Summer 2021

A review of recent global tax legislation changes relevant to some of our clients and an overview of other worldwide tax titbits.

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A simple guide to President Biden's proposed tax reforms

US is currently debating arguably the biggest tax reforms in its history. Because there are major proposed changes to the existing tax regimes, we will break them down in a simplified form for our readers in two articles. In this article, we will take a look at some of the reforms proposed by President Biden which are mostly focused on Capital Gains Tax and the elimination of 'step-up in basis' tax loophole. In our next newsletter, we will then discuss the proposed amendments to Estate Taxes.

President Biden introduced a $1.8 trillion American Families Plan ('AFP') on 28th April 2021 – a plan directed at lower and middle-income American families by helping them through investments in education, childcare, and healthcare amongst others. It is meant to work together with other economic recovery packages such as the American Jobs Plan and the American Rescue Plan ('ARP'). The AFP offers radical tax reforms aimed at wealthy Americans and promises no tax increases for anyone making under $400,000 per year. The plan will be partially funded by an estimated $661 billion collected through additional or higher taxes from high-income taxpayers and pass-through businesses like partnerships, sole proprietorships, and S corporations.

Marginal Income Tax rate increase for high earners

One main proposal is to increase the top marginal tax rate for high-income individuals and families from 37% back to 39.6%, which was the prevailing rate prior to President Trumps' tax cut in 2017. The 39.6% will apply to income over $452,700 for single filers and $509,300 for joint filers. The AFP proposal demonstrates an endeavour to move to a more progressive tax system, taxing through higher marginal tax rates on high earners and expanding refundable Tax Credits for lower-income taxpayers - such as the Earned Income Tax Credit, the Child and Dependent Care Tax Credit and the Health Insurance Premium Tax Credit proposed under the ARP. For those who are not too familiar with US tax system, which is known for being considerably complicated and comprising varying rules and exceptions, Tax Credits are used by the Government to allow disadvantaged taxpayers to reduce the amount of tax owed.

Capital Gains Tax and 'Step-up in basis'

The other significant tax proposal revolves around the elimination of the 'step-up in basis.' Before getting into what the proposal entails, one needs to understand what is the 'step-up in basis' under the current tax system and what will be the significance of its elimination. The 'Step-up in basis' is an IRS tax rule that allows heirs to use the value of an inherited property at the time of inheritance, instead of the original purchase value, as the basis value when calculating Capital Gains Tax (CGT) upon the decedent's death. The 'step-up in basis' rule thus deviates from fundamental tax principles, and has long been criticised for being a tax loophole for wealthy individuals who are able to evade or reduce CGT liability by placing their assets in estate trusts.

With the elimination of the 'step-up in basis', the AFP introduces CGT on appreciated assets passing from a decedent to family members, in addition to applicable Gift and Estate Taxes, and will not only apply to lifetime gifts and transfers at death but also to extended holding periods for assets in trusts, partnerships and other non-corporate entities. The AFP therefore proposes to tax unrealised capital gains at death for unrealised capital gains worth over $1 million at ordinary Income Tax rates, which will be levied at the top marginal rate of 39.6%. Thus, if the new marginal rate (i.e. 39.6%) is added to the 3.8% Net Investment Income Tax (NIIT) which will continue to apply, this will result in a combined top marginal rate of

43.4%, compared to the current rate of 23.8% (20% on long term capital gains and 3.8% NIIT).

What this means in simple terms in that assets appreciate in value over time and when they are sold, that appreciation is 'realised' and should therefore be subject to CGT. Because of the 'step-up in basis', when heirs inherit those same assets and the assets are sold, they will not owe any CGT. Let's take the example of stocks bought by a father for $3,000 20 years ago and now valued at $100,000. If the father sell the stocks, he will be taxed on realised capital gains of $97,000 (i.e. value to the stocks today less what was paid for the stocks, known as the basis value). However, if the father dies while holding the stocks, and the stocks are inherited by the son, the son will benefit from the 'step-up in basis' and when he sells the inherited stocks, he will not owe any CGT. With the elimination of the 'step-up in basis', the son will be subject to the CGT on the USD 97,000 or more if the stocks are not sold immediately and left to appreciate further.

