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In this article, the author compares Hong Kong's common reporting standard with other versions and raises some questions that authorities should consider.

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Under section 50A(1) of the Hong Kong Inland Revenue Ordinance (the HK CRS rules), the term “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; both of these will be specifically dealt with below. If a trust company (or a fund manager), acting for its customers, meets the gross income test, it will be classified as an investment entity under paragraph (d) (Type A IEFI).¹ A trust can be treated as a financial institution (FI) or a nonfinancial entity (NFE). If a trust meets both the gross income test and the managed-by test, the trust is classified as investment entity under paragraph (e) (Type B IEFI).²

The Hong Kong-U.S. Model II IGA

The Model II intergovernmental agreement concluded between Hong Kong and the U.S. on November 13, 2014, states:

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 Hong Kong Inland Revenue Department, Guidance for Financial Institutions (2017), at Chapter 16, para. 1.

² *Id.* at Chapter 17, para. 11.

- 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.³

The term “investment entity” appears in the OECD guidance for the common reporting standard, the U.S. Foreign Account Tax Compliance Act regulations, IGAs, and HK CRS rules. Both the OECD and HK versions are based on the U.S. regs.⁴ The Model II IGA definition is much less restrictive. It specifies only one condition rather than two and has a lower threshold for defining investment entities. However, the Hong Kong-U.S. Model II IGA provides that the Hong Kong reporting FI can use the definition in the FATCA 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 an entity’s classification as either an FI or an NFE.

Type A

The HK CRS rules require that a Type A IEFI primarily conducts as its business-specific listed activities and that at least 50 percent of its gross income is attributable to those activities for the shorter of either the three-year period that ends on December 31 before the year in which the determination regarding whether the entity is an investment entity is made, or the period during which the entity has existed. Entities that do not meet the gross income condition are automatically classified as NFEs.

Because of those rules, fewer investment entities will meet the Type A IEFI requirements of

the HK CRS rules than under the Model II IGA rules.

A Type A IEFI may act as a trustee or administer or manage financial assets or money for multiple customers. However, a private trust company is not an investment entity if it does not charge any fees for the services rendered to the trust and does not have any corporate director(s).

Type B

The HK CRS rules specify two conditions for a Type B IEFI: a managed-by condition and a gross income condition.

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

To satisfy the gross income requirement, at least 50 percent of a Type B IEFI’s gross income must be “primarily attributable to investing, reinvesting, or trading in financial assets” for the shorter of either the three-year period that ends on December 31 before the year in which the determination regarding whether the entity is an investment entity is made, or the period during which the entity has existed. An IEFI that does not meet that condition is classified as an NFE, even if it meets the managed-by condition.

Reclassification Issues

Because of the differences between the HK CRS rules and the Model II IGA rules, some investment entities that have been classified as FIs under the Hong Kong-U.S. Model II IGA will not be classified as IEFIs. An entity not classified as an FI will be considered an NFE — but that reclassification will not occur without determining whether the entity is an IEFI under the HK CRS rules. A reporting FI in Hong Kong has reporting obligations, but an NFE there does not, and a wrong classification could cause irreversible damage to account holders.

³Under item (k) of article 1 (definition, Model II IGA).

⁴U.S. Treas. reg. 1.1471-5(e)(4)(i)(A) and (B), respectively.

If an entity is classified as a Type B IEFI, the total value of all trust property will be reported for its settlors, beneficiaries having a mandatory right to distributions, and any other person exercising ultimate control over the trust.⁵ If it is classified as an NFE, it must disclose to the reporting FI where it maintains a financial account the balance or value and the gross amount paid and credited to the financial accounts in the relevant period for its settlors and beneficiaries, as well as the gross amount paid or credited in the relevant period for beneficiaries who received discretionary distributions.⁶

Financial and Reportable Accounts

A trust classified as a 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 IEFI).⁷ 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.

The settlors, any protectors, and the beneficiaries must always be treated as controlling persons of a trust, regardless of whether any of them exercises control over the trust. If a settlor, beneficiary or other person exercising ultimate control over the trust is itself an entity, that entity must be looked through, and the ultimate natural controlling person 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.⁸

⁵ Hong Kong Inland Revenue Department, *supra* note 1, at Chapter 17, para. 28. This happens if an FI trust does not calculate its account value at the end of the reporting year.

⁶ *Id.* at para. 43.

⁷ See para. (c) of the definition of financial account under section 50A(1) of the HK CRS rules.

Conclusion

The logic of the OECD CRS is that if a beneficiary or settlor resides in a reportable jurisdiction, it is a reportable person. Therefore, the equity interest in the trust that is considered to be held by a beneficiary or settlor is a reportable account. Some jurisdictions do not impose income tax and thus do not define tax residence. A beneficiary may therefore not be considered a reportable person simply because he has a residence in a reportable jurisdiction for tax purposes. To close the gap, the OECD CRS guidance provides that a reportable person that has the right to directly or indirectly receive a mandatory distribution or that may directly or indirectly receive a discretionary distribution from the trust will be treated as a beneficiary.⁹ The OECD rules lay out a residence test and a distribution test for the due diligence procedures a reporting FI must perform to identify any reportable accounts. The concept of financial accounts embraces that of reportable accounts, but not the other way around.

The HK CRS rules do not include a residence test, so some financial accounts would be treated as reportable accounts in the absence of due diligence procedures to identify the residence of the account holder. Thus, a clarification is needed to provide clear guidance for reporting FIs and other stakeholders. ■

⁸ See OECD, *Implementation Handbook of Standard for Automatic Exchange of Financial Account Information in Tax Matters*, Chapter 6, para. 214, at 80. The term “controlling person” corresponds to the term “beneficial owner” as described in Recommendation 10 and the interpretive note in the Financial Action Task Force’s 2012 recommendations.

⁹ OECD, *Standard for Automatic Exchange of Financial Account Information: Common Reporting Standard*, “Section VIII: Defined Terms,” para. C(4).