

Are Anti Money Laundering and Counter Financing of Terrorism Based Practices for Validation of Tax Residency Inadequate for AEOI/CRS Purposes?

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Introduction

The State of Tax Justice 2021 Report¹ released by the Tax Justice Network shows that jurisdictions miss out on US\$483 billion annually on tax returns - \$312 billion due to tax abuse by multinational corporations and an additional \$171 billion by individuals through cross-border tax evasion.

As the Pandora Papers leak has once again confirmed, financial secrecy remains a defining feature of offshore finance. Secrecy jurisdictions – countries that provide opportunities for non-residents to hide their real tax residency and/or their wealth from the disclosure to the tax authorities² – attract an ever-rising volume of financial assets owned by wealthy individuals.³

In October 2018 the Organisation for Economic Cooperation and Development (“OECD”) released guidance to prevent tax evasion through the use of Citizen-by-Investment (“CBI”) and Resident-by-Investment (“RBI”) schemes⁴ and called on financial institutions and investment entities to adjust their existing AML/KYC processes. This means individual and collective portfolio managers and certain trusts need to identify schemes that can be misused as tools to hide assets held abroad from disclosure under the Automatic Exchange of Information and Common Reporting Standard (“AEoI/CRS”) reporting.

Being involved in conversations on anti-money laundering and know-your-customer (“AML/KYC”) procedural questions, I am surprised to learn that even today Hong Kong-based small FIs notably rely on AMLO procedures to identify and verify their account holders/beneficial owners’ tax residency status and derive the AEoI/CRS reporting status.

This indicates that these FIs have not implemented AEoI/CRS compliance frameworks defined in the Inland Revenue (Amendment) (No. 3) Ordinance 2016.⁵

The reason why this is the case might be:

- the lack of experience in the assessment of international tax measures
- the lack of understanding of how the non-implementation of AEoI/CRS framework will impact them and their involved employees from a financial and legal standpoint
- the lack of adequate resources

With this article, I like to share my view on why AML/CFT related due diligence measures are not sufficient to meet AML/KYC needs under AEoI/CRS and what are the risks of neglecting the implementation of AEoI/CRS compliance frameworks on FIs.

Discussion

The Cap. 615 Anti-Money Laundering and Counter-Terrorist Financing Ordinance requires FIs, authorised insurers, licenced insurance agents, licensed insurance agencies, licensed insurance broker companies, Designated Non-Financial Businesses and Professions (DNFBP) - such as solicitors, foreign lawyers and their employees (including trainee solicitors), accountants, real estate agents and trust or company service providers (“TCSP”) (but not barristers or notaries)⁶ - and issuers of stored value facilities (i.e. a plastic card issued by its issuer to the user⁷) to

establish client due diligence procedures identifying the account holder/beneficial owner and verify the source of funds and source of wealth⁸.

For a customer that is a natural person, FIs should identify the customer by obtaining at least the following identification information:

- full name
- date of birth
- nationality and
- unique identification number (e.g. passport number) and document type⁹

It should be noted that the focus of AMLO is not the verification of an account holder's/beneficial owner's residency for tax purposes.

The 2018 Knight Frank wealth report stated that:

“34% of Ultra High Net Worth Individuals (UHNWIs) already hold a second passport and 29% are planning to purchase one (under jurisdiction-specific Citizenship by Investment or Residence by Investment (CBI/RBI) Schema - note from the author)”.

On October 16, 2018, the OECD published a risk assessment on CBI/RBI Schema and came to the following conclusion:

