

## Tax

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# Tax Analysis

## State Administration of Taxation ("SAT") released draft "Due Diligence Procedures on Financial Account Information in Tax Matters for Non-residents" Are you ready?

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On 14th October 2016, the State Administration of Taxation ("SAT") published on its official website Due Diligence Procedures on Financial Account Information in Tax Matters for Non-residents (Consultation Paper) (the "Consultation Paper") to seek public comments on this matter. This also signifies that China will soon adopt the Organization for Economic Co-operation and Development's ("OECD") Standard for Automatic Exchange of Financial Information in Tax Matters ("AEOI") to identify financial accounts held by non-Chinese residents and to exchange financial account information with other jurisdictions participating in AEOI.

### 1. Background on the Implementation of the Due Diligence Procedures on Financial Account Information for Non-residents

SAT in its press release provided a detailed explanation on the background on implementing AEOI. The history of the exchange of financial account information originated from the U.S. Foreign Account Tax Compliance Act ("FATCA"). Under the U.S. income tax rules, U.S. tax residents are taxed on their worldwide income. However, realizing that many U.S. tax residents may have evaded tax by hiding their assets in offshore accounts, the U.S. government enacted FATCA as part of the Hiring Incentives to Restore Employment Act (HIRE Act) of

2010, requiring non-U.S. financial institutions to perform due diligence on their financial account holders in order to identify and report information on financial accounts held by U.S. citizens and tax residents. Account holders who fail to cooperate and provide the required documentation for FATCA purposes will be subject to a 30% withholding tax on U.S. withholdable payments made to the account and the relevant financial institution would have to report of such account holder's information to the U.S. Internal Revenue Service ("IRS"). To encourage other jurisdictions to participate in FATCA, the U.S. has also entered into Intergovernmental Agreements ("IGA") with countries and territories around the world to implement FATCA locally.

In response to the growing concern of tax residents hiding their financial assets in offshore accounts to evade their home country taxation, OECD published AEOI in year 2014. The AEOI was written with reference to the IGA framework established under FATCA with an aim to promoting multilateral exchange of financial account information between jurisdictions and to combating offshore tax evasion. OECD's AEOI comprises key operating components such as Model Competent Authority Agreement ("MCAA") and Common Reporting Standards ("CRS"). MCAA is the agreement to be signed by each jurisdiction's tax authority to implement CRS while CRS defines the standards of its implementation, including defining the types of financial institutions that would be subject to CRS ("Reporting Financial Institutions"), financial accounts subject to due diligence procedures and reporting ("Financial Accounts"), and specific due diligence procedures to be carried out by the financial institutions. It should be noted that OECD has published CRS Definitions, CRS Implementation Handbook and CRS-related Frequently Asked Questions.

Back in September 2014, China stated that it would participate in AEOI and signed MCAA in December 2015. Consequently, China has agreed to implement CRS due diligence procedures starting from 1st January 2017 and complete its first exchange of financial account information in September 2018. Building on the AEOI framework, China aims to formulate a set of due diligence procedures that would be most suitable to its local financial institutions.

## 2. Major Scope of the Consultation Paper

Before this public consultation, the SAT had sought comments from representatives from various regulatory authorities, including People's Bank of China, China Banking Regulatory Commission, China Insurance Regulatory Commission and China Securities Regulatory Commission with respect to the draft CRS regulations. Considering that the due diligence processes will begin 1st January 2017, this is likely to be the last consultation before the implementation of the regulation.

The scope of the Consultation Paper includes: the types of financial institutions and related financial accounts that would be impacted, the extent of the financial account information to be reported, and the residence indicia for determining the financial account holder's tax residency. At the same time, the Consultation Paper also set out the due diligence procedure required for opening new and for

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remediating pre-existing financial accounts, while illustrating the differences in due diligence between individual and entity accounts. The SAT also mentioned that after the implementation of CRS, it will also release additional guidance on dealing with practical implementation issues.

### **3. The Requirements and Implications of AEOI on Financial Institutions**

AEOI has specific definitions on the scope of Reporting Financial Institutions. Therefore, when an entity determines whether it is required to report financial account information under the AEOI, it should first determine whether it is considered a Reporting Financial Institution. According to the AEOI, Reporting Financial Institutions include depository institutions, custodial institutions, investment entities, and specified insurance companies and its affiliates. The Consultation Paper defines the scope of Reporting Financial Institutions to include commercial banks, rural credit unions & policy banks, security companies, futures companies, securities investment fund management companies, trusts, insurance companies that issue cash value insurance and/or annuity contracts, assets management companies, private equity funds etc.

Once an entity is considered a Reporting Financial Institution, it should determine what accounts will constitute "Financial Accounts" under AEOI. In addition to depository accounts (e.g. savings accounts), other accounts such as custodial accounts, securities trading accounts, wealth management accounts, investment accounts, accounts held with trustee, collective wealth management accounts, cash value insurance contract and/or partnership interest in private equity funds, etc. are also considered to be "financial accounts" under AEOI.

In addition to Financial Accounts that are directly held by individuals, the AEOI also requires Reporting Financial Institutions to identify and determine Financial Accounts held by non-financial entities ("NFEs"). For such entities, Financial Institutions may be required to perform due diligence on the controlling persons of the entity to determine whether they are tax residents in another jurisdiction. This due diligence requirement aims to identify tax residents in other jurisdictions holding financial assets through NFEs instead of holding them directly. This will certainly increase the complexity of compliance when due diligence is performed.