The discussion of eliminating the ‘step-up in basis’ does not only focus on taxation on selling of assets after a decedent’s death, but extends to taxation on unrealised gains at the time of transfer. The AFP therefore goes even further by introducing CGT when appreciated assets are transferred and distributed to and from trusts, partnerships and other non-corporate entities.

This means that tax will be due when a person receives an asset, rather than when they sell the asset. The most common capital assets include stocks, bonds, jewellery, art collections, coin collections, precious metals and real estate properties that have been in the family for a long time and which have appreciated significantly over time.

Other capital gains measures

In addition to the elimination of the ‘step-up in basis’, the AFP also proposes limiting ‘Like-Kind Exchanges’ (also referred to as ‘1031 exchanges’) which is a long-standing and regularly used strategy for deferring CGT. ‘Like-Kind Exchange’ is part of a system of CGT provisions that unfairly allows the wealthy to avoid taxes on capital and is a key tool mainly used by real estate investors.

Essentially, ‘Like-Kind Exchanges’ allow investors to defer capital gains by swapping one property for another one of a like-kind, thus allowing them to maintain their capital in their investments and defer the recognition of gains. While the ‘Like-Kind Exchanges’ will still be allowed, the new provision limits the deferral in capital gains to only $500,000.

Private equity and carried interest

Lastly, the AFP comes after Private Equity’s most coveted and lucrative tax break – carried interest – and commits to putting an end to the carried interest loophole. Currently carried interest are treated as capital gains, arguing that profits earned from funds owned by real estate investors, managers of private equity or venture capital firms merely represents a return on investment and cannot be considered as income. Thus they are taxed at a Capital Gains rate, which is much lower to the ordinary Income Tax rate. The AFP proposal eliminates the availability of the lower CGT rate for a partner’s share of income on an ‘investment services partnership interest’ and on its sale should the partner’s taxable income exceeds $400,000. If successful, this will be a significant structural change to the US’ Tax system that will highly impact the Private Equity industry as we know and arguably have consequences on long term investment in the US.

Other proposed changes

Noticeably absent from the AFP are changes to Wealth Transfer Taxes – such as Gift Tax, Estate Tax or Generation-skipping Transfer (GST) Tax. Proposed changes to the transfer taxes have already been introduced to Congress but the law is yet to be voted. We will look at the proposed amendments to Estate Taxes in another article in our next newsletter.

Will crypto be the new source of tax revenue for governments in a post-pandemic world?

Bitcoin, Ripple, Litecoin and Ethereum are only few of the many cryptocurrencies that currently exist which allows secure online payment using blockchain technology. A cryptocurrency is a form of digital asset based on a network that is distributed across a large number of computers. This decentralised structure allows them to exist outside the control of governments and central authorities.

On a more technical note, crypto-asset networks, such as Bitcoin, are controlled through a network, often referred to as a 'consensus' where users are responsible for verifying transactions or issuing new cryptocurrency and where a sufficient proportion of the network must agree to a transaction or technological change before it can go ahead. 'Proof of Work' is a consensus algorithm used in crypto mining which requires users, known as miners, to solve complex equations to validate blockchain transactions and where miners are rewarded every time they find the correct combination. Crypto Staking, which is an alternative to crypto mining, is an activity where a user holds his funds in a cryptocurrency wallet to support a specific blockchain network's security and operations. Staking uses a 'Proof of Stake' mechanism that allows users to generate a passive income only by holding coins. When validating transactions, the users are rewarded with new coins, proportionate to the number 'Staked'.

