

Hong Kong

Some Issues Relating to the Application of Hong Kong's CRS Rules

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In this article, the author contrasts terminology used in the OECD Common Reporting Standard and the Hong Kong rules to adopt it, which are set out in amendments to the Inland Revenue Ordinance in 2016 and 2017. The article discusses the inconsistencies in logic in the Hong Kong terminology. The author also compares the legislative practices of other offshore finance centres on the use of the same terminology, and advocates legislative amendment to rectify the discrepancies.

1. Introduction

In an earlier article,^[1] the author explained, from an historical perspective, how Hong Kong has amended its domestic tax rules to remove domestic interest requirements, in order to sign tax treaties with its trading partners, and how Hong Kong introduced automatic exchange of information (AEOI) rules, which are in compliance with the OECD's Common Reporting Standard (CRS) (OECD CRS).^[2]

Hong Kong has acted quickly in response to the radical change in the global environment in respect of transparency and international cooperation in tax matters. Specifically, its legislative body enacted the Inland Revenue (Amendment) (No.3) Ordinance 2016^[3] and the Inland Revenue (Amendment) (No. 2) Ordinance 2017.^[4]

This article examines whether the 2016 and 2017 amendments are in full compliance with the OECD CRS, and how other financial centres, which are CRS participating jurisdictions, have achieved full compliance.

Some of the terms defined in section 50A of the Hong Kong Inland Revenue Ordinance (IRO) (the HK CRS rules) appear not to be in agreement with those in the OECD CRS.^[5] The terms that are inconsistent include "reporting financial institution", "reportable person", and "passive NFE". As these main definitions are directly or indirectly used in defining other terms, such as "reportable account" and "investment entity", and in the context of the due diligence requirements, the legal basis for the HK CRS rules framework may be shaky.

2. Reporting Financial Institution

The definition of "reporting financial institution"^[6] in the HK CRS rules does not adopt the term "participating jurisdiction financial institution" used in the OECD CRS, which is defined as a financial institution that is resident in a participating jurisdiction.

The OECD CRS rules state:

The term "Reporting Financial Institution" [B] means any Participating Jurisdiction Financial Institution [A] that is not a Non-Reporting Financial Institution [C].

Sub-groups B and C fall under group A by virtue of the residence rule, but sub-group C is specifically mentioned as non-reporting financial institutions because it presents a low risk of being used to evade tax, due to the unique characteristics or size of the financial institutions in that sub-group. Given that A includes B and C, B and C are not the same types of financial institution. Obviously, the OECD CRS means that sub-group B and sub-group C have a parallel relationship.

However, the drafters of the Hong Kong CRS rules have modified the logic of this piece of the OECD CRS. Under the HK CRS rules:

"reporting financial institution" [B] means—

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1. A. Chan, *Recent Developments in Hong Kong's Exchange of Information Rules*, 22 Asia Pac. Tax Bull. 6 (Nov./Dec. 2016), Journals IBFD.

2. OECD, *Standard for Automatic Exchange of Financial Account Information in Tax Matters* (OECD, 2014), at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters_9789264216525-en#WZOL0raxXZ4#page6. The CRS is an official publication of the OECD and has no legal force on any jurisdiction. Each jurisdiction must make its own laws to put AEOI in place.

3. See <http://www.gld.gov.hk/legazette/pdf/20162026/es12016202622.pdf>.

4. See <http://www.legco.gov.hk/yr16-17/english/ord/2017ord004-e.pdf>.

5. As defined in sec. VIII OECD CRS.

6. Sec. 50A(1) IRO.

- (a) a financial institution that is resident in Hong Kong (excluding any branch of the financial institution located outside Hong Kong); or
 - (b) a branch located in Hong Kong of a financial institution that is not resident in Hong Kong, [A]
- but does not include a non-reporting financial institution [C].

It is noted that the term “participating jurisdiction financial institution” is not used in the HK CRS rules in defining “reporting financial institution”, but it appears in the definition of “passive non-financial institution” (passive NFE).

3. Reportable Person

In defining “reportable person”, the drafters of the HK CRS rules have omitted the term in the OECD CRS, “reportable jurisdiction person”, which means an individual or entity that is resident in a participating jurisdiction under domestic tax laws.

