Everything you need to know about CRS…

but were afraid to ask

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Exchanging information: why it matters

CROSS-BORDER TAX non-compliance is a vexing problem for national governments. A key to combating this issue is cooperation between various countries' tax authorities to better fight tax evasion and protect tax system integrity. To engender cooperation, many countries have tax treaties in place to exchange information on companies or individuals suspected of tax evasion. However treaties have proven ineffective, as the information is only shared upon request.

As a result, a new approach has emerged over the past five years to try to eliminate cross-border tax avoidance. This system was developed through the cooperation of the Organisation for Economic Co-operation and Development (OECD), and the G20 countries, in close collaboration with the European Union (EU), whereby the transfer of all the relevant information regarding cross border taxpayers is automatically and systematically disseminated.

This system has come to be known as the Common Reporting Standard ("CRS"). The system has created a global information-gathering and reporting requirement for financial institutions. Under CRS, financial institutions must determine where all customers are tax resident – usually where a customer is liable to pay income or corporate taxes. If a bank customer is tax resident outside the country where he/she holds account(s), the financial institution may need to give the national tax authority this and other account-related information, which may then be shared between different countries' tax authorities.

The standard consists of three components:

- **CRS** – contains reporting and due diligence rules
- **Model Competent Authority Agreement** (Model CAA) – contains detailed rules on exchange of information
- **OECD Commentaries** – provides additional guidance on local implementation of CRS and CAA

CRS implementation is underway in participating countries through national legislation, and, as of April 2016, 100 governments have committed support to CRS.

What has to be exchanged?

Each country will annually automatically exchange with the other countries that have joined the CRS, the information below:

- Name, address, TIN, date and place of birth of each reportable person
- Account number
- Name and identifying number of reporting financial institution
- Account balance or value as of end of relevant calendar or, if account was closed during such year or period, closure of account

Reportable accounts: who, what, why

OECD does not specify what is reportable – rather, it allows participating countries to determine what accounts are reportable. The term "reportable account" means Jurisdiction A Reportable Account or a Jurisdiction B Reportable Account as context requires, provided it has been identified as such pursuant to due diligence procedures, consistent with the Annex in place in Jurisdiction A or Jurisdiction B

Either jurisdiction may negotiate and determine its own reportable accounts in its agreement. For example, the United States, with its citizenship-based taxation, has established in FATCA Intergovernmental Agreements that accounts held by U.S. citizens and U.S. persons for tax purposes in the other country's jurisdiction are required to be reported via FATCA.

Financial accounts information will be exchanged only between countries and territories for which the convention is in force and in effect. Therefore, if a jurisdiction doesn't sign the convention, this jurisdiction will neither automatically report account information nor automatically receive account information from jurisdictions which signed the convention.

Consider the following cases:

Both Jurisdiction A and Jurisdiction B signed the convention.

- Jurisdictions will exchange the information.
- Jurisdiction A will report to Jurisdiction B.
- Jurisdiction B will report to Jurisdiction A.

Jurisdiction C signed the convention, Jurisdiction D didn't sign the convention.

- No information exchange between Jurisdiction C and Jurisdiction D.
- Jurisdiction C will not report to Jurisdiction D.
- Jurisdiction C will not report to the Jurisdiction D.

In other words, Vietnam won't exchange the information, while France will. This means that:

- If a tax resident of France has an account in Vietnam, his/her account will not be reported to French authorities by Vietnam authorities.
- If a tax resident of Vietnam has an account in France, his/her account will not be reported to Vietnamese authorities by French authorities.

It should be noted that absence of automatic information exchange between a pair of jurisdictions does not mean that there will be no information exchange at all. Information may be exchanged either on request or spontaneously:

- **On request** – A situation when a competent authority of one jurisdiction asks for particular information from a competent authority of another jurisdiction. Information request should relate to a specific tax investigation, either criminal or civil. This type of exchange is conducted according to Tax Information Exchange Agreements (TIEAs) that may exist between jurisdictions.
- **Spontaneously** – Provision of information to a competent authority of one jurisdiction that is foreseeably relevant to a competent authority of another jurisdiction and that has not been previously requested.

So what's the difference between CRS and FATCA?