The growth of the crypto industry over the past decade has prompted many countries to regulate it, especially by imposing taxes on cryptocurrency. The treatment of crypto assets and the tax regime applicable vary from country to country, and taxes may range from capital gains, income or corporate taxes. Other countries have gone the opposite way, deciding to attract crypto investors and businesses looking to mitigate taxes of their crypto assets and transactions. By so doing, some countries have emerged as crypto tax havens due to their governments' relatively lax crypto tax laws. One way or the other, there have been major developments from a regulatory and tax perspective in the crypto industry worldwide.

China

We cannot discuss crypto currencies without mentioning China which became the first country to debut a national digital currency, the digital Yuan. China aims to use the digital Yuan as an alternative currency to digitise the country and make retail payments easier and faster. Unlike other cryptocurrencies that work on the principle of decentralisation, the digital Yuan is completely centralised. It is in fact the World's first digital currency where the government holds complete control over its exchange and distribution, thus making it a secure and reliable form of currency. It has an official handler, Yuan Paygroup, which will act as an official broker and will be the leading organisation for the distribution and exchange of the digital Yuan.

With the creation of the first Central Bank Digital Currency and the launch of the digital Yuan and the Blockchain-based Service Network (BSN), China is definitely challenging the United States' dominance over the financial and technological industry. With its new digital currency, China is hoping to encourage more bank-to-bank wire transfers in the Chinese currency rather than the American Dollar which currently dominates international payments.

To allow its central bank to test its digital currency, China is coming with aggressive measures against cryptocurrencies, such as banning financial institutions and payment companies from providing services related to cryptocurrency transactions, and warning investors against speculative crypto trading. China's ban on bitcoin mining may see up to 90% of bitcoin mining capacity, or one-third of the global crypto network's processing power, to be suspended in the short term. This is alarming given that it believed that 65% of miners and maintainers operate from China. It is not implausible to consider that the country's ban on cryptocurrency mining and trading could escalate further and lead to a full-fledged ban on private digital assets.

Many privacy advocates are also concerned at the amount of data that the Chinese Government will be able to collect through the new digital Yuan, allowing them insight on people's transactions and spending behaviours. For the government, the blockchain data structure will ensure unprecedented traceability and control which will arguably change the future of global financial system.

US

Last year, the US Internal Revenue Service (IRS) introduced a question on the 2020 tax form that asked, “at any time during 2020 did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency.” Albeit a small step, it acknowledged the increasing interest in crypto assets. With an increasing demand for a regulatory framework, a legislation to regulate cryptocurrencies and other digital assets was finally introduced in July 2021. The “Digital Asset Market Structure and Investor Protection Act” boldly tackles the treatment of crypto assets under five securities acts, the Commodity Exchange Act and the Bank Secrecy Act.

The proposed law seems to compel the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) to provide legal clarity on digital assets through joint rulemaking. Statutory definitions of digital assets and securities will be added to the statutory definition of “monetary instruments” in the Bank Secrecy Act, which will permit crypto to be subject to already established anti-money laundering, record keeping and reporting standards. To promote transparency and forestall fraudulent cases, the bill will create a requirement for digital asset transactions which were not recorded on a publicly distributed ledger to be reported to a Digital Asset Trade Repository.

Also in July 2021, the US Senate voted a $1 trillion Infrastructure Bill which could be partially funded by taxes levied on cryptocurrency and digital-asset transactions. A cryptocurrency tax reporting requirement, similar to current reporting rules for traditional brokers of stocks and bonds, will require anyone who provides a service that executes transfers of digital assets to report them to the IRS. The proposal also calls for businesses to report crypto transactions of more than $10,000 to the IRS.

It is apparent that the US is recognising the untapped tax revenue that lie in the crypto industry to fund its various recovery packages post Covid-19. The US treasury even estimated $700 billion in untapped tax revenue from crytpo trading in next decade. However, unlike China which opted to digitise its currency, it is understandable why US may be unwilling to do so. The U.S. Office of the Director of National Intelligence has shared its concerns over cryptocurrencies undermining the U.S. dollar as the world’s reserve currency. Currently, there are research projects being carried out – one by the Digital Currency Initiative at the Massachusetts Institute of Technology (MIT) in collaboration with Federal Reserve Bank of Boston and the other one by the Digital Dollar Foundation – to explore the concept of a digital dollar.