The OECD CRS defines the term “reportable person” as:

a *Reportable Jurisdiction Person* other than: (i) a corporation the stock of which is regularly traded on one or more established securities markets; (ii) any corporation that is a Related Entity of a corporation described in clause (i); (iii) a Governmental Entity; (iv) an International Organization; (v) a Central Bank; or (vi) a Financial Institution. [Emphasis added.]

The term “reportable jurisdiction person” means:

an individual or Entity that is resident in a Reportable Jurisdiction under the tax laws of such jurisdiction, or an estate of a decedent that was a resident of a Reportable Jurisdiction

By contrast, the HK CRS rules state that a “reportable person”:

- (a) means
 - (i) an individual or entity that is a resident for tax purposes of a reportable jurisdiction; or
 - (ii) an estate of a decedent who was a resident for tax purposes of a reportable jurisdiction; but
- (b) does not include–
 - (i) a corporation the stock of which is regularly traded on an established securities market ... ;
 - (ii) a corporation that is a related entity of a corporation mentioned in subparagraph (i);
 - (iii) a governmental entity;
 - (iv) an international organization;
 - (v) a central bank; or
 - (vi) a financial institution.

The term “reportable jurisdiction person” is not adopted in the HK CRS rules.

Again, what is a parallel relationship under the OECD CRS is replaced by an inclusive relationship under the HK CRS rules. The defects in the definition of “reportable person” in the HK CRS rules do not stand alone. The term “reportable person” is used in the definition of “reportable account” in section 50A of the IRO and in Schedule 17D of the IRO, which prescribes the due diligence procedure that a reporting financial institution must follow.

4. Reportable Account

Section 50A of the IRO states that a “reportable account”:

- (a) means a financial account–
 - (i) that has been identified as such under the due diligence requirements in Schedule 17D; and
 - (ii) that is held by–
 - (A) at least one reportable person; or
 - (B) a passive NFE with at least one controlling person being a reportable person ...

The concept of reportable account is based on the definitions of reportable person and passive NFE. The legal base is doubtful if the inconsistency in the logic of the definitions of these two terms is not properly amended.

The reason why the drafters avoid using the term “residence” may be attributable to section 14 of the IRO. Section 14 is the main charging provision of Hong Kong’s source-based tax system.^[7] Basically, with the exception of air and shipping services income, Hong Kong does not impose taxes by reason of residence of an individual or entity. Instead, taxes are imposed on the profits arising in, or derived in a tax year from the activities that a person carries on in, Hong Kong in respect of a trade, business or profession. The scope of section 14 has remained unchanged for many years.

In 2007, the author pointed out the inherent defect of section 14, compared with a residence-based tax system, and explained why Hong Kong could not sign comprehensive double treaty agreements (DTAs) with some of its major trading partners, including the United States.^[8] It is noted that other offshore financial centres, such as the Cayman Islands and the British Virgin Islands, which also do not impose income tax on a residence basis, have not altered the OECD CRS definitions in their respective domestic CRS rules.

5. Reportable Jurisdictions and Participating Jurisdictions

Under Part 1 and Part 2, respectively, of Schedule 17E of the IRO, the HK CRS rules give two separate lists for each of reportable jurisdictions and participating jurisdictions.^[9]

A jurisdiction that commits to the OECD CRS must sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (the Convention). The jurisdiction becomes a CRS participating jurisdiction by joining the Convention and signing the Multilateral Competent Authority Agreement (the MCAA), pursuant to article 6 of the Convention. Alternatively, a jurisdiction can become a CRS participating jurisdiction by entering into a bilateral DTA, containing an article commensurate with article 26 of the OECD Model Tax Convention, and a bilateral Competent Authority Agreement (CAA) with another participating jurisdiction.

