News Flash
China Tax and Business Advisory

China releases CRS compliance requirements for financial institutions

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In brief

Recently, the State Administration of Taxation (SAT) released *the Discussion Draft on the Administrative Measures on the Due Diligence Procedures for Non-residents' Financial Account Information in Tax Matters (*the Discussion Draft)to solicit public opinion. The Discussion Draft provides detailed requirements for domestic financial institutions (FIs) to collect financial account information held by foreign individuals and entities. The Discussion Draft received a lot of attention from both FIs and taxpayers in China.

The issuance of the Discussion Draft earmarks the localisation of Common Reporting Standard (CRS) in China through legislation. As a new standard adopted by various tax authorities around the world to tackle with the issue of lack of transparency on cross-border information, CRS requests for exchange of financial accounts information of foreign individuals and foreign enterprises between governments, so as to improve tax compliance internationally. So far, 101 jurisdictions have committed to implement CRS[1], and there are 84 signatories to the multilateral instrument to implement the CRS[2].

The Discussion Draft provides guidance for FIs to comply with the CRS obligations, including different requirements for pre-existing accounts and new accounts, the sample forms to be filled in, as well as the contents and methods to report information. FIs are suggested to take swift actions to meet the new compliance requirements.

Collecting information is the starting point for tax authorities. How to facilitate the exchange of information among different governments, and more importantly, how to leverage the vast amount of information exchanged for the purpose of tax administration will be the next essential steps that require further exploration. In the backdrop of increasing tax transparency worldwide, taxpayers operating globally or receiving overseas income must pay more attention to the tax compliance and tax risk management all over the world.

In detail

Background

CRS was firstly introduced by the Organization of Economic Cooperation and Development (OECD) in 2014, and was then endorsed by the G20. With the joint supports from OECD and G20, the influence of CRS was growing very fast. The Contracting Parties to the *Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information* (Multilateral Agreement), which was developed to implement includes most major economies and traditional offshore financial centers in the world. As the United States insists the bilateral approach to implement its *Foreign Account Tax Compliance Act* (FATCA), it is the only major economy that is not covered under the Multilateral Agreement for CRS.

The objective of CRS is to ensure that tax authorities in each jurisdiction could obtain information of the financial accounts of individuals/enterprises that are non-tax residents through FIs in its jurisdiction and exchange the information collected with tax authorities of jurisdictions where these individuals/enterprises are resident for purpose of tax administration and tax examination.

The scope of the information of financial accounts to be collected

The Discussion Draft is the domestic legislation for China to implement the Multilateral Agreement, therefore its framework and basic requirements generally follows the OECD standard with further clarifications on a couple of concepts. The basic elements include:

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- Reporting FIs: depository institutions, custodial institutions, specified insurance companies and their branches are included in the scope. However, FIs such as financial companies, finance leasing companies and automotive finance companies are not covered under the scope of reportable institutions.
- Financial accounts: the definition of financial accounts specified in the Discussion Draft generally follows those in the OECD standard, including depository accounts, custodial accounts, insurance, etc. FIs are not only required to conduct due diligence on new accounts but also on pre-existing accounts.
- Reportable information: FIs shall provide the information of the account holder (including name, address, tax residency status, tax identification number, etc.), the information of the account number, the balance of the account, as well as other reportable information based on the different types of the accounts (for instance, deposit account shall report the total interest amount within a year), etc.

Due diligence requirements for FIs

According to the Discussion Draft, the reporting FIs shall conduct due diligence and identify the reportable information of accounts. Although for most of the FIs, the majority of their clients are Chinese tax resident enterprises or individuals whose information is not required to be reported, due diligence still shall be conducted on all of the account holders as a part of the due diligence procedures. FIs are obligated to conduct due diligence on identifying the tax residency status of financial account holders. However, given that they are not professional institutions for tax investigation, their liability is limited. That is to say, FIs shall perform review and reasonableness check based on the information provided or declared by the account holders.

Specifically, the Discussion Draft follows the classification standard of OECD and provides different requirements on new accounts and pre-existing accounts. Meanwhile, entities and individuals are subject to different investigation procedures and standards. Take individuals as an example:

- For new individual accounts, FIs should identify the tax residency status of the account holders according to the tax residency self-certification (self-certification) form signed by individuals. Where it is determined to be a non-resident individual, the FI shall collect and record the reportable information. FIs need to review whether the self-certification is reasonable. Where certain information is found to be unreasonable, the account holders shall be required to file a self-certification or to explain.
- For pre-existing low value individual accounts (the total account balance in the same FI and its related institutions does not exceed 6 million RMB at the end of 31 December 2016), FIs should determine the tax residency status of the account holder based on his or her address. For pre-existing high value individual accounts (the total account balance exceeds 6 million RMB in the above-mentioned situation)， FIs should perform electronic record search and paper record search as well as inquire clients managers to identify his or her tax residency status. It should be noted that considering current foreign exchange rate for RMB to USD, the threshold of 6 million RMB is slightly lower than OECD standard, i.e. 1 million USD.

The requirements of due diligence on new entity accounts are basically the same with that on individuals. But for the pre-existing entity accounts, special requirements are prescribed as follows: for the pre-existing entity accounts whose total balance does not exceed 1.5 million RMB, due diligence procedure can be exempted; for the high value entity accounts of specific types, where passive income such as dividends or interest accounts for more than 50% of the total receipts of the current year, FIs shall identity the tax residency status through the controlling persons or the authorised signatories the self-certification.

