Nowhere to hide? Changes in tax planning for PRC-based clients

The purpose of this article is to bring to readers' attention anticipated developments in Chinese tax laws that will necessitate a review of all offshore tax planning structures that have been implemented by China-based clients. In some cases, where China-based clients have not been tax compliant in the past, thought needs to be given as to how their tax positions might be regularized before the Chinese tax authorities discover the facts through information exchange rules that will come into effect in the near future.

The tax world is not keeping still. The days when advisers called the shots with their aggressive tax planning for their clients are rapidly becoming a thing of the past. Instead, over the last few years, tax authorities have been flexing their muscles and hitting back at tax avoiders and evaders. (In case you're wondering, the first is legal and the latter is not.) This initiative is being conducted earnestly on a global level and is being coordinated by the OECD with the full support of tax administrations around the world, the G20, the media, a group of very vocal NGOs, and the public. Whatever you might think about the correctness of these developments, they are a reality. The focus on tax compliance going forward is no longer whether people are behaving correctly in accordance with tax laws and regulations, but whether they are paying their "fair share of tax". Anti-avoidance legislation which is being increasingly enacted around the world will, over time, prevent corporations and individuals arranging their affairs so as to avoid paying tax where the tax authority feels that tax ought to be paid.

How do these startling statements apply to Mainland China? In fact, China is among the countries leading these initiatives, as least so far as corporations are concerned. In 2008, China enacted comprehensive corporate tax reforms to prevent tax avoidance, and the rest of the world has since adopted similar approaches. It is actively participating in the more recent global tax changes that are taking place.

For those readers who advise clients who are based in Mainland China, you need to be aware that significant changes to the individual income tax regime are inevitable over the next few years. This makes it essential for your clients to review their tax arrangements and tax filing positions on the Mainland and, for tax-compliant clients, to consider whether their structures will continue to be tax-effective. Conversely, for non-compliant clients, it will be essential to strategize about what steps they need to take to meet the new challenges they will be facing.

By way of background, if the truth be told, up to now, it hasn't been overly difficult for PRC residents to tax-plan their offshore assets so as to avoid paying PRC taxes. The greater difficulty has been for clients to get their assets out of China, taking into account the foreign exchange control laws. (The forex rules are progressively being relaxed, and many commentators say it's only a matter of time before all exchange controls are lifted altogether.) Once that was done, it was a relatively simple matter of putting those assets into an offshore (say, BVI) company, preferably one held by an offshore discretionary trust established for the benefit of the client's family.

If this structuring was done properly and administered properly thereafter, the client would have no Chinese tax liability on the income and gains that were subsequently earned by the offshore company (or trust). Under the tax rules that currently apply to individuals, the income and gains cannot be attributed to the client for Chinese tax purposes. There are no anti-avoidance provisions If this structuring was done properly and administered properly thereafter, the client would have no Chinese tax liability on the income and gains that were subsequently earned by the offshore company (or trust). Under the tax rules that currently apply to individuals, the income and gains cannot be attributed to the client for Chinese tax purposes. There are no anti-avoidance provisions Chinese owners; and there are no offshore trust rules that attribute the income and gains of offshore trusts back to the Chinese settlor and beneficiaries (in the absence of a trust distribution to a beneficiary, and even then it is arguable whether such distributions are taxable in any event).

Of course, the position is totally different if the offshore assets are owned by a PRC corporation or an offshore corporation that is effectively managed from within China), in which case the much wider provisions of the corporate tax laws apply.

This rosy situation will not continue. There are three imminent changes looming which, taken together, create a perfect storm which is going to have a profound effect on offshore tax structuring for Chinese clients. These are (a) the coming changes to the individual income tax laws in China, (b) the impact of the Common Reporting Standard and (c) greater scrutiny of the real place of residence (effective management) of offshore companies (and trusts).

<u>(a) Changes to the individual income tax laws</u>

When China enacted her corporate tax reforms in 2008, the changes were profound. Most importantly for the wealth management industry, the Chinese tax authorities made no secret of the fact that, once the dust had settled on the corporate tax reforms, they would then focus on updating the Individual Income Tax (IIT) Law that sets out the tax rules that apply to individuals. These changes are now fast approaching. So far, it is unclear when this will occur. Rumours abound, but the latest report we have heard is that the new law has already been drafted and is now being reviewed by the State Council. True or not, the fact is that changes are inevitable.

We do not know yet what the new IIT Law will say. We expect that it will impose a comprehensive tax on all income earned by PRC residents (domiciliaries), and will introduce a lower but more uniform tax rate. We assume that the new IIT Law will contain general anti-avoidance provisions which will enable the tax authorities to disregard offshore structures that have been set up for the main purpose of avoiding tax. It's likely that the new IIT law will include controlled foreign corporation rules that will attribute the earnings of offshore investment companies back to their PRC owners for tax purposes.

We do not know whether the new law will seek to tax PRC settlors of foreign trusts on the income and gains of the trusts they have set up, although we know that this is under consideration. This is not a fanciful concept. Other countries such as the US, Canada, UK, Australia and others already apply such rules, so there are plenty of precedents for the PRC tax authorities to draw on.

We do not know whether existing offshore structures will be exempted from these new rules. Perhaps that will be the case, but this should not be assumed. It's a dilemma – should you encourage your client to set up an offshore trust structure now, in the hope that it will be exempted from the new changes, but gambling that the structures might turn out to be tax-ineffective? Of course, there are many other reasons why offshore trusts make so much sense for HNWI clients (eg, succession planning), so the non-tax benefits might make this an easier decision than might at first sight appear. And, of course, to the extent an offshore structure is established for non-tax reasons, the more likely it is that the authorities would not seek to apply the new anti-avoidance rules to defeat them.