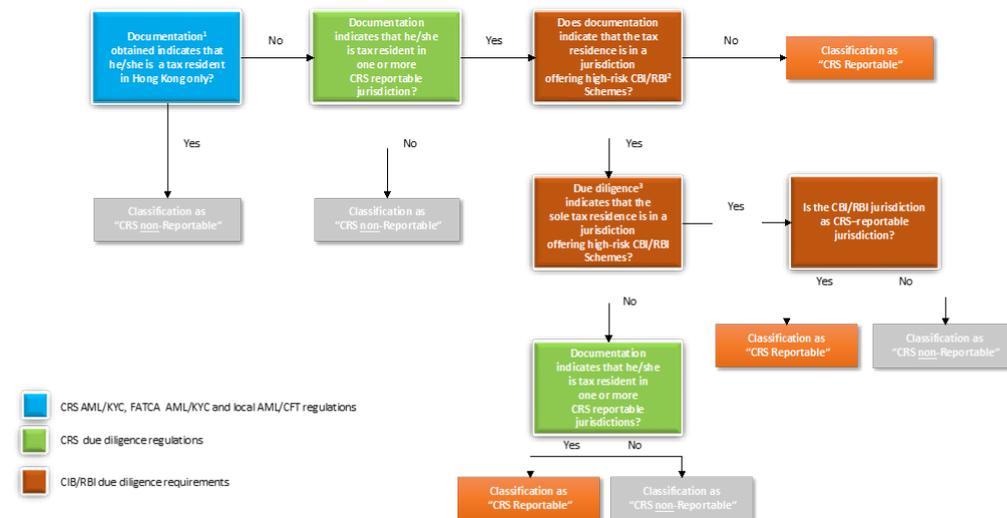
“While residence and citizenship by investment (CBI/RBI) schemes allow individuals to obtain citizenship or residence rights through local investments or against a flat fee for legitimate reasons, they can also be potentially misused to hide their assets offshore by escaping reporting under the OECD/G20 Common Reporting Standard (CRS).”¹⁰

To address these concerns, the OECD framework, when implemented into local legislation, requires FIs to have extended AML/KYC procedures in place enabling them to identify offshore account holder residents in a jurisdiction that offers high-risk CBI/RBI schemes.

The OECD defines high-risk schemes as “Schemes that are potentially high-risk for these purposes are those that give a taxpayer access to a low personal income tax rate of less than 10% on offshore financial assets and do not require the significant physical presence of at least 90 days in the jurisdiction offering the CBI/RBI scheme.”

To meet AML/KYC objectives under AEOI/CRS, FIs are obliged to perform indicia-based due diligence on the account holder/beneficial owner to identify their tax residency and to obtain an AEOI/CRS self-certificate to validate the tax residency status claimed.

The graphic below depicts local and international measures to be considered when onboarding individual clients.



1) Documentation includes all relevant client documentation to be obtained under the HK AML Ordinance and a valid CRS self-certification to validate the account holder's tax residency and FATCA self-certification to confirm US tax payer status
 2) "Citizenship by investment" (CBI) and "Residence by Investment" (RBI) schemes are being offered by a substantial number of jurisdictions and allow foreign individuals to obtain citizenship or temporary or permanent residence rights on the basis of local investments or against a fee and maybe abused to circumvent AEOI/CRS reporting. High-risk CBI/RBI schemes are those that give access to a low personal income tax rate on offshore financial assets or do not require an individual to spend a significant amount of time in the location offering the scheme.
 3) To the extent that the account holder is claiming residence in a CBI/RBI jurisdiction, further investigations may be initiated to ascertain whether the documentation provided is incorrect or unreliable (Source: OECD residence/Citizenship by investment schemes)

Latest developments in the field of international tax transparency standards

In 2017, the Hong Kong Inland Revenue Department launched measures to validate FIs' correct implementation of AEOI/CRS compliance frameworks.¹¹

In November 2021 Indonesia's Minister of Finance Sri Mulyani Indrawati and the President of the Asian Development Bank ("ADB"), Masatsugu Asakawa, firmly supported the launch of an Asia Initiative¹² on tax transparency and called on jurisdictions in the region to join this important milestone to support post-pandemic recovery efforts.

In her keynote speech¹³ delivered on the opening of the 2021 Global Forum plenary meeting, Minister Indrawati insisted on regional cooperation as a key factor to advance the transparency agenda.¹⁴

In the first Asia Initiative meeting held on 16 February 2022, 49 participants came together, among whom there were 15 tax commissioners and deputy commissioners (participants) from 18 Asian members of the Global Forum¹⁵ and three development partners.

This capacity-building initiative aims at promoting in the Asian region the implementation of the internationally agreed standards on transparency and exchange of information of the Global Forum (tax transparency standards) and the use of these standards to tackle tax evasion and other illicit financial flows.¹⁶

The activities initiated by the established Asian Initiative on tax transparency highlight the critical role of the implementation and use of the tax transparency standards in a sustainable post-pandemic recovery and the importance of a stronger regional and international cooperation to address tax evasion and other illicit financial flows.

Key takeaways

Agendas launched by the Inland Revenue Department and the OECD Asia Initiative illustrate that FIs cannot neglect the implementation of AEol/CRS compliance frameworks in the long term as tax authorities agreed that the implementation of tax transparency measures becomes a high ranked priority.