Although some observers call CRS "a global extension of FATCA," and sometimes referred to as GATCA, the systems have key differences. Unlike FATCA – which requires financial institutions to look only for U.S. reportable accounts – CRS requires financial institutions to identify all reportable customers' residency. And because CRS does not contain many *de minimis* thresholds under FATCA, financial institutions must report significantly higher volumes of information.

There are several differences in term definitions between CRS and FATCA Model 1 IGA. CRS defines a passive nonfinancial entity to include managed investment entities resident in jurisdictions that don't participate in CRS – of particular concern to U.S. fund and trust industries.[1] So financial institutions are required to look through managed investment entities to classify controlling persons of any fund outside a CRS jurisdiction that holds an account. Under FATCA Model 1 IGA, there's no need to look through managed investment entities because they're considered financial institutions.

CRS roster of participating countries

> The following countries will start reporting in 2017: Anguilla, Argentina, Barbados, Belgium, Bermuda, British Virgin Islands, Bulgaria, Cayman Islands, Colombia, Croatia, Curacao, Cyprus, Czech Republic, Denmark, Dominica, Estonia, Faroe Islands, Finland, France, Germany, Gibraltar, Greece, Greenland, Guernsey, Hungary, Iceland, India, Ireland, Isle of Man, Italy, Jersey, Korea, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mexico, Montserrat, Netherlands, Niue, Norway, Poland, Portugal, Romania, San Marino, Seychelles, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Trinidad and Tobago, Turks and Caicos Islands and United Kingdom
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> Starting to report in 2018: Albania, Andorra, Antigua and Barbuda, Aruba, Australia, Austria, The Bahamas, Belize, Brazil, Brunei Darussalam, Canada, Chile, China, Cook Islands, Costa Rica, Ghana, Grenada, Hong Kong (China), Indonesia, Israel, Japan, Kuwait, Marshall Islands, Macao (China), Malaysia, Mauritius, Monaco, Nauru, New Zealand, Qatar, Russia, Saint Kitts and Nevis, Samoa, Saint Lucia, Saint Vincent and the Grenadines, Saudi Arabia, Singapore, Saint Maarten, Switzerland, Turkey, United Arab Emirates, Uruguay and Vanuatu

However, there are still more than 100 countries[2] that will not participate in automatic information exchange. Many of those that have not signed are small countries. Among the large countries, the U.S. has not signed the treaty. In April 2016, shortly after the release of the Panama papers, Panama agreed to comply with the standard.

CRS impact and opportunity

Although CRS information exchange hasn't begun, according to OECD Secretary General Angel Gurría, the looming implementation has already increased global tax collections by more than 50 billion. Gurría notes that this "found revenue" was approximately 125 times the OECD's annual operating budget, implying that effective tax administration essentially pays for itself. The point is not to increase anybody's tax burden but to enhance the collection of taxes due under current law.

This increased tax revenue is impressive given that CRS has yet to take effect. No information will be exchanged under CRS until September 2017 at the earliest, but some taxpayers have already come forward to declare and pay any taxes due to their relevant tax authorities.

> Apparently, these people once played fast and loose with tax authorities when it came to disclosing offshore assets. But today, with CRS looming, they've realized continued noncompliance is ill advised. One obvious implication is that treaty-based information sharing (i.e., exchange on request) was not the strongest deterrent to cross-border tax evasion.

It's easy to understand the limitations of treaty-based information exchange. The country making the request often must possess specific details about the taxpayer in question because tax treaties generally prohibit fishing expeditions. Although treaty-based information exchange is not going away, its practical usefulness is superseded by automatic information exchange regimes like CRS or FATCA.

Planning

There are some immediate planning opportunities for foreign persons, including non-resident aliens (NRAs) who maintain foreign trusts in jurisdictions that are or will now become a CRS participant.

The biggest opportunity is creating trusts in the U.S. or domesticating foreign trusts, as the U.S. has not signed on to be a participant in CRS. U.S. trusts for NRAs have long been favored to avoid or delay U.S. gift taxes for those clients with U.S. citizen or U.S. resident children or family members. This type of planning remains a viable and tax-advantaged method for international families.

