CONSULTATION ON AUTOMATIC EXCHANGE OF FINANCIAL ACCOUNT INFORMATION IN TAX MATTERS ("AEOI") IN HONG KONG

SUBMISSION

1. The Law Society of Hong Kong welcomes the opportunity to participate in the public consultation concerning the implementation of automatic exchange of information ("AEOI") in Hong Kong.

2. This submission is in response to the Consultation Paper released by the Treasury Branch of the Financial Services and the Treasury Bureau on 24 April 2015 on Automatic Exchange of Financial Account Information in Tax Matters in Hong Kong (the "Consultation Paper"). We would be happy to provide more detailed technical comments when the draft legislation is presented.

3. Our recommendations are as follows:

   (a) Financial Institutions ("FIs") should be able to adopt the "wider approach" with respect to collecting and keeping information of all non-HK tax resident account holders.

   (b) The definition of "Investment Entity" should not include unregulated private investment entities, such as private trusts and personal investment companies.

   (c) Mandatory Provident Fund Schemes and Occupational Retirement Schemes that are registered with the Mandatory Provident Fund Schemes Authority ("MPFA") should be classified as Non-Reporting FIs.

   (d) FIs should be able to enter sponsoring arrangements, similar to those under the Foreign Account Tax Compliance Act ("FATCA") Intergovernmental Agreement ("IGA").

   (e) The Hong Kong Government should publish rules or guidance regarding how FIs should assess the reasonableness of self-certifications.

(f) The AEOI legislation should include clear rules regarding who are Controlling Person(s) in different financial services segments such as funds, trusts, insurance, etc.

(g) Existing tax-related offences and sanctions in the Inland Revenue Ordinance, Cap 112 should be used or referenced for the enforcement of the AEOI requirements, without enacting any AEOI-specific sanctions.

(h) Existing search and seizure rules should be used to enforce the AEOI requirements, without enacting any AEOI-specific search and seizure rules.

(i) The AEOI regime should require general notifications to account holders, whilst allowing them to review and correct their personal and financial data during business-as-usual account servicing processes, but without requiring FIs to provide each account holder with the specific information to be exchanged.

4. Further, it is imperative for the Government to initiate a communication and education program at the earliest opportunity, and ahead of the rollout of the Common Reporting Standard ("CRS"), for residents and non-residents of Hong Kong on the AEOI regime. Specifically, the program will clearly explain the roles and responsibilities of customers and FIs under the CRS due diligence and reporting requirements that will be in effect in Hong Kong.

5. The following is our comments in detail.

Allowing FIs to Adopt the "Wider Approach"

6. The Consultation Paper notes that it would be possible for FIs to identify and keep information of all non-HK tax resident account holders, though subject to FIs being able to comply with the data privacy regime in Hong Kong (the "wider approach").

7. FIs strongly prefer to adopt the wider approach because the alternative approach would impose very high compliance costs and is inefficient.

8. Our concern is that under the Personal Data (Privacy) Ordinance, Cap 486 ("PDPO"), FIs will be able to implement the wider approach only if they are "required or authorized" to collect the personal data[1].

9. There are a few ways to ensure that FIs can lawfully adopt the wider approach:

[1] See Section 60B(a) of the PDPO.

(a) If the wider approach is mandatory under the Inland Revenue Ordinance, Cap 112 ("IRO"), then it will not violate the PDPO as the collection of personal data is *required* under the IRO.

(b) If the IRO explicitly notes that FIs are *authorized* to collect the relevant personal data of all non-HK tax resident account holders, then it will not violate the PDPO as the collection of personal data is *authorized* under the IRO. This alternative will allow FIs to choose whether to adopt the narrow or the wider approach.

(c) The PDPO can be amended to include a new exemption for collection of the relevant personal information of all non-HK tax resident account holders.

10. It is very important that the aforementioned pieces of legislation are amended to allow FIs to adopt the wider approach, and to ensure Hong Kong remains aligned with global views on adoption of the wider approach at this point.

Definition of "Investment Entity"

11. The definition of "Investment Entity" should not include unregulated private investment entities, such as private trusts and personal investment companies. Classifying these entities as FIs would impose much higher costs on the wealth management industry in Hong Kong. This is also unnecessary under the CRS and would not better achieve the CRS' goals.