UK

In March 2021, UK tax authorities, the HMRC, published a new a manual to provide guidance on the taxation of crypto assets for individuals and businesses. Although the manual does not have force of law, the new manual reflects the pre-existing guidance but also covers new topics such as Staking and derivatives over crypto assets.

In the UK, tax on cryptocurrency are generally treated similar to stocks where realised gains are subject to Capital Gains Tax (CGT). Thus CGT will apply on disposal of crypto assets including selling cryptocurrency for money, exchanging cryptocurrency for another cryptocurrency, using cryptocurrency to pay for goods or services and giving away cryptocurrency to another person. On the other hand, cryptocurrency received from mining or ‘staking’ efforts is considered a form of income. When mining as a business, the mining income will be added to trading profits and be subject to Income tax. The new guidance confirms that even when staking activities do not amount to a trade, crypto-assets awarded for successful staking will be subject to Income Tax. Where staking activities do amount to a trade, profits will be either taxed under the Corporation Tax or the Business Income Tax.

The HMRC also provided clarifications that investing in cryptocurrency does not meet the definition of gambling and is not tax-free, as opposed to income from gambling.

Japan

In May 2020, amendments to the Payment Service Act were made following recommendations from the Financial Action Task Force (FATF). Crypto assets exchangers and custodians of crypto assets will therefore be required to implement anti-money laundering and countering the financing of terrorism controls. The amendment also includes characterising cryptocurrencies as "crypto assets" rather than "virtual currencies" based on the rationale that most crypto assets are not used as currencies. Several provisions have also been prescribed regarding applications for registration of a crypto asset exchanger, the service of crypto assets exchangers as well as the transactions of Financial Instruments Service Operators.

This year, Japan’s Financial Services Agency (FSA) has announced that it will implement the FATF ‘Travel Rule’ which was created to prevent cryptocurrencies from being used for money laundering and terrorist financing. Under the rule, virtual asset service providers will have to capture their users’ information accurately and share transaction data of senders and recipients. The FSA requested the Japan Virtual and Crypto Assets Exchange Association to advise its members to prepare for this implementation.

Regulations and taxation are coming

Similar to how wealthy families were drawn to offshore banking in 19th century Europe in order to mitigate taxes from governments looking for new tax opportunities, it seems that we are moving towards a similar landscape for the crypto industry post-pandemic. It has been observed that most governments are reclassifying Cryptocurrencies as Crypto Assets, thus opening them to future taxation, if not already. Foresighted investors are already looking for ‘workarounds’ under existing lax crypto regulations. Some have started using their pension plans as a means to defer tax responsibilities or retirement accounts are allowed to buy, sell, or hold crypto. Others are using Private Placement Life Insurance policies to purchase cryptocurrencies which will be held until death and then passed on to heirs tax free.

Most governments are becoming increasingly aware of the future significance of the crypto industry. It is not a matter of ‘if’ but ‘when’ the world will tighten regulations around crypto and draw tax revenue from crypto to bounce back their respective economy post Covid-19. One can only question, is this the beginning of a new financial era?

Tax Titbits

Is Australia paving the way in making the tax world an even smaller place?

The Australian Taxation Office (ATO) announced a new data matching program that will allow them access to data on passenger movements from the Department of Home Affairs. It is estimated that details on over 670,000 individuals will be shared each financial year. Data on passengers will include the full name, personal identifier, date of birth, gender, arrival and departure dates, passport information and status types (visa status, residency, lawful and Australian citizen).

With an objective to promote voluntary compliance and increase confidence in the Australian tax system, data matching will be used as part of the ATO's risk-detection model. It is a powerful administrative and law enforcement tool that will verify identity and residency status based on passengers' movements and presence in Australia. It will also help the ATO in determining residency status for Australian tax and superannuation by profiling and assessing candidates.