The time frame for FIs to perform due diligence procedures and report relevant information

The detailed time arrangement for FIs to perform due diligence procedures is listed as below:

- conduct due diligence procedures for new accounts since 1 January 2017;
- complete due diligence procedures for pre-existing high value individual accounts as of 31 December 2017;
- complete due diligence procedures for pre-existing low value individual accounts and all of pre-existing entity accounts by 31 December 2018.

As the Discussion Draft does not set out the due date for reporting relevant information collected during due diligence procedures, the SAT ensures that it will coordinate with relevant financial regulatory institutions to separately formulate relevant provisions. Given the condition that China is committed to prepare and exchange first batch of information by September 2018, the materials of new accounts opened in 2017 and pre-existing high value individual accounts will be probably included in the first-batch information. In short, FIs shall provide aforementioned information before September 2018.

Penalties for non-compliance

Unlike FATCA, there has no unified measure in CRS to punish FIs not performing due diligence procedures, which shall be regulated by their domestic laws and regulations. China's *Tax Collection and Administration Law* (TCAL) does not stipulate relevant penalty rules and according to *Administrative Penalties Law*, the SAT and financial supervision institutions have no rights to create a new type of administration penalties for CRS non-compliance. As such, according to the Discussion Draft, Chinese tax authorities could only provide relevant advices to financial supervision bodies for reference and it is up to these bodies to enforce within the power provided in the existing relevant laws and regulations.

The Discussion Draft stipulates that if a financial institution fails to perform due diligence obligations, its tax payment credit rating will be affected. This may not look like an important issue, but with different tax payment credit rating, the tax authorities will adopt different approach in tax risk management level. For example, taxpayers of A or B tax payment credit rating will be convenient in the input VAT deduction procedures. If the tax payment credit rating a financial institution is downgraded because it fails to fulfill its due diligence obligations under CRS, it will significantly increase its time cost in other tax compliance.

Competent authorities

In the past, there was no precedent that tax authorities take the lead to set forth practical compliance rules for FIs. The reason that this time the SAT leads the implementation of due diligence procedures required in CRS is to combat tax avoidance and exchange tax-related information with tax authorities in other jurisdictions. Although there is no detailed requirement of reporting by FIs in the Discussion Draft, it is anticipated that in the light of its Article 40, the required information is probably reported by FIs to financial supervision institutions, and then financial supervision institutions share such information with the SAT. Therefore, financial supervision institutions play a monitor role the reporting process.

The takeaway

Overall impact

Due to foreign exchange control, legal regime and other reasons, foreign enterprises and individuals rarely choose to open offshore accounts in China for tax evasion purpose. Thus the territory that the Discussion Draft applies is not the key area for CRS network. However, it is important to know that the issuance of the Discussion Draft shows China's willingness to participate in international tax cooperation. Meanwhile, from taxpayers' perspective, improved transparency of global financial accounts will demand a higher requirement for tax compliance on their global businesses.

Challenges faced by FIs

According to the Discussion Draft, FIs should start their due diligence procedures from 1 January 2017, which is included in the time line publicly committed by China. This could not be delayed. In this regard, it is anticipated that during the implementation of due diligences procedures, FIs may inevitably face a lot of challenges, including:

- Whether the existing system and relevant working procedures (e.g. Anti-Money Laundry Procedures for client's identification) are ready and compatible with the new CRS requirement;
- As the Discussion Draft covers FIs' branches and units at very local level, the workload and difficulty to provide training to relevant personnel will be consequently increased;
- To better respond to clients' uncertain reaction on the due diligence procedures, FIs are suggested to make reasonable strategy to further communicate with clients and reduce potential negative impact.

Suggested responding strategies for FIs

Given the tight timeline, FIs are suggested to attach great importance to the compliance requirements set forth in the Discussion Draft and make sufficient preparation from aspects of compliance requirement, system modification, human resources allocation, etc.

In details, FIs could take into consideration of following suggestions in stages:

- Initial stage to assess the impact and establish internal guidelines: after the assessment on the impact brought by due diligence procedures and identification of the gap to make the modification, FIs could build-up relevant compliance policy, conduct the training to relevant personnel and speed up modification of the information system;
- Implementation stage to the new accounts and pre-existing accounts: due diligence procedures for new individual accounts and new entities accounts should be performed in a timely manner; as for pre-existing accounts, relevant system could be modified in due course in order to complete their due diligence procedures;
- Post stage for information reporting and internal monitoring: in this stage, FIs need to provide internal guidance on the reporting of tax-related information and monitor the whole internal flow at the same time.

Enterprises and individuals owning foreign accounts

The SAT emphases that localisation of CRS does not mean adding new taxes to taxpayers in China. The targets are not enterprises and individuals which are tax compliance, but those with tax avoidance and evasion activities via foreign accounts.

Although the specified time line for exchange of information has been determined, it still has a long way to explore how jurisdictions involved could take full advantage of the limited information exchanged through CRS. In other words, it may still take some time for CRS to play an important role in cracking down tax avoidance after its implementation. Currently, Chinese tax authorities are increasing their use of information collected from various sources. Along with the revision of a series of tax laws, e.g. TCAL, *Individual Income Tax Law*, etc., it is believed that their capability to make use of overseas information collected will be further enhanced in the future. By that time tax avoidance and evasion activities through foreign financial accounts will be easily identified. In this regard, it is suggested that taxpayers should pay more attention to their global tax compliance.

Endnote

1. *For the detailed list of jurisdictions committing to implement CRS, please refer to the official link on OECD website: http://www.oecd.org/tax/transparency/AEOI-commitments.pdf*
2. *For the detailed list of Contracting Parties to the Multilateral Agreement, please refer to the official link on OECD website: http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/MCAA-Signatories.pdf*

Let's talk

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