To meet international tax transparency standards, FIs should understand that the reliance on AMLO related due diligence procedures is not sufficient as it does not support the identification of the account holder/beneficial owner's final tax residency.

In my opinion, the question is not if FIs get identified as non-compliant related to AEol/CRS regulatory requirements, it is a question of when they get identified as non-compliant.

The Inland Revenue Ordinance (IRO) includes punitive provisions to sanction financial institutions, service providers and others for offences committed.

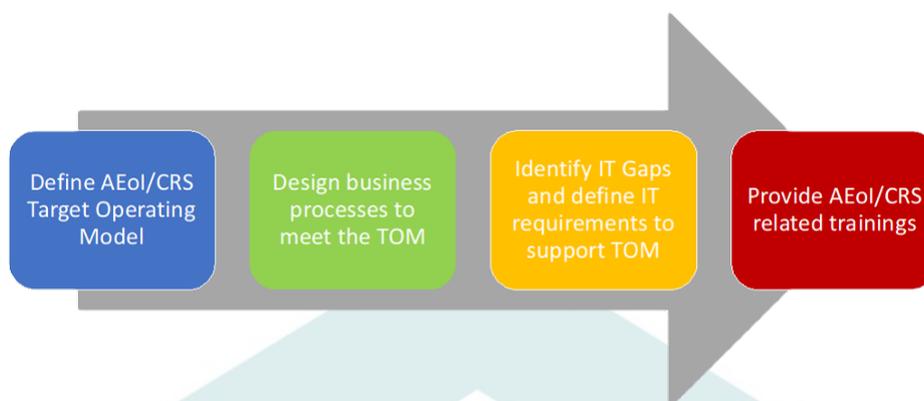
Three main categories of penalty are imposed to sanction non-compliance, submission of incorrect returns, and defrauding with intent. The levels of penalties go up to HK\$50,000 with imprisonment for six months or three years as laid down in sections 80B to 80F of the IRO.

How can we help to mitigate the risks to be treated AEol/CRS as non-compliant?

Almost every function in a financial institution is impacted by CRS: operations, compliance, internal audit, legal, sales and service, financial crime, tax and technology.

Instead of taking the view that AEol is a cost without a benefit, financial institutions should be taking advantage of the improved data quality and connection of account information to build analytics capabilities to deliver more targeted services and products to their clients.

Our team of specialists can support you on the following topics:



About the Author

Marco Zavar is a banker and holds an LL.M in international business and tax law obtained by the Frankfurt School of Finance and Management, Frankfurt and the MCI – Management Center Innsbruck.

He works as a managing consultant and project manager implementing operating models to strengthen financial institutions' compliance framework to combat financial crime (money laundering and tax evasion) through the misuse of offshore accounts.

¹ [State of Tax Justice Report 2021](#)

² [OECD Model Mandatory Disclosure Rules for CRS Avoidance Arrangements and Opaque Offshore Structures](#)

³ [State of Tax Justice Report 2021](#)

⁴ [OECD Residence/Citizenship by investment schemes](#)

⁵ [Inland Revenue \(Amendment\) \(No. 3\) Ordinance 2016](#)

⁶ [Hong Kong Lawyer - Designated Non-Financial Businesses and Professions](#)

⁷ [HKMA - FEATURE ARTICLE Implementation of the Stored Value Facilities Regulatory Regime](#)

⁸ [HKMA - Guidelines on Anti-Money Laundering and Counter-Financing of Terrorism \(For Authorized Institutions\)](#)

⁹ [SFC - Guideline on Anti-Money Laundering and Counter-Financing of Terrorism](#)

¹⁰ [OECD Residence/Citizenship by investment schemes](#)

¹¹ [Inland Revenue Department - AEOI Compliance website](#)

¹² [ASIA INITIATIVE Sustaining the recovery through enhanced tax transparency](#)

¹³ [2021 Global Forum Plenary Meeting](#)

¹⁴ [OECD Global Forum on Transparency And Exchange of Information For Tax Purposes](#)

¹⁵ Brunei Darussalam, Cambodia, China, Georgia, Hong Kong, India, Indonesia, Japan, Korea, Macau, Malaysia, Maldives, Mongolia, Pakistan, Philippines, Saudi Arabia, Singapore, Thailand

¹⁶ [First Asia Initiative Meeting - Statement of Outcomes](#)