HKFi The Hong Kong Federation of Insurers 香港保險業聯會

HK IFA 香港投資基金公會

Trustee 香港信託人公會 Hong Kong Trustees' Association

Date: 2 August 2013

To: Mr Jackie Liu, FSTB

From: Joint Industry FATCA Working Group

Subject: Comments re Annex I of the Draft Model 2 IGA and Other FATCA Implementation Concerns

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Our joint working group has considered FSTB's request for comments on possible due diligence concerns / issues that members may experience in implementing Annex I of the Draft Model 2 Intergovernmental Agreement ("IGA") dated July 12, 2013. In addition to this, following the recent passing of the Inland Revenue (Amendment) (No. 2) Bill 2013 to allow Hong Kong to enter into tax information exchange agreements (TIEAs), we wish to raise certain concerns we have in this regard and would also like to seek clarification from FSTB (and/or IRS via FSTB) on the points raised below.

Note: All section references below are to Annex 1 of the Draft Model 2 IGA dated July 12, 2013 unless otherwise stated.

ANNEX I OF THE MODEL 2 INTERGOVERNMENTAL AGREEMENT

While there are certain points which are specific to individual working group members which are elaborated on separately under Appendix 1 and 2, there are a number of points which are common to all working group members. These points are outlined below:

(a) U.S. Treasury Regulations vs IGA

- Paragraph C of Section I provides that, *"as an alternative to the procedures described in each section of this Annex I, Reporting [FATCA Partner] Financial Institutions may rely on the procedures described in relevant U.S. Treasury Regulations to establish whether an account is a U.S. Account or an account held by a Nonparticipating Financial Institution, except that if an account is treated as held by a recalcitrant account holder under procedures described in relevant U.S. Treasury Regulations, such account shall be treated as a U.S. Account for purposes of this Agreement. Reporting [FATCA Partner] Financial Institutions may make such election separately for each section of this Annex I either with respect to all relevant Financial Accounts or, separately, with respect to any clearly identified group of such accounts (such as by line of business or the location of where the account is maintained)."*

  It is unclear what is meant by *"the procedures described in relevant U.S. Treasury Regulations"* i.e. what is the scope of the procedures referred to, and / or how narrowly an FFI may define *"the procedures described in each section of this Annex*

I" when determining whether an account is a U.S. Account or an account held by a Nonparticipating Financial Institution.

(b) <u>New Individual Accounts</u>

- Subparagraph B of Section III seems to require an FFI to get a self-certification from "all" new individual account holders, and not only those with U.S. Indicia. If read literally, this is more onerous than the January 2013 final regulations because there is apparently no U.S. Indicia trigger in Annex I.

- Upon the opening of new individual accounts, no time period is given in subparagraph B of Section III to a Reporting Financial Institution (RFI) for appropriate documentation to be collected to clarify the correct status of a new account holder. However, under §1.1471-4(c)(4)(i) of the final FATCA regulations, an FFI has 90 days to complete the requisite identification and documentation procedures. We would recommend a similar data collection/ curing period, i.e. 90 days, be provided for customer on-boarding under the Hong Kong IGA.

(c) <u>Change in Circumstance</u>

- We note that in the case of a change in circumstance, no time period is stipulated in subparagraph C2 and D5(b) of Section II regarding the time available for an RFI to collect the required self-certification and/or documentary evidence before treating the account as a U.S. Account. As such, the account could be treated as a U.S. account as soon as one or more U.S. indicia is/are associated with the account. However, under §1.1471-4(c)(2)(iii)(C) of the Regulations, following a change in circumstance, an FFI has a period of 90 days after the change in circumstance to obtain the appropriate documentation. We would recommend a similar data collection/ curing period, i.e. 90 days, be provided for a change in circumstance under the Hong Kong IGA.

(d) <u>Definition of Active NFFE</u>

- The "Active NFFE" definition (subparagraph B(4) of Section VI) contains the following as one of its tests: *"Less than 50 percent of the NFFE's gross income for the preceding calendar year or other appropriate reporting period is passive income and less than 50 percent of the assets held by the NFFE during the preceding calendar year or other appropriate reporting period are assets that produce or are held for the production of passive income..."* The notions of passive income and passive assets are not defined in Annex I or in the IGA.