Under section 49(1A) of the IRO and pursuant to article 151 of the Basic Law of the Hong Kong Special Administrative Region (SAR), Hong Kong has the capacity to enter into CAAs under DTAs or tax information exchange agreements (TIEAs) concluded with other jurisdictions. But the Convention is open to signing by sovereign states only. At the time of China’s joining the Convention, the Government of the Hong Kong SAR opted out of the Convention after consultation with the Central People’s Government of China, as provided for under article 153 of the Basic Law of the Hong Kong SAR. Therefore, currently Hong Kong is not a party to the Convention.^[10] Consequently, Hong Kong now faces the risk of not meeting the OECD’s and European Union’s assessment criteria,^[11] with respect to AEOI compliance. If listed as a non-cooperative jurisdiction, Hong Kong could be subject to counter-measures, which would make it an unattractive place for investment and business. Therefore, upon the request of the Hong Kong government, China’s government has recently given in-principle approval to extend the application of the Convention to Hong Kong.^[12]

The OECD CRS provides that the term “participating jurisdiction” means a jurisdiction (i) with which an agreement on the automatic exchange of financial account information is in place and (ii) which is identified in a published list,^[13] whilst the term “reportable jurisdiction”

7. Sec. 14 states that:

- (1) Subject to the provisions of this Ordinance, profits tax shall be charged for each year of assessment at the standard rate on every person carrying on a trade, profession or business in Hong Kong in respect of his assessable profits arising in or derived from Hong Kong for that year from such trade, profession or business (excluding profits arising from the sale of capital assets) as ascertained in accordance with this Part.
- (2) In the case of—
 - (a) a corporation; and
 - (b) a corporation (relevant corporation) to which a share of the assessable profits of a partnership is apportioned under section 22A and is charged in the partnership name under section 22,
profits tax shall be charged on the assessable profits of that corporation, or on that share of the assessable profits of that relevant corporation, as the case may be, at the rate specified in Schedule 8.

8. See K.K. Chan, *A Commentary on Hong Kong’s Tax Treaties*, 13 Asia-Pac. Tax Bull. 2 (2007), Journals IBFD.

9. The list of reportable jurisdictions is published in the Gazette by the Hong Kong government (see <https://www.elegislation.gov.hk/hk/2017/4/en>) and released on the Inland Revenue Department’s website. However, the list of participating jurisdictions has been removed from the website for some time.

10. See the explanation given by the China’s State Administration of Taxation (3 Feb. 2016), at <http://www.chinatax.gov.cn/n810341/n810760/c2004643/content.html>; the decision at the 15th Meeting of the Standing Committee of the Twelfth National People’s Congress of China (1 July 2015), at http://www.npc.gov.cn/npc/xinwen/2015-07/02/content_1940459.htm; and China’s declaration in the instrument of ratification deposited with the Secretary General of the OECD that it did not extend application of the Convention to Hong Kong (16 Oct. 2015): “[p]ursuant to Article 29, paragraph 1, of the Convention, unless otherwise notified by the Government of the People’s Republic of China, the Convention shall not apply to the Hong Kong Special Administrative Region and the Macao Special Administrative Region of the People’s Republic of China.”

11. In July 2017, the OECD declared that a jurisdiction is non-cooperative if it fails to meet two of the following three criteria: (i) it signed the Convention (or equivalent), (ii) it committed to the automatic exchange of financial account information (where required); and (iii) it achieved at least a “largely compliant” rating in the OECD Global Forum’s peer review for exchange of information on request (EOIR): see <https://www.oecd.org/tax/transparency/fast-track-review-procedure-frequently-asked-questions.pdf>. In November 2016, the EU stipulated that a jurisdiction could be regarded by the EU as compliant on tax transparency if it fulfils at least two of the following three criteria: (a) it has an AEOI arrangement in place with all EU Member States by the end of 2017, either by signing the MCAA or through bilateral DTAs (and, in future, obtains at least a rating of “largely compliant” from the Global Forum); (b) it obtains a rating of at least “largely compliant” from Global Forum with respect to EOIR; and (c) it participates in the Convention, or has a network of DTAs covering all EU Member States (allowing both EOIR and AEOI), either already in force or expected to enter into force within a reasonable time frame: see <http://data.consilium.europa.eu/doc/document/ST-5674-2017-INIT/en/pdf>.

12. See Legislative Council Panel on Financial Affairs, Application of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters in Hong Kong, paper for discussion (5 June 2017), p. 5.

