Labuan IBFC
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Labuan IBFC Editorial

THE NEW WORLD ORDER: CHASE OR BE CHASED BY TRANSPARENCY AND SUBSTANCE

AUTOMATIC EXCHANGE OF INFORMATION, TRANSPARENCY AND COMPLIANCE

The Common Reporting Standard (CRS) is currently the hot topic amongst those in the financial services industry and international business. So what is CRS and why is it attracting so much attention? How does it impact us and how can we prepare for it?

Simply put, CRS is a standard set by a multilateral body known as the Organisation for Economic Co-operation and Development body (OECD), aimed at facilitating the Automatic Exchange of Information (AEOI) for tax purposes, which in turn is an initiative by both the OECD and the Global Forum on Transparency, which is a sub-grouping of the G20 nations.

The OECD is a forum where 34 governments with market economies work together to promote economic growth, co-operation and sustainable development. Besides these 34 member economies, OECD also comprises more than 70 non-member economies, known as CRS-participating jurisdictions.

In general, the implementation of CRS is a key vehicle of the AEOI which is aimed at preventing tax evasion via the global automatic exchange of information between participating jurisdictions. The principle idea is simple yet effective; after all it is about sharing information and enlarging the circle of access to that information.

CRS requires financial institutions licensed in a jurisdiction signed up to this protocol, to report financial accounts held, directly or indirectly by account holders, both individuals and incorporated entities that are deemed foreign entities in that particular jurisdiction.

Therefore, for the purpose of identification account holders will be required to furnish a vast amount of information such as tax residency, personal identification, and bank accounts as well as balances. In short, the implementation of CRS will unveil information that was previously protected under banking confidentiality, foundations or trusts.

This requirement of transparency and the need for compliance will soon be the new normal for all future financial activities. The other initiative by OECD, Base Erosion Profit Shifting (BEPS) also seeks to create a global level playing field in the way corporations are taxed in the multiple jurisdictions that they operate in.

BEPS adopts tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations. Under this framework, over 100 countries and jurisdictions collaborate to implement these measures. Together, the CRS and BEPS initiatives will change the way businesses and individuals operate across borders.

With such an imminent change looming, how does this affect us?

TAX PLANNING IN A NEW NORMAL GLOBALISED WORLD

With globalisation permeating every business activity, it is normal and even expected that companies operate in multiple jurisdictions.

The fact remains cross-border activities still carry with it a vast amount of operational and statutory friction, as such international financial centres (IFCs) exist, and thrive based on the fact that these jurisdictions are adept at reducing this friction.

IFCs offering tax incentives and business-friendly legislation encourage the intermediation of trade and investments.

Indeed, some business experts have compared IFCs to the oil that lubricates globalisation, and unless we subscribe to the belief that globalisation is dead, the question remains: How do businesses and individuals continue to benefit from IFCs in this landscape of enhanced transparency?

Substance is a common tax concept used in assessing cross-border tax situations, which calls into question the level of operational activity and decision-making process which is conducted in a particular jurisdiction.

In general, a company needs to demonstrate that it has substance in its functional structure such as a physical office, staff administering the day-to-day operations of the company and the necessary operating tools or equipment.

Domestic management staff should have basic decision-making authority to run the business while key decisions are made by the board of directors in the jurisdiction.

Without such arrangements, the tax authorities would conclude that key management decisions for a particular company are not made in the jurisdiction where the company is operating, creating a lack of economic substance.

Simply put, tax residency will not be automatically applied even if a company is registered in a particular jurisdiction. There has to be substance to the operations of a company in any jurisdiction it operates in, towards creating and evidencing economic substance.

As there is no exhaustive list or a version of the “universal truth” when it comes to defining or curating substance- substance needs to be carefully planned in order to avoid potential challenges by tax authorities. It does not help that the criteria accepted in one jurisdiction as satisfying substance requirements may be deemed insufficient in another.

It is also paramount that companies planning to set up cross-border structures consider incorporating their business units in jurisdictions that have double tax treaty with their home country. This will provide certainty with regard to establishing tax residency of a company.

Becoming a tax resident means that the company is taxed based on the tax rules of that treaty party as prescribed in the double tax treaty. In contrast, a cross-border company structure operating in jurisdictions without double tax treaty agreements may risk higher withholding taxes and possible risk of having to pay double tax.

It is also worth noting that companies without substance may not be considered as a tax resident of the treaty party, denying treaty benefits.

Establishing a company in a particular jurisdiction with the hope that its mere incorporation via registering a company with a fiduciary service provider or a trust company in that said jurisdiction will provide access to the tax treaty network is simply wishful thinking.

Yes, building substance incurs additional cost but considering the business interruption risk, wasted resources and the tax burden a company may have to risk when the structure is challenged by the tax authorities, it is always better to be safe than sorry, especially when the company’s reputation is at stake.

To this end, companies that established cross-border structures may consider restructuring its existing business structure to ensure the creation of sufficient substance.

Towards this, the re-domiciliation of these structures or corporate entities to jurisdictions which enable substance creation which give access to a wide range of double tax treaties may be a good start.

RE-DOMICILIATION: A POSSIBLE SOLUTION?

Re-domiciliation occurs when a company undergoes a relocation process from one jurisdiction to another, while retaining its legal identity.

The company does not need to go through a liquidation process and there is no need to transfer its assets and liabilities to a newly incorporated company. Nor is it necessary to liquidate the original company to avoid possible tax and other statutory implications in the country of origin.

A key advantage is the fact that the business of the company can continue operating without disruption and hence, reduce operational down time and benefit from a significant savings in administration and miscellaneous costs.

Indeed, this is by no means a stretch of the imagination to state that the process of re-domiciliation allows companies to have the freedom to choose a jurisdiction according to their current needs, while ensuring business continuity.

It is worth noting that as the creation of substance becomes increasingly important, it is essential that Asian-based businesses with cross-border structures consider re-domiciling their entities closer to home.

In the long run, this makes for a more cost-efficient way to develop economic substance in the region of origin. This is where we believe Labuan IBFC is well placed to benefit from the global drive towards transparency and substance.

When considering building substance, it is imperative to consider jurisdictions that have both operational and cost advantages. For example, being in the same time zone and accessibility of that jurisdiction to headquarters are some key factors.

Other key considerations in choosing a jurisdiction to re-domicile is the jurisdiction's compliance to international laws and standards, the range of the double tax treaties it provides access to, availability of infrastructure and human talent.

Inevitably, business owners and members of senior management need to start looking at future proofing their cross-border operations. The world of international tax planning is undergoing a drastic change and as always, it pays to plan early.

Without a doubt, the automatic exchange of information and transparency is now the new normal. In this new world order, the choices are simple: businesses either chase or be chased by standards of transparency and substance.

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