Privacy

As discussed above, FATCA and CRS have some key differences. Under FATCA, the U.S. will not report information about cash accounts held by entities, non-cash accounts that do not earn U.S. source income or the identity of controlling persons of entities, although the entity itself may be reported.

So an NRA – hoping to minimize exposure to CRS of sensitive or private information – need only hold assets in a U.S. financial institution in the form of a cash account or a non-cash account held by an entity. If the entity is established in a country not subject to a U.S. FATCA reciprocal Inter Government Agreement (IGA), then neither the controlling persons of the entity nor the entity itself will be reported, assuming all corporate rules are followed and the entity structure is bona fide and not a sham. Using a U.S. trustee but structuring the trust as foreign trust under U.S. law allows an NRA access to these benefits without incurring U.S. tax on anything other than U.S. source income (see below).

U.S. taxation of NRAs and resident aliens

In the U.S., NRAs are normally taxed only on U.S. source income, including income effectively connected to a U.S. trade or business, salary, compensation or U.S. investment income. This U.S. source income is generally taxed at a 30% flat rate but may be reduced by an applicable tax treaty. Non-domiciliaries are only subject to U.S. transfer taxes (estate, gift and generation-skipping transfer taxes) on U.S.-situs assets.

The U.S. taxes resident aliens on worldwide income derived from any source, including but not limited to, U.S. employment income, foreign employment income, U.S. passive income, foreign passive income and U.S. capital gains. In some situations, the resident alien can defer U.S. tax through like-kind exchanges and corporate reorganizations or by taking advantage of exclusions for a personal residence.

Foreign trusts sitused in the U.S.

U.S. income tax is payable by U.S. beneficiaries if the foreign trust is not a grantor trust. A trust is a foreign trust under U.S. law if it does not meet both of these requirements:

- A court within the U.S. exercises primary supervision over the administration of the trust
- One or more U.S. persons have authority to control all substantial decisions of the trust

A U.S.-sitused trust is a foreign grantor trust (FGT) to the NRA Grantor if:

- The trust is revocable by the grantor or on consent of unrelated person with no interest in the trust, or
- Distributions are allowed only to the grantor or the grantor's spouse during the grantor's lifetime, or
- The trust is a grandfathered grantor trust created prior to September 19, 1995

If the foreign trust is a non-grantor trust, distributions are taxable to U.S. beneficiaries, the character of distributions from current year income and gains flow through to beneficiaries, distributions of accumulated income and gains are taxed as ordinary income, plus there is an interest charge for accumulations of offshore income.

Existing non-U.S. sitused trusts

CRS requirements outside the U.S. and tax treatment are driving a trend toward domestication of offshore trusts to the U.S.

- The trustee should evaluate whether a non-grantor foreign trust's ownership of foreign investment companies will be subject to foreign personal holding company, controlled foreign corporation or passive foreign investment company rules.
- If the foreign trust is expected to accumulate income, the trustee should consider possibly converting the foreign trust to a U.S. domestic trust.
- Trustees should also consider whether the trust has or will acquire U.S. beneficiaries, how long the existing or potential U.S. beneficiaries will remain U.S. income tax residents and the trust's investment and distribution strategy both at the time of conversion and in the future.

Perpetual U.S. trusts

The NRA dynasty trust is a strategy for foreign citizens with U.S. citizen and/or green card children, grandchildren and great grandchildren (whether born or unborn).

Benefits include:

- NRA parent/grandparent can transfer unlimited amount of assets on-shore into trust without gift, estate or generation-skipping taxes.
- Assets are not subject to state income tax with trustee if sitused in a tax-favored U.S. jurisdiction.
- Life insurance investment option (traditional or private placement life insurance) is frequently chosen for the trust, thereby also avoiding federal income taxes within the trust. Life insurance option may also provide for federal and state income-tax-free withdrawals for the U.S. beneficiaries.
- Dynasty trust can continue to benefit U.S. beneficiaries and provide creditor protection.

Self-settled trusts may be attractive for NRAs who anticipate immigrating to the U.S. Prior to immigration, an NRA may generally make unlimited transfers to a self-settled trust in certain U.S. jurisdictions with the NRA as a permissible beneficiary without incurring any U.S. transfer tax. After immigration, if the grantor as a permissible beneficiary needs assets, he or she can generally be distributed to by an independent trustee. If properly structured, assets may be excluded from one's estate and protected from creditors and lawsuits.