13. Para. D(4), sec. VIII, OECD CRS.

means a jurisdiction (i) with which an obligation to provide financial account information specified in section I of the CRS is in place , and (ii) which is identified in a published list.^[14]

There are two versions of the obligation to provide financial account information: reciprocal and non-reciprocal. The non-reciprocal version is adopted in a situation where a jurisdiction that imposes no income tax (jurisdiction A) and a jurisdiction that imposes income tax (jurisdiction B) enter into a CAA, pursuant to which the exchange of financial account information will be one-way, flowing from jurisdiction A to jurisdiction B. For example, a non-reciprocal bilateral CAA has been concluded between Singapore (which imposes income tax) and the Cayman Islands (which does not impose income tax). From Singapore's perspective, the Cayman Islands is a participating jurisdiction to which Singapore owes no obligation to exchange financial account information.^[15] From the perspective of the Cayman Islands, Singapore is not only a participating jurisdiction but is also a reportable jurisdiction, to which it owes an obligation to exchange financial account information.^[16] Under the CRS framework, a participating jurisdiction embraces a reportable jurisdiction, but not the other way round.

After the 2016 amendment, the Government of Hong Kong proposed an amendment bill to the IRO in 2017 (the 2017 amendment), which became effective on 1 July 2017.^[17] In brief, the 2017 amendment added 72 reportable jurisdictions to the list of reportable jurisdictions prescribed under the HK CRS rules, dramatically increasing the total number of reportable jurisdictions from 2 to 74.^[18] As a result of the 2017 amendment, by the end of July 2017 the number of reportable jurisdictions exceeded the number of comprehensive DTAs and TIEAs that Hong Kong has concluded with other jurisdictions.^[19]

According to the report by the Bills Committee of the Hong Kong Legislative Council, it takes time for the Hong Kong government to negotiate CAAs and, in many cases, some of Hong Kong's DTAs and TIEAs will need to be amended to allow for AEOI. Another reason why a step-by-step approach to CAA negotiation is not adopted is that, because financial institutions are currently mandated to identify and collect information in relation to accounts held by tax residents of confirmed AEOI partners included in the list of reportable jurisdictions, it is difficult for Hong Kong to exchange back-year data with jurisdictions that become AEOI partners in later years.^[20]

However, the government has missed the point that some of the jurisdictions added to the list of reportable jurisdictions do not impose tax on income at all, while others impose tax only on income with a local source (in the same way as Hong Kong does).^[21] These no-tax and domestic source-only jurisdictions have no interest in receiving financial account information from Hong Kong under the CAA concluded with Hong Kong. In this regard, the reporting financial institutions are required to do more than is necessary by way of collecting and reporting financial account information under the Hong Kong CRS rules.

As a separate but related matter, Hong Kong has entered into a Model-II intergovernmental agreement (IGA) with the United States on the implementation of FATCA, pursuant to which Hong Kong financial institutions are required to submit to the United States Internal Revenue Service information on bank accounts maintained by United States citizens and green card holders in Hong Kong. The United States-Hong Kong Model II IGA is not reciprocal^[22] because the bank account information only flows one way: from Hong Kong to the United States. Hong Kong, which imposes tax only on locally sourced income, does not need, for Hong Kong tax purposes, information on bank accounts maintained by Hong Kong residents in the United States.

6. Passive Non-Financial Entity

The HK CRS rules provide that a "passive NFE" means:

- (a) an NFE^[23] that is not an active NFE; or
- (b) a financial institution that–
 - (i) falls within the description in paragraph (e) of the definition of **investment entity** in this subsection;
 - (ii) is not a participating jurisdiction financial institution; and
 - (iii) is not a financial institution in Hong Kong ...

[Emphasis in original.]

14. Para. D(5), sec. VIII, OECD CRS and para. 118, Commentary on Section VIII concerning Defined Terms, OECD CRS, p. 194.

