number of customers. However, there is an exception.^[6] A private trust company (PTC) is not an investment entity provided that it does not charge any fees for the services rendered to the trust and that its directors are natural persons.

Type B

In respect of Type B investment entity financial institution (Type B IEFI), the HK CRS rules specify two tests: a managed-by test; and a gross-income test.

Managed-by test

The HK CRS rule provides that there are four types of managing investment entities: a custodial institution, a depository institution, a specified insurance company, or an entity mentioned in paragraph (a), (b), (c) or (d) under Investment Entity. In contrast, the Model II-IGA rule provides that *any entity* (emphasis added) can act as the managing company. The HK CRS rule provides that if the managing entity is not one of the four types of entity, the entity cannot be Type B IEFI and thus be classified as an NFE (even if it meets the gross-income condition). In contrast, the Model II IGA rule provides that any entity can act as the managing company.

Gross-income test

To satisfy the gross income requirement, at least 50% of the gross income of a Type B IEFI must be primarily attributable to investing, reinvesting, or trading in financial assets for the shorter of either the 3-year period ending on 31st December before the year in which the determination is made whether the entity is an investment entity, or the period during which the entity has been in existence. An entity that cannot meet the condition is classified as an NFE, even if it meets the managed-by condition. In contrast, the HK-US model II-IGA does not impose the gross income requirement.

Classification Issues

The differences between the HK CRS rules and the Model I IGA mean that under the HK CRS rules, some of the investment entities that have been classified as financial institutions under the US-HK Model II-IGA rules will not be classified as an IEFI. An entity that is not classified as an FI will be considered to be a non-financial entity (NFE). But that re-classification will not occur automatically without a determination is made as to whether the entity is an IEFI under the HK CRS rules. A reporting financial institution in Hong Kong has reporting obligations to the tax authority and an NFE does not. A wrong classification may cause irreversible damage to the account holders. This happens as a result of a classification

of entity as an IEFI under which the value of all the trust property is reported to the tax authority, but that should have not happened if the entity had been classified as an NFE.

Due diligence procedure

The OECD CRS provides that the reporting FI must apply the due diligence procedure to identify entity accounts with respect to which reporting is required.

The reporting FI must review information maintained for regulatory or customer relationship purposes (including information collected pursuant to AML/KYC Procedures) to determine whether the information indicates that the Account Holder is resident in a Reportable Jurisdiction. If it is resident in a reportable jurisdiction, the account must be treated as a reportable account.^[7]

The HKCRS rules provide that

“The reporting financial institution must review information maintained for regulatory or customer relationship purposes (including information collected and maintained pursuant to AML/KYC procedures) to determine the account holder's residence.”^[8]

There is a difference between “determining whether the entity is resident in a reportable jurisdiction” as per the OECD CRS, and “determining the residence of the entity account holder” as per the HKCRS rules. The language of “residence of the account holder” under the HKCRS rules can cover the following groups of account holders who are resident in a non-reportable jurisdiction:

- (i) the account holder who is resident in a non-CRS jurisdiction (such as the U.S. A.);
- (ii) the account holder who is resident in a jurisdiction that has not committed itself to automatic exchange of tax information (such as Taiwan);
- (iii) the account holder who is resident in a CRS participating jurisdiction with which Hong Kong has not concluded a competent authority agreement (CAA); pursuant to which Hong Kong has an obligation to exchange of financial account information;

The scope of “residence of the account holder”, used in the HK CRS rules, is wider than that of “resident in a reportable jurisdiction”. It cannot be placed in the contexts of the OECD CRS. In this connection, the reporting FI is required to report more number of reportable

accounts under the HKCRS rules than the number of reportable accounts under the OECD CRS.