Foreign grantor trusts administered in the U.S. are established as a foreign trust for U.S. tax purposes and therefore treated the same as an offshore trust.

Benefits include:

- Typically, trust assets are all in offshore entities, and trust is not generally subject to U.S. income tax (except for any U.S.-source income)
- Trust is typically revocable, and distributions are only to grantor or grantor's spouse
- Upon grantor's death, trust can be transformed to a U.S. dynasty trust to avoid U.S. income tax on distributions of accumulated income
- Trust may be funded with other offshore corporate entities, such as private investment companies, to avoid U.S. estate taxes
- Trust may reduce exposure to sovereign risks
- Forced heirship protection
- U.S. is generally a transparent, non-blacklisted jurisdiction

Standby U.S. dynasty trusts are a strategy for foreign citizens with U.S. beneficiaries who have established foreign trusts in offshore jurisdictions. Upon grantor's death, the foreign trust pours trust assets over to an existing (nominally funded) standby U.S. dynasty trust. This can avoid income tax filing requirements of U.S. beneficiaries and negative U.S. income tax rules on distributions of accumulated income and avoids U.S. transfer taxes.

Conclusion

The U.S. is still a favored jurisdiction for immigration, and U.S. taxes are not necessarily a deterrent to immigrants with wealth, but the U.S. is also becoming a favored jurisdiction for trust situs for international families wishing to avoid CRS requirements.

With proper planning, international clients can take advantage of U.S. trust laws and jurisdiction to minimize taxes and provide privacy and stability for family members.

[1] Under Section VIII, part D, paragraph 8 (ii) of February 2014 document setting out CRS.

[2] Currently, the countries not agreeing to CRS include Afghanistan, Aland Islands, Algeria, American Samoa, Angola, Armenia, Azerbaijan, Bahrain, Bangladesh, Belarus, Benin, Bhutan, Bolivia, Bonaire, , Bosnia and Herzegovina, Botswana, Bouvet Island, Burkina Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Christmas Island, Cocos (Keeling) Islands, Comoros, Congo, The Democratic Republic of the Cote D'Ivoire, Cuba, Djibouti, Dominican Republic, Ecuador, Egypt, El Salvador, Equatorial Guinea, Eritrea, Ethiopia, Falkland Islands, Fiji, French Guiana, French Polynesia, French Southern Territories, Gabon, Gambia, Georgia, Guadeloupe, Guam, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Heard Island and McDonald Islands, Honduras, Iran, Iraq, Jamaica, Jordan, Kazakhstan, Kenya, Kiribati, Korea, Kuwait, Kyrgyzstan, Lao, Lebanon, Lesotho, Liberia, Libya, Macedonia, Madagascar, Malawi, Maldives, Mali, Martinique, Mauritania, Mayotte, Micronesia, Moldova, Mongolia, Montenegro, Morocco, Mozambique, Myanmar, Namibia, Nauru, Nepal, New Caledonia, Nicaragua, Niger, Nigeria, Norfolk Island, Northern Mariana Islands, Oman, Pakistan, Palau, Palestinian, Papua New Guinea, Paraguay, Peru, Philippines, Pitcairn Islands, Puerto Rico, Reunion, Rwanda, Saint Barthelemy, Saint Helena, Saint Martin, Saint Pierre and Miquelon, Sao Tome and Principe, Senegal, Serbia, Sierra Leone, Solomon Islands, Somalia, South Georgia and The South Sandwich Islands, Sri Lanka, Sudan, Suriname, Svalbard and Jan Mayen, Swaziland, Syria, Taiwan, Tajikistan, Tanzania, Thailand, Timor-Leste, Togo, Tokelau, Tonga, Tunisia, Turkmenistan, Tuvalu, Uganda, Ukraine, United States, United States Minor Outlying Islands, Uzbekistan, Vanuatu, Venezuela, Vietnam, Virgin Islands, U.S. Wallis and Futuna, Western Sahara, Yemen, Zambia and Zimbabwe.

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