15. See <https://www.iras.gov.sg/IRASHome/Quick-Links/International-Tax/Common-Reporting-Standard-CRS/>.

16. See <http://www.gov.ky/portal/pls/portal/docs/1/12400628.PDF>.

17. Inland Revenue (Amendment) (No. 2) Ordinance 2017.

18. See Sch. 17E, IRO.

19. At 1 August 2017, Hong Kong had concluded 37 DTAs and 7 TIEAs (making a total of 44) with other jurisdictions: see <http://www.ird.gov.hk/eng/tax/dta1.htm>.

20. Report of the Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2017, para. 5, at <http://www.legco.gov.hk/yr16-17/english/bc/bc03/reports/bc0320170607cb1-1022-e.pdf>.

21. For example, the Bahamas, the Cayman Islands and Vanuatu do not impose tax on income, while Gibraltar and the Seychelles impose tax only on locally-sourced income.

22. See articles 2 and 3 of the *Agreement between the Government of the United States of America and the Government of the Hong Kong Special Administrative Region of the People's Republic of China for Cooperation to Facilitate the Implementation of FATCA*. A model II-IGA will not expressly provide whether it is reciprocal or non-reciprocal. Reciprocity can only be determined with reference to the contents of the IGA.

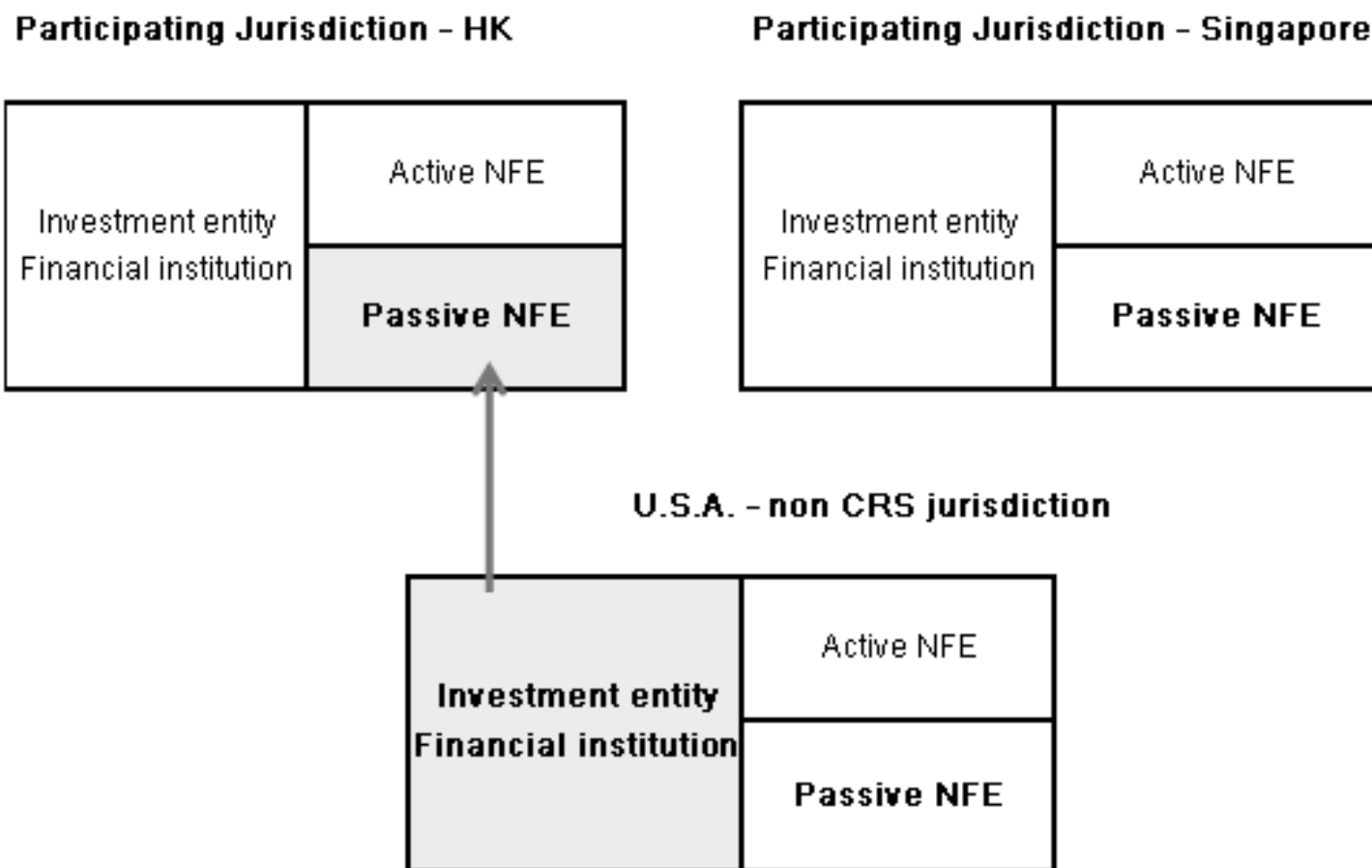
23. Defined in sec. 50A(1) IRO as "an entity that is not a financial institution".