Financial account and reportable account

A trust classified as Type B IEFI will not carry on business in its own name and, as a rule, has no financial accounts with a bank. Under section 50A(1), the financial account is the equity interest or the debt interest in the financial institution (Type B investment entity).^[9] If the investment entity is a trust, the equity interests are considered to be held by any settlor, beneficiary of all or a portion of the trust, or other natural person having ultimate control over the trust property.^[10]

The settlor(s), protector(s) if any, the beneficiaries or classes of beneficiaries, must always be treated as controlling persons of a trust, regardless of whether or not any of them exercises control over the trust.^[11] If a settlor, beneficiary or other person exercising ultimate control over the trust is itself an entity, the entity must be looked through, and the ultimate natural controlling person(s) behind that entity must be treated as the equity interest holder. The term “controlling person” as applies in the context of passive NFE will also apply here.^[12]

Concluding comments

The logic of the OECD CRS guidance is that if a beneficiary or settlor is resident in a reportable jurisdiction, the beneficiary or settlor is a reportable person. Therefore the equity interest in the trust that is considered to be held by the beneficiary (reportable person) is a reportable account. Due to the fact that some jurisdictions do not impose income tax, the laws of those jurisdictions do not define tax residence.^[13] Accordingly a beneficiary may not be regarded as a reportable person by the very reason that he has a residence in a reportable jurisdiction for tax purposes. To close the gap, the OECD CRS provides that “a reportable person will be treated as being a beneficiary of a trust if such *reportable person* (emphasis added) has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust.”^[14] The OECD CRS has two tests with respect to the due diligence procedures that the reporting financial institution (an IEFI) has to perform to identify whether the beneficiary of a trust is a reportable person. One is a residence test, and the other is the distribution test. The concept of financial accounts embraces that of reportable account, but not the other way round.

In contrast, the HK CRS rules have not included the residence test. ^[15] The term "reportable person" is not used in the HKCRS rules, which reads: "... if *such person* (emphasis added) (a) has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or (b) may receive, directly or indirectly, a discretionary distribution from the trust." That means some of the financial accounts would not be treated as reportable accounts if the residence test has been used in the due diligence procedures to determine whether the beneficiary of the FI trust is a reportable person. It is noted that other offshore finance centers such as Singapore, Bermuda, the Cayman Islands and the British Virgin Islands have adopted both the residence and distribution tests in their respective CRS rules. A review of this matter is much desirable.

[1] The author has granted a sole license to Tax Note International to publish this article. The author can be reached at alfred@china-tax.net.

[2] Paragraph 1, Chapter 16, Guidance for Financial Institutions, HK Inland Revenue Department

[3] Paragraph 11, Chapter 17, Guidance for Financial Institutions, HK Inland Revenue Department

[4] Under item k) of Article 1 - Definition, Model II-IGA

<https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/FATCA-Agreement-Hong%20Kong-11-13-2014.pdf>

[5] Treasury Regulations 1.1471-(5)(e)(4)(i)(A), and (B) respectively

[6] If the trustee and the investment manager are individuals, then the trust is not an FI, and therefore it is an NFE. The trust is not an FI but an NFE if it directly holds non-financial assets like landed properties and yachts.

[7] Paragraph D(1), section V, CRS

[8] Paragraph 5(1), Part 5, Schedule 17D, IRO

[9] See paragraph (c) of the definition of Financial Account under section 50A(1), IRO

[10] Section VIII – Defined terms, CRS. P50-P51; and Sub-section 1, Section 50A, IRO

[11] See paragraph 134, Commentary on Section VIII, concerning defined terms, CRS, page 198. Again, it is contrary to one's intuition.

[12] See paragraph 214 in Chapter 6, Standard for Automatic Exchange of Financial Account Information in Tax Matters, the CRS Handbook, OECD, page 80. The term "controlling person" corresponds to the term "beneficial owner" as described in Recommendation 10 and the Interpretive Note of Recommendation 10 contained in 2012 FATF Recommendations.

[13] Such non-residence jurisdictions include the Cayman Islands, British Virgin Islands and Hong Kong.