Financial Accounts can be classified into pre-existing accounts and new accounts. According to AEOI, the Consultation Paper also sets out different due diligence requirements and timelines for pre-existing individual accounts, pre-existing entity accounts, new individual accounts and new entity accounts as follows:

- From 1st January 2017, carry out due diligence procedures for new individual and entity accounts;
- By 31st December 2017, complete due diligence procedures on pre-existing high value individual accounts (individual account with an aggregate balance or value that exceeds RMB 6,000,000 as of 31st December 2016); and
- By 31st December 2018, complete due diligence procedures on pre-existing low value individual accounts and all pre-existing entity accounts.

### **4. The implications on Financial Account Holders**

Although AEOI requires Reporting Financial Institutions to comply with due diligence procedures to identify and report financial accounts held by residents of other participating jurisdictions, it will also have a deep and far-reaching impact on tax residents holding financial assets in foreign countries who have not properly complied with their resident country's tax obligations.

Currently, over 100 jurisdictions have committed to implementing AEOI. These jurisdictions not only include the world's largest economies but also low tax jurisdictions such as British Virgin Islands, Cayman Islands, Bermuda, Barbados and British Guernsey, which are the first batch of jurisdictions to participate in the implementation of AEOI (early adopters). These jurisdictions will commence the information exchange starting from the year of 2017 and thus already started the due diligence procedures according to the AEOI on 1st January 2016.

In other words, if a Chinese tax resident holds financial assets outside China, then despite the fact that these assets are held in the form of cash deposits, stock securities, insurance products with investment nature, or held through a trust structure or special purpose vehicles, these financial accounts may be regarded as reportable Financial Accounts by the jurisdiction where such accounts are maintained. Similarly, in light of the growing number of Chinese emigrants, due to their change of resident status or prolonged periods of stay in other foreign jurisdictions, they may have become tax residents in such other foreign jurisdictions. Consequently, their Financial Accounts maintained in China may be regarded as reportable "Financial Accounts". Accordingly, information of these Financial Accounts will be reported to SAT and exchanged with the respective jurisdictions of these emigrants.

AEOI requires reporting of Financial Accounts held by tax residents of another AEOI participating jurisdictions. The exchange of financial account information between participating jurisdictions will strengthen the management and control over tax revenue to be collected from tax residents in these jurisdictions. AEOI itself does not impose or increase any tax burden for tax residents worldwide. However, for taxpayers who attempt to willfully evade tax by hiding their financial assets and related income overseas, tax authorities may use the information obtained through AEOI to better monitor their tax residents' offshore financial assets and income, adding pressure to their tax residents to report and pay tax on offshore assets and income.

### ***Deloitte's Observation***

The global commitment to AEOI and its implementation not only impact Financial Institutions, but also persons holding offshore financial assets including Chinese enterprises investing overseas.

### **Obligation of Reporting Financial Institutions:**

- In addition to properly interpret and implement AEOI, Reporting Chinese Financial Institutions would also need to understand the complicated rules and the differences between local legislations to be issued by SAT and regulations prescribed under AEOI;
- To review products and business transactions to determine whether specific product/transaction would constitute "Financial Account" under AEOI;
- To amend current account opening procedures and enhance information system to accommodate due diligence procedures and reporting requirements in accordance with AEOI;
- To establish a compliance program on due diligence procedures, formulate relevant procedures and perform relevant system upgrade; and
- To update its compliance program and monitor change in circumstances to ensure continue compliance with AEOI under situations where there are changes in account holders' resident status, new and emerging investment products and change in client profile.

### **Offshore Assets/Financial Accounts Holder**

Financial account holders are encouraged to sort out the impact of the AEOI with respect to their offshore financial assets. They should understand the implications of AEOI in the location where the assets are held and the related local requirements or information required to comply with the AEOI. Account holders may also consider the implications of AEOI on holding financial assets under different investment structures such as trusts, partnerships and special purpose vehicles.

### **China Enterprise with Overseas Investments**

Many enterprises that participate in M&A transactions overseas should have already experienced the impact of FATCA/AEOI in the past couple years. For example, if an entity opens an account with an overseas bank, the bank will ask the entity to fill in a relevant form or a self-declaration to declare the entity's classification under FATCA/AEOI. If the entity is investing in an offshore fund, the fund manager would request for the tax residency of the entity and possibly its controlling persons' tax residency. Alternatively, an investment manager of an offshore fund may already have reported tax information with respect to the limited partners of the offshore fund to the respective tax authority or IRS for FATCA purposes. Therefore, with respect to overseas investment, you would be required to determine your CRS/FATCA classification and certify such on a self-certification form provided by your counterparty. It is

essential that account holders respond to the specific request from the financial institution timely to avoid non-compliance consequences. How to monitor development of local regulations in respective jurisdictions, determine an entity's FATCA/CRS status and/or identify an entity's controlling persons, have become common challenges for Chinese enterprises investing offshore.

To conclude, AEOI is being widely adopted and implemented globally. AEOI will have a long-lasting impact on Financial Institutions' compliance strategy, Chinese overseas investments and financial asset management.

Deloitte will be providing a series of analyses, including the details on how AEOI impacts different Financial Institution's compliance program, what to prepare for in order to comply with local AEOI requirements when investing overseas, and etc. Please stay tuned!

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