Item (iii) of paragraph (b) only appears in the HK CRS rules; it does not appear in the OECD CRS, nor does it appear in the definitions of passive NFE in the CRS rules of other participating jurisdictions, such as Singapore^[24] and the Cayman Islands.^[25]

Both item (i) and item (ii) of the HK CRS rules qualifies, in grammatical terms, the financial institution under paragraph (b), by deeming all financial institutions in the non-CRS regime to be passive NFEs. Paragraph (b) is an anti-avoidance provision in the OECD CRS and is specifically designed to guard against the avoidance of CRS reporting by tax evaders.

Item (iii) has an inconsistency in its logic, and it should be deleted. If only a Hong Kong financial institution is excluded, financial institutions in other participating jurisdictions are left unaddressed. Under the OECD CRS, a participating jurisdiction and a non-participating jurisdiction are two mutually exclusive concepts. According to the logic of item (iii), financial institutions in other participating jurisdictions should have been included. The Figure illustrates the point.

Figure: Definition of passive NFE under the HK CRS rules



For example, an investment entity resident in Singapore should be excluded according to the logic of item (iii). The exclusion of a financial institution in Hong Kong is not exhaustive.

Therefore, item (iii) of paragraph (b) should be deleted in order to preserve the consistency in the meaning of the term “passive NFE” in the HK CRS rules.

7. Due Diligence for Pre-existing Entity Accounts

With respect to due diligence for pre-existing entity accounts, the HK CRS rules provide that:^[26]

24. See Section VIII: Defined Terms, The Schedule – Common Reporting Standard, Income Tax (International Tax Compliance Agreement) (Common Reporting Standard) Regulations 2016, Singapore, at <http://statutes.agc.gov.sg/aol/search/display/view.w3p;ident=5cde2b19-8cd4-43be-a603-52df964936dc;page=0;query=Compld%3Ad6236ede-2d7b-4cf2-b78c-d39907559d20%20ValidTime%3A02%2F12%2F2016%20TransactionTime%3A02%2F12%2F2016;rec=0#Sc->.
25. See Section VIII: Defined Terms, Schedule 1, The Tax Information Authority (International Tax Compliance) (Common Reporting Standard) Regulations 2015, Supplement No. 1 published with Extraordinary Gazette No. 80 (16 Oct. 2015), Cayman Islands, at [http://tia.gov.ky/pdf/Tax_Information_Authority_\(International_Tax_Compliance\)_Common_Reporting_Standard_Regulations_2015.pdf](http://tia.gov.ky/pdf/Tax_Information_Authority_(International_Tax_Compliance)_Common_Reporting_Standard_Regulations_2015.pdf).
26. Paras. 5(1), (2) and (3), Part 5, Sch. 17D, IRO.

[t]he reporting financial institution must review information maintained for regulatory or customer relationship purposes (including information collected and maintained pursuant to AML/KYC^[27] procedures) to determine the account holder's residence [which] includes a place of incorporation or organization, or an address in a reportable jurisdiction. ... If the information indicates that the account holder is a reportable person, the reporting financial institution must treat the account as a reportable account

In order to determine whether the entity is a reportable person, the OECD CRS provides that the reporting financial institution must:^[28]

[r]eview 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 [which] includes a place of incorporation or organization, or an address in a Reportable Jurisdiction.