<u>(b) Common Reporting Standard (CRS)</u>

Another fundamental change affecting China is the new CRS. Around 100 jurisdictions have committed to automatic exchange of information with each other. In China's case, this will commence in 2018.

Under the CRS, countries will gather information about bank accounts, securities accounts and certain insurance products in their countries that belong to PRC residents, and will transmit that information to the Chinese tax authorities.

We expect that the Chinese authorities will then check whether the PRC resident account-holder has reported these offshore dividends, interest and gains to the relevant Chinese tax bureau and paid Chinese tax thereon. Needless to say, if such income has not been reported, presumably the tax authorities will assess the resident on such income and impose penalties for non-reporting. Also, we would expect the tax authorities to investigate non-reporting of such offshore assets for prior years, as well as how the assets arose in the first place.

Assume that one of your PRC clients has a bank deposit in London and a securities account in Hong Kong. The UK and Hong Kong tax authorities will provide that information, on an annual basis, to the Chinese tax authorities, together will details of account balances and income and gains earned on those accounts.

For accounts held by offshore companies, disclosures will be made where a PRC resident has at least a 25% direct or indirect shareholding in the company, or if the company is effectively controlled by a PRC resident. (In the context of determining "control", the concept is similar to that of an "ultimate beneficial owner" for know-your-customer purposes.) Where the company is owned by a trust, or where the account is in the name of the trustee itself, disclosures will be made about their accounts where the trustee, settlor, any protector or any beneficiary of the trust is a PRC resident.

A minor point worth noting is that the CRS reporting obligations are reciprocal. This means that China will also be reporting to other governments the income earned by residents of those countries on bank and securities accounts held in China. However, because it would be unusual for foreign residents to maintain accounts in China, the information flows under CRS will be largely one-way so far as China is concerned.

The USA is not a party to the CRS arrangements. This has led some to wonder whether it would make sense for PRC residents to move their banking and securities accounts into the USA. Of course, the USA already has FATCA, and most FATCA reporting is, at least in theory, reciprocal. That said, China has not yet formally implemented FATCA and, in any event, the USA's obligation under FATCA to provide information about accounts held in the USA by non-US persons is relatively limited. But regardless, such benefits are likely to be short-lived and will likely only delay the inevitable.

The fact that the PRC resident does not in fact have a liability to pay Chinese tax with respect to the foreign accounts will not prevent disclosures being made. This means that many offshore structures that have been properly planned and are technically effective to avoid PRC tax will come to the attention of the Chinese tax authorities. The result is that even clients who are tax-compliant can expect to have their offshore structures and accounts reviewed by the PRC tax authorities.

<u>(c) Responses of local tax bureaux</u>
Finally, how these matters are handled will depend on the attitude taken by the local tax bureau that is in charge of reviewing the resident's tax affairs. There are two issues to note in this regard.

First, different tax bureaux in China take different views as to what is and is not tax-effective so far as offshore structuring is concerned. So, even if clients believe that their tax planning is sound and proper, you should not assume that the local tax bureau will agree. As mentioned above, different tax bureaux have been known to take inconsistent positions. Also, some bureaux have applied the wider corporate tax laws in dealing with individuals and their offshore assets. Perhaps your clients will prevail, but at the least they might expect to be thoroughly investigated by their tax bureaux.

Secondly, although structures might be tax-effective on paper, much depends on how such structures are in fact being operated. The concern is this. If an offshore company or trust is as a practical manner being effectively managed by the PRC resident from within China, there is scope for the tax bureau to assert that the company (or trust) is itself a PRC resident and is therefore subject to PRC tax on its income and gains (at the rate of 25%). This is obviously a risk where the evidence shows that trustees and offshore directors effectively have done what they were told to do by the PRC client, and where there is no evidence that they have exercised their decision making powers independently. In such a case, it is the company (or the trustee) that will bear the tax liability, not the client.

(d) What do you need to do now?
What is the strategy for your China-based clients?

The first (and most obvious) step is to review the offshore structures that have been implemented by them. If they are tax-compliant, at the least, steps need to be taken now to ensure that the structure will survive an audit by the Chinese tax authorities. This might require preparation of documents to serve as evidence.

Secondly, for clients who have not been tax-compliant, it seems inevitable that they will be identified by the PRC tax authorities. Thought needs to be given as to what steps can be taken pre-emptively to avoid an investigation down the line which will necessitate the payment of back taxes, interest and possible penalties. An obvious step would be for those clients to make disclosures as soon as possible before information exchanges commence under CRS, and to take advantage of any opportunities to negotiate the amount of tax in default as well as penalties and interest. This is preferable to having the authorities find out the facts through CRS information exchanges and then subjecting the client to a formal investigation which would likely result in much harsher treatment. (Many countries have implemented amnesty programmes to assist people to "come clean", but there is no indication that China plans to do the same.)

Thirdly, internally, you should investigate how offshore structures have in fact been administered. In particular, you should investigate whether there is enough evidence available (preferably in documentary form) to establish that the offshore directors and trustees truly are responsible for the decision-making within these entities, and do not simply do what their PRC client tells them to do. If investigation reveals that the evidence falls short, then changes in the administration procedures should be implemented now and applied in the future, and necessary documentation should be prepared.

Author: Michael Olesnicky