  Subparagraph 2 of Article I of the IGA template says: *"Any term not otherwise defined in this Agreement* [i.e. the IGA] *shall, unless the context otherwise requires ..., have the meaning that it has at that time under the law of the Party applying this Agreement [i.e. Hong Kong law], any meaning under the applicable tax law of that Party prevailing over a meaning given to the term under other laws of that Party."*

  The Hong Kong Inland Revenue Ordinance does not define passive income and passive assets. Therefore, for Hong Kong, it is unclear how the passive income/passive income test in the "Active NFFE" definition would be applied. Clarification would be very helpful to Hong Kong FFIs because, if an NFFE is properly deemed active, there is no need to determine whether it has U.S. owners above it.

(e) Determination of Entity Status Based on "AML/KYC Procedures"

- In respect of the determination under Annex I of (a) whether an account holder is a Specified U.S. Person, (b) whether a Non-U.S. Entity is an FI and (c) whether an NFFE is an Active NFFE or passive NFFE (subparagraphs D(1), (2) and (4) of section IV and subparagraph B of section V), under certain circumstances "AML/KYC Procedures" can be utilized. The term "AML/KYC Procedures" is defined to mean *"customer due diligence procedures of a Reporting [FATCA Partner] Financial Institution pursuant to the anti-money laundering or similar requirements of [FATCA Partner] to which such Reporting [FATCA Partner] Financial Institution is subject."*

  In Hong Kong, the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance provides the AML/KYC standards that are to be followed. We would like a clarification that, if Hong Kong FFIs are permitted by such Ordinance or other Hong Kong laws to apply different AML/KYC procedures to different products/clients on a risk-based basis (e.g., to apply "simplified due diligence" procedures permitted by Hong Kong, or to use risk measurements to determine the minimum level of percentage ownership by a beneficial owner of an entity before the beneficial owner has to be identified), such different procedures would be acceptable for purposes of determinations under Annex I that turn on the Annex I-defined term "AML/KYC Procedures".

(f) Sponsored Investment Entity and Other Concepts

- If an FFI is a "sponsored investment entity" that is part of a sponsored FFI group, its due diligence process (e.g., to be performed by the "sponsoring entity") can be affected as a result. While Annex I may not generally get into such level of detail, it would be helpful in Annex I to have a reference to the rules in the January 2013 final regulations surrounding sponsored investment funds applying, as relevant, to Hong Kong sponsored investment funds.

- It would also be helpful to have the concept of documentation sharing regarding consolidated obligations and common agents/sponsors from the January 2013 final regulations be referenced in Annex I.

- The units or other equity issued by certain exchange-traded funds ("ETFs") in Hong Kong is held in the name of HKSCC Nominees Limited. It would give better guidance to the market if Annex I clarified whether such holder would be the party due diligenced by the ETF or not.

(g) Clarification on Self-Certification

- What is required to be included in a document for it to constitute a self-certification within the meaning of Annex I should be made more explicit in the Annex, particularly when Hong Kong is a Model 2 jurisdiction where emphasis is not placed on FATCA requirements becoming reflected into local laws implementing FATCA as would occur in a Model 1 jurisdiction.

- The criteria for reasonableness in an FFI reviewing a self certification provided by a financial account holder should be clarified in Annex I.

For purposes of subparagraph B(2) of Section III of Annex I, the requirement that a second valid self certification be obtained if there has been a change of circumstances should be expanded upon. For instance, the circumstances under which the second self-certification can be relied upon by the FFI should be stated.

(h) <u>Compliance with Hong Kong Enabling Legislation/Mechanism</u>

- Although we are still to see how the Hong Kong Government will ensure that FFIs sign up to an FFI agreement, given we expect the Government to insist on such requirement, a situation could still arise where a foreign entity/branch that is related to the Hong Kong RFI fails to comply with the FATCA regulations. In such instance, we understand that the Hong Kong RFI would lose its participating status. This could also be beyond the control of the Hong Kong entity/branch.

  Similar to the Model I IGA, we would want the IRS to confirm that a Hong Kong RFI's related entity can effectively operate as a limited FFI indefinitely as long as the limited FFI:

  (1) identifies itself as an NPFFI;
  (2) identifies its U.S. accounts and reports, when permitted;
  (3) does not specifically solicit U.S. accounts that are held by non-residents or NPFFIs that are not established in the country where the limited FFI is operating; and
  (4) the Hong Kong RFI does not use the limited FFI in its group to circumvent its obligations under the relevant rules.

(i) <u>Miscellaneous Points</u>

- Subparagraph B(1)(g) of Section II: There is a rule in the January 2013 final regulations that says "hold mail" and "in care of" addresses as the sole address do not have to be searched at all in electronic searching of pre-existing individual account holders. In this subparagraph it only states that: *"In the case of a Preexisting Individual Account that is a Lower Value Account, an 'in-care-of' address outside the United States or 'hold mail' address shall not be treated as U.S. indicia."* Can the more favorable rule from the January 2013 final regulations be adopted in Annex I?