The ATO hopes that with this program, it will potentially identify illegible claims and/or non-compliance. When a discrepancy is detected, the ATO will request verification of information provided by contacting the taxpayer, usually by phone, letter or email. The taxpayer will be required to confirm accuracy of information provided within at least 28 days. Should they fail to do so, the ATO will then proceed with administrative actions.

The benefits for countries to connect their tax and immigration authorities are unmistakable. Looking forward, we foresee Europe adopting tools such as Australia's data matching sooner rather than later. Australia's measure reiterates the growing interest of countries to share data among their own agencies but the program may also greatly benefit countries interested in sharing travel information with other countries' authorities by means of cross-border information-sharing agreements. For instance, the US and Canada have a Visa and Immigration Information-Sharing Agreement, which allows both countries to share of information on third-country nationals who apply for a visa or permit. Europe's Schengen Agreement is another example which comprises exchanging visitor visa data from the Schengen states and has allowed European government authorities to spot travelers who have passed a tax threshold or have misused immigration regimes, whether intentionally or otherwise.

Is Hong Kong using tax treatment for carried interest to compete with the USA?

On 28th April 2021, Hong Kong passed the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Bill 2021 that provides concessionary tax treatment for carried interest and will be effective as from 1st April 2020. This follows Hong Kong's recent efforts to establish itself as a leading asset and wealth management hub in Asia and attract fund executives and operations to Hong Kong. With this bill, Hong Kong rightly addresses concerns that fund managers, investment managers and/or general partners have had regarding the tax exposure relating to the compensation they receive for their investment management services, which is known as carried interest.

Qualifying carried interest will broadly include carried interest received from gains from investments in private companies. Thus advisory fees, management fees or remuneration that a fund executive receives regardless of how a fund performs will not be eligible for tax concession. Qualifying carried interest also needs to arise from qualifying transactions in private equity only, where qualifying transactions include transactions in shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by a private company. Shares or comparable interests of a special purpose entity or interposed special purpose entity which is solely holding one or more investee private companies will also be treated as qualifying transactions.

The bill further includes a Substance Requirement on eligible recipients. They must have an average of at least two employees in Hong Kong carrying out investment management services and at least HK$2 million of operating expenditure incurred in Hong Kong in each relevant year of assessment. The funds will also need to be certified by the Hong Kong Monetary Authority and the Inland Revenue Department.

Hong Kong's treatment of carried interest is much in contrast to US' recent measures announced by President Biden and which was discussed in one of our main articles (refer to 'US proposes new tax reforms'). While the US is moving towards eliminating the carried interest loophole, Hong Kong is providing concessionary tax treatment on carried interest. This legislative move, and its timing with US' announcement to tax carried interest, whether strategically or opportunistically, may prove beneficial to Hong Kong and attract many asset managers to the country.

China proposes reforms to family trusts

In the annual session of the National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) held in March 2021, several NPC and CPPCC representatives proposed a reform of the family trust legislation. The proposed reforms follows a significant increase in China's High Net Worth Individuals population over the last decade and an increasing demand in family trusts which are used as wealth management and succession planning tools.

China's Trust Law has been around for more than 20 years, yet there are no specific legislations on family trusts and no clear rules on the taxation of trusts. The definition, from a regulatory perspective, of a family trust only came about in 2018, through a circular by the Trust Supervision and Administrative Department of the China Banking and Insurance Regulatory Commission, defining it as a trust business where a trust company accepts the entrustment of a single person or family to provide tailor-made management and financial services. The amount or value of the family trust property should be at least RMB 10 million and beneficiaries should be family members. Save this definition, no other rules or guidance have been provided, thus causing many uncertainties surrounding the use of family trusts.

The proposal tackles first and foremost an amendment to the trust law to refine the rules concerning the transfer of trust property, the duties of the trustee and beneficiaries' rights. The proposal also advocates a comprehensive taxation regime for trust, where the ownership of trust property should be clarified and a trust property registration system should be established. A taxation regime will be fundamental for tax treatment for the transfer and distribution of trust property, and for the set-up and termination of a family trust. Is it to be noted that the proposed reforms to family trust legislation have however not been included in the NPC Standing Committee's Legislative Plan for 2021.