[14] Paragraph C(4), Section VIII: Defined Terms, CRS, OECD

[15] Sub-section 1, Section 50A, IRO provides that "equity interest—

(a) in relation to a partnership that is a financial institution, means either a capital or profits interest in the partnership;

(b) in relation to a trust that is a financial institution, means—

(i) an interest held by a settlor or beneficiary of the whole, or any part, of the trust; or

(ii) an interest held by an individual exercising ultimate control over the trust; ...” and

Sub-section 10 provides that "For paragraph (b)(i) of the definition of equity interest in subsection (1), a person is the beneficiary of all, or a portion, of a trust if the person

(a) has the right to receive directly or indirectly (including through a nominee) a mandatory distribution from the trust; or

(b) may receive, directly or indirectly, a discretionary distribution from the trust.”

Legal terms such as financial accounts, account holders, reportable accounts, reportable persons, controlling persons are used in determining whether an entity is an investment entity financial institution (an IEFI). A comparison between those terms are given below:

Financial account vs Reportable accounts under the OECD CRS rules

	Financial Institutions that are not an investment entity	Investment entity that is a trust (note)
Financial account	A financial account is an account maintained by a financial institution, including a (i) depository account, (ii) a custodial account, (iii) cash insurance contract or annuity contract. A financial account does not include an excluded account.	Financial account: the equity interest or the debt interest in the trust
Account holder	A trustee or nominee is not the account holder. In the case of a cash insurance contract or an annuity contract, the person who is entitled to access the cash value or change the beneficiary of the contract. [i]	The financial account is considered to be held by (i) any person who are treated as a settlor, a beneficiary of all or a portion of the trust, or (ii) any other natural person having ultimate control over the trust property
Reportable account	A financial account held by a reportable person or if by a passive NFE, the controlling person(s) who are the reportable person	If the beneficiary or settlor of a trust is resident in a reportable jurisdiction, the beneficiary or settlor is a reportable person. The equity interest held by the beneficiary or settlor is the reportable account. [ii]

Reportable person	<p>A reportable person is a reportable jurisdiction person other than: corporations whose stock is listed, related entity of such listed entities, government entity, central bank, international organization, financial institution.</p> <p>A reportable jurisdiction person: an individual or entity that is resident in a reportable jurisdiction under the tax laws of such jurisdictions.</p>	<p>if the beneficiary (or settlor who is a beneficiary) is resident in a reportable jurisdiction, the beneficiary is the reportable person.</p> <p>A reportable person will be treated as being a beneficiary of a trust if such reportable person has the right to receive directly or indirectly (for example, through a nominee) a mandatory distribution or may receive, directly or indirectly, a discretionary distribution from the trust.” [iii]</p>
Controlling person of the financial account	<p>The term “Controlling Persons” means the natural persons who exercise control over an Entity (such as a corporation or interest in a partnership).</p>	<ul style="list-style-type: none"> a. The settlor(s), protector(s) if any, the beneficiaries or classes of beneficiaries, must always be treated as controlling persons of a trust, regardless of whether or not any of them exercises control over the trust. [iv] b. If a settlor, beneficiary or other person exercising ultimate control over the trust is itself an entity, the entity must be looked through, and the ultimate natural controlling person(s) behind that entity must be treated as the equity interest holder. c. The term “controlling person” as applies in the context of passive NFE will also apply here. [v]

[i] Paragraph E, section VIII, CRS, p60

[ii] Paragraph 215, Handbook of CRS.

[iii] Standard for Automatic Exchange of Financial Account Information in Tax Matters, OECD, p51

[iv] See paragraph 134, Commentary on Section VIII, concerning defined terms, CRS, page 198. Again, it is contrary to one’s intuition.

[v] See paragraph 214 in Chapter 6, Standard for Automatic Exchange of Financial Account Information in Tax Matters, the CRS Handbook, OECD, page 80. The term “controlling person” corresponds to the term “beneficial owner” as described in Recommendation 10 and the Interpretive Note of Recommendation 10 contained in 2012 FATF Recommendations.