There is a missing link between “the residence of the account holder” and “a reportable person” in the HK CRS rules. The language of “residence of the account holder” can cover the following groups of account holders who are resident in a non-reportable jurisdiction:

- (1) an account holder who is resident in a non-CRS jurisdiction (e.g. the United States);
- (2) an account holder who is resident in a jurisdiction that has not committed itself to AEOI (e.g. Taiwan);
- (3) an account holder who is resident in a CRS participating jurisdiction with which Hong Kong has not concluded a CAA.

Unlike the definition of “reportable person” in section VIII of the OECD CRS, which refers to a resident in a reportable jurisdiction,^[29] the language of “residence of the account holder”, used in the HK CRS rules, does not distinguish between “resident in a reportable jurisdiction” and “resident in a non-reportable jurisdiction”. Accordingly, the residence of an account holder under the HK CRS rules cannot be placed in the context of the OECD CRS.

In contrast, the term “resident in a reportable jurisdiction” in the OECD CRS provides a link between a reportable person and a reportable account. The logic of the OECD CRS can be understood in the following way: a person (entity) resident in a reportable jurisdiction, with which a CAA is in place, is a reportable person. If the account is held by such a reportable person (entity), then the account is a reportable account.

8. Persons Controlling a Passive NFE

In determining the residence of controlling persons of a passive NFE, the HK CRS rules provide that:^[30]

- (1) [w]ith respect to an account holder of a pre-existing entity account (including an entity that is a reportable person), the reporting financial institution must identify whether the account is held by a passive NFE with one or more controlling persons, and determine the residence of the controlling persons.
- (2) If any of the controlling persons of a passive NFE is a reportable person, then the account is to be treated as a reportable account.

To determine whether the entity is a passive NFE with one or more controlling persons who are reportable persons, the OECD CRS provides that:^[31]

... the Reporting Financial Institution must determine whether the Account Holder is a Passive NFE with one or more Controlling Persons who are Reportable Persons. If any of the Controlling Persons of a Passive NFE is a Reportable Person, then the account must be treated as a Reportable Account

The logic of the OECD CRS is that if the controlling person of a passive NFE is resident in a reportable jurisdiction, the controlling person of that passive NFE is a reportable person. Therefore, an account held by a passive NFE with such a controlling person is a reportable account.

Again, the language of “residence of the controlling person” under the HK CRS rules can cover:

- (1) a controlling person who is resident in a non-CRS jurisdiction;
- (2) a controlling person who is resident in a jurisdiction that has not committed itself to AEOI;
- (3) a controlling person who is resident in a CRS participating jurisdiction with which a CAA is not in place.

27. I.e. customer due diligence procedures required to be carried out by a reporting financial institution pursuant to any anti-money laundering requirements or similar requirements (including requirements to know a customer) to which the reporting financial institution is subject: see sec. 50A IRO.

28. Para. D(1), Section V: Due Diligence for Preexisting Entity Accounts, OECD CRS.

29. See sec. 3. above.

30. Para. 6, Part 5, Sch. 17D, IRO.

31. Para. D(2), Section V: Due Diligence for Preexisting Entity Accounts, OECD CRS.

The language of “residence of the controlling person” under the HK CRS rules is a modified version of the OECD CRS³² and has a wider meaning than that of “the controlling person who is a reportable person” in the OECD CRS, so it cannot be read in the same context as the OECD CRS. Consequently, a reporting financial institution will report more reportable accounts to the tax authority under the HK CRS rules than that under the OECD CRS.

9. Concluding Comments

The terms in the HK CRS rules should have been clearly defined because they lay the foundation for the structure on which the CRS legal framework is built. Hong Kong CRS reporting will commence in 2018 with respect to 2017 financial account information. If the inconsistencies in logic between the OECD CRS and the HK CRS rules in relation to the terms used are not fixed quickly in the HK CRS rules, they will continue to cause confusion for the stakeholders (including financial institutions, account holders and professional intermediaries) who implement the HK CRS rules.

³² Other offshore finance centres, such as Singapore, the Cayman Islands and the British Virgin Islands, have adopted the same modified version in the due diligence procedure for pre-existing entity accounts.