- Subparagraph C(4) of Section VI: There is a currency translation rule that seems to translate the U.S.$50K and U.S.$250K (as of 30 June 2014) threshold tests for preexisting account holders based on the 31 December 2013 exchange rate. While pegging of the HKD to the USD causes currency volatility to not be a concern, it may be more convenient for FFIs to be able to translate the described thresholds based on the exchange rate on, for the numbers described above, 30 June 2014.

TAX INFORMATION EXCHANGE AGREEMENTS

With the passing of the TIEA legislation, FIs are seeking clarity on how this is to be implemented for the purposes of providing information to the U.S. Inland Revenue Service

(IRS) under the proposed Hong Kong – U.S. IGA. Of particular concern is whether the Personal Data (Privacy) Ordinance (PDPO) has been (or will be) suitably addressed such that members, in passing details of recalcitrant account holders to the Hong Kong Inland Revenue Department (IRD), will not be in breach of PDPO regulations.

Under the IGA, RFIs will be required to forward the personal details of recalcitrant account holders to the IRD where they do not have the specific consent from the accountholder to forward their personal details and account information to the IRS. However, in forwarding the information to the IRD, knowing that the information is to be used by the IRD for the specific purpose of forwarding such information to the IRS, a purpose for which consent has not been obtained by the RFI, RFI may be in breach of the PDPO.

We have read the PDPO in conjunction with the new TIEA legislation and believe that the following analysis should apply.

According to the Personal Data (Privacy) Ordinance ("PDPO"), any use or exchange of personal data should generally follow the six data protection principles outlined under Schedule 1 of the Ordinance. Regarding the use of personal data, Principle 3 states that *"Personal data shall not, without the prescribed consent of the data subject, be used for a new purpose."* This requirement of obtaining a prescribed consent from the data subject for any new purposes (other than the purpose for which the data was to be used at the time of the collection of the data or directly related to such purpose), is however, subject to certain exemptions contained in Section 58 of the PDPO. One such exemption includes personal data held for the purposes of the assessment or collection of any tax duty. The provision adopts a rather broad definition of tax, which includes any tax of a territory outside Hong Kong if:

(i) arrangements having effect under section 49(1A) of the Inland Revenue Ordinance (Cap 112) are made with the government of that territory; and

(ii) that tax is the subject of a provision of the arrangements that requires disclosure of information concerning tax of that territory.

With the recent amendment to Section 49(1A) of the Inland Revenue Ordinance which allows disclosure of information with non-treaty jurisdictions, provided the Chief Executive declares an information exchange agreement with the U.S. to have been made, any subsequent information exchange between the IRD and the IRS regarding the individual's U.S. tax position should not be bound by Principle 3 under the PDPO, i.e. prescribed consent from the relevant individuals should not be required for the IRD to pass the information to the IRS for U.S. tax investigation purposes. We would appreciate your confirmation that the above interpretation is in line with that of FSTB and/ or, we would appreciate your views as to how FIs would not be in breach of the PDPO in passing information to the IRD if the above analysis is incorrect.

Appendix 1

IGA FATCA Due Diligence Comments for the Retirement Schemes Industry

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1. IGA Main Text May Potentially Require MPFs and ORSO Schemes Complying with FATCA to Not Accept New Scheme Members Identified as US, If They Do Not Consent to FATCA Reporting

If MPF and ORSO schemes end up not being protected by Annex II of an IGA, the HK Government would promise the U.S., through the text of the IGA Model 2 (if standard version), that the HKSARG would *"direct an enable all Reporting Hong Kong Financial Institutions to: ... d) with respect to New Accounts identified as U.S. Accounts, obtain from each Account Holder consent to report [to the IRS] ... as a condition to account opening"*. (Subparagraph 1(d) of Article 2 of IGA Model 2)

This means that, if (i) the FATCA due diligence process causes an MPF or ORSO scheme to identify an employee or self-employed person (as applicable) seeking to join the scheme as a US person, but (ii) the individual refuses **to consent (to the extent required** under applicable Hong Kong laws after the passage of the TIEA legislation to consent[1]) to be reported by such scheme to the IRS, then technically **such MPF or ORSO scheme may not be able to take on the new scheme member.**

If this is the case, this could raise issues for MPF schemes in particular because they are government-mandated retirement schemes and it could constitute an offense under Hong Kong law for (a) an employer not paying into an MPF scheme in respect of an employee meeting certain criteria or (b) a self-employed person meeting certain criteria not paying into an MPF scheme.