The concept of trust registration is nothing new in the world of taxation, UK being just one example which we discuss in the next article (refer to 'HMRC provides clarifications on Trust Registration'). A worldwide trend towards trust registration can be contemplated and it may not be too long in the foreseeable future that all trusts will be registered and the notion of incognito trusts will cease to exist.

UK sets example on how Trust Registration will become the norm

On 17th May 2021, the HMRC published a dedicated Trust Registration Service (TRS) manual to provide further clarifications on areas of uncertainties regarding UK's trust registration which were not addressed in its Technical Response Document published last year and also confirmed reporting obligations for trustees holding pensions and life policies. The concept of the trust register was introduced by the Fourth Money Laundering Directive ('4MLD') in line with EU's anti-money laundering objectives and the Fifth Money Laundering Directive ('5MLD') was later introduced to address some of the gaps.

The manual provides guidance for trusts with a UK tax liability which were already required to register under the 4MLD regime, known as 'registrable taxable trusts' and trusts that have been required to register following the introduction of the 5MLD regime, known as 'registrable express trusts'. The publication focuses on the type of trusts that will need to register, information required for TRS registration, deadline for registration and trustee data retention obligations.

The publication also confirms exclusion from the requirement to register for estates and trusts created on death, employee share scheme trusts, co-ownership trusts of jointly held property where the trustees and beneficiaries are the same persons, charitable trusts and UK registered pension schemes. It is now transparent that trusts holding policies which have surrender value would qualify as 'excluded trusts' and therefore be exempted from registration. They will continue to qualify as 'excluded trusts' until the policy is surrendered.

HMRC has also announced its intention to extend the deadlines until later in 2022. Currently existing 'registerable taxable trusts' are required to register by 31st January, or in some cases by 5th October, following the end of the tax year in which the trust is liable for UK taxation while existing 'registerable express trusts' are required to register by 10th March 2022.

All of our trusts, including our pension trusts, have been registered as required.

David Rawson-Mackenzie founded Centurion Group in 1995, as a financial services company providing corporate, trust and fund services. David heads up tax advisory services for the Group.

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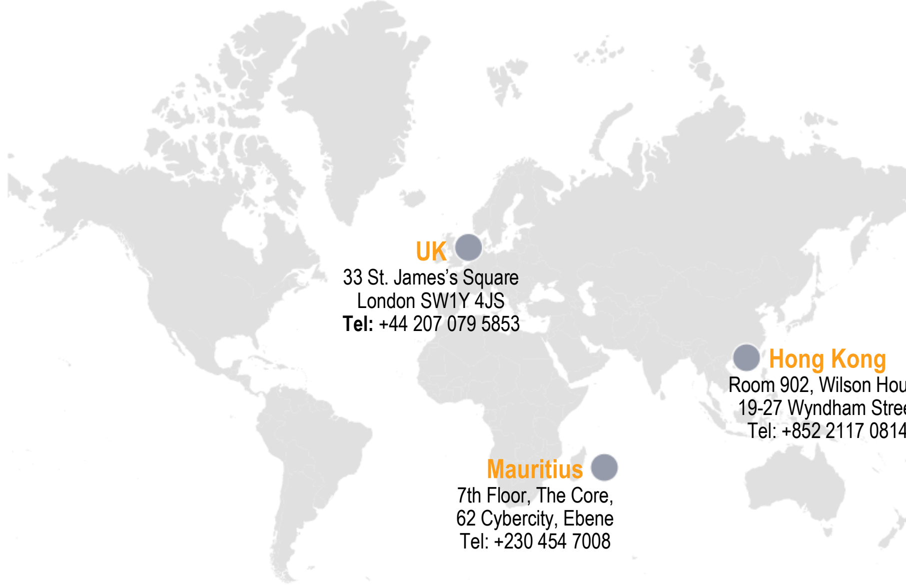

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