This could also raise issues for ORSO schemes because some ORSO schemes are MPF-exempted ORSOs. If the employee is identified as US and refuses to provide consent to be reported to the US by either the MPF-exempted ORSO or the relevant alternative MPF scheme, the employee could potentially be precluded, by what FATCA asks the HK Government to covenant, from joining either scheme.

Even with an ORSO scheme that is not an MPF-exempt ORSO, an employee may have expectations about having access to the benefits of its employer's ORSO scheme. The employee could lose such access if identified as a US person and he is unwilling to be reported to the US.

2. Possible Financial Accounts at Retirement Schemes Potentially Attributable to Employers

Annex I requires FATCA due diligence to be on "Preexisting Entity Accounts" and "New Entity Accounts". Entity due diligence for FATCA purposes is complex and the HK retirement schemes industry doubts if such due diligence requirements were intended to be aimed at the employer entities which establish retirement schemes for employees. The

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[1] *Additional analysis would be required on whether this issue goes away if Hong Kong law did not require such consent. There could still be an issue because the text of the Model 2 IGA contemplates the IGA country directing FFIs in that country to obtain such consent before new financial account holder onboarding.*

following three types of pension scheme accounts are booked under the names of the relevant employers sponsoring the retirement schemes or are otherwise attributed to them:

(i) "Reserved Accounts" under retirement schemes (including but not limited to MPF and ORSO schemes) which hold benefits, including (a) benefits which, on account of termination of employment, fail to vest in the relevant employees, and are kept as reserve and (b) over-contributions by employers, which may be used to offset future obligations of employers to pay contributions or severance payments/long service payments or to refund employers;

(ii) "Forfeiture Accounts" under retirement schemes (including MPF and ORSO schemes) which hold benefits forfeited, such as in the event of the bankruptcy of an employee, in accordance with the applicable scheme rules (with forfeited benefits being often, at the discretion of the relevant trustee, subsequently paid out to scheme members (or their family members) for the purposes of alleviating hardship); and

(iii) Accounts set up by employers for or in the names of defined-benefit retirement schemes which hold contributions from employers ear-marked to meet the funding needs of the schemes. . The balances of such accounts are typically subject to regular actuarial reviews which may, in the case of over-funding (i.e. where, in the opinion of the actuary conducting the review, the balance exceeds the funding needs of the relevant defined-benefit scheme), allow certain portions of the balance of an account of this type to be, pursuant to the relevant scheme rules, paid back to the employer in question.

The retirement schemes industry is of the view that employer entities should not be required to be made subject to FATCA due diligence in respect of the above-mentioned accounts. In any event, there is, at present, not enough certainty in Annex I for the industry to determine whether employer entities are covered by FATCA due diligence requirements in respect of those accounts.

Appendix 2

IGA FATCA Due Diligence Comments for the Insurance Industry

In Section II of Annex I covering Preexisting Individual Accounts, there is a provision addressing Preexisting Individual Accounts that are Cash Value Insurance or Annuity Contracts. The relevant portion of the paragraph is outlined below:

A. <u>Accounts Not Required to Be Reviewed, Identified, or Reported</u>. Unless the Reporting [FATCA Partner] Financial Institution elects otherwise, either with respect to all Preexisting Individual Accounts or, separately, with respect to any clearly identified group of such accounts, the following Preexisting Individual Accounts are not required to be reviewed, identified, or reported as U.S. Accounts:

> 1. ....
>
> 2. ....
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> 3. A Preexisting Individual Account that is a Cash Value Insurance Contract or an Annuity Contract, provided the law or regulations of [FATCA Partner] or the United States effectively prevent the sale of such a Cash Value Insurance Contract or an Annuity Contract to U.S. residents (*e.g.*, if the relevant Financial Institution does not have the required registration under U.S. law, and the law of [FATCA Partner] requires reporting or withholding with respect to insurance products held by residents of [FATCA Partner]).
>
> 4. ....

Hong Kong insurers cannot solicit for business/customers in the US unless they have the appropriate U.S. license to do so. This U.S. licensing restriction should therefore apply to Hong Kong insurers such that they could benefit under the above carve out unless they have specifically sought a U.S license.

However, the aforementioned provision goes on to include an example which we believe is not consistent with the provision in question as it adds a requirement for there to be a law in Hong Kong requiring reporting or withholding with respect to insurance products held by Hong Kong residents.

We would like to request that clarification be sought as to whether we can rely on the licensing restriction alone in determining whether this section applies to Hong Kong insurers or whether there is a specific requirement for Hong Kong law to require reporting or withholding with respect to insurance products held by Hong Kong residents.