12. According to the CRS , the term "Investment Entity" should be interpreted in a manner consistent with similar language set forth in the definition of “financial institution” in the Financial Action Task Force Recommendations" ("FATF Recommendations"). This reference is also included in the FATCA intergovernmental agreements ("IGAs"). In the context of the FATCA IGAs, the Canadian Government interpreted this definition as including 13 types of regulated entities, but not including unregulated private trusts and personal investment companies. To our knowledge, the Canadian Government has not yet published its draft legislation for AEOI. If Canada or any other major jurisdiction adopts a similar approach with respect to the implementation of AEOI, we recommend following this approach.

13. This interpretation is consistent with the FATF Recommendations and do not include unregulated private trusts and personal investment companies in the definition of "financial institutions." Moreover, this interpretation is consistent with Hong Kong's Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance Cap 615 ("AMLO") which implements the FATF Recommendations as domestic Hong Kong law according to which the term "financial institution" does not include unregulated private trusts and personal investment companies.

14. If unregulated private investment entities are not classified as FIs, they will likely fall within the definition of Passive Non-Financial Entity ("NFE"), as most of these entities' gross income and assets are passive. As Passive NFEs, these entities will be required to report their Controlling Persons who are Reportable Persons on their self-certification forms. Consequently there is no practical difference between identifying the Reportable Persons as Account Holders or as Controlling Persons. Therefore, the purpose of the CRS - identifying and reporting Reportable Persons - will also be achieved if these unregulated private investment entities are classified as Passive NFEs and not as FIs.

15. Therefore, we recommend adopting this approach if Canada or any other major jurisdiction adopts this approach in its AEOI legislation.

Mandatory Provident Fund Schemes and Occupational Retirement Schemes

16. The Hong Kong Government indicated that they intend to include Mandatory Provident Fund Schemes and Occupational Retirement Schemes that are registered with the MPFA in the list of Non-Reporting FIs, even if these may not fully satisfy the requirements under the CRS.

17. We strongly support this position. According to CRS, it is possible to treat an entity as a Non-Reporting FI if it presents a low risk of being used for tax evasion, has substantially similar characteristics to other kinds of Non-Reporting FIs (including Broad and Narrow Participation Retirement Funds), and is defined in domestic law as a Non-Reporting FI, provided that the status of such Entity as a Non-Reporting FI does not frustrate the purposes of the CRS.

18. We hold the view that all of these requirements are satisfied with respect to the Mandatory Provident Fund Schemes and Occupational Retirement Schemes. As noted in the Consultation Paper, these entities present a low risk of being used for tax evasion and have substantially similar characteristics to other exempt retirement funds. Also, including them in the list of Non-Reporting FIs will not frustrate the purpose of the CRS.

19. Therefore, we recommend classifying Mandatory Provident Fund Schemes and Occupational Retirement Schemes as Non-Reporting FIs.

Sponsoring Arrangements

20. Under FATCA, certain Foreign Financial Institutions ("FFIs") are allowed to enter into sponsoring arrangements in which one FFI undertakes another FFI's FATCA obligations. The CRS and the Consultation Paper include in the list of Non-Reporting FIs list one of these arrangements - Trustee-Documented Trust.

21. We believe that all sponsoring arrangements available under the FATCA IGAs should be available in Hong Kong for AEOI purposes.

22. This is particularly important for funds and other entities that do not have the capacity to fulfill the compliance obligations. Having a sponsoring arrangement is an acute need for personal investment companies if the Hong Kong Government decides to classify them as FIs. Allowing FIs to enter these arrangements will likely improve AEOI and better achieve the purpose of the CRS as the compliance obligations will be conducted by sponsoring FIs who have better experience, knowledge and capacity to satisfy the AEOI requirements.

23. Therefore, we recommend including the FATCA IGA sponsoring arrangements in the proposed legislation.

Assessing Reasonableness of Self-Certifications

24. According to the CRS and the Consultation Paper, FIs should assess the reasonableness of self-certifications. Based on Section VII of the Commentary, a Reporting Financial Institution is considered to have confirmed the "reasonableness" of a self-certification if, in the course of account opening procedures and upon review of the information obtained in connection with the opening of the account (including any documentation collected pursuant to AML/ KYC Procedures), it does not know or have reason to know that the self-certification is incorrect or unreliable.

25. The "reasonableness" standard is vague in that it is not clear as to what FIs should do in situations where questions regarding self-certifications arise.

26. We recommend publishing rules or guidance regarding how FIs should make this assessment of "reasonableness".

27. We suggest addressing concrete examples and typical situations in which the reasonableness of a self-certification might be in question.

28. Here are a few examples of practical issues that FIs will need guidance on:

    (a) If non-HK passport holders certify that they are residents of Hong Kong, should the FI require a copy of their HK ID or any other document that show that they have the right to abode in Hong Kong?

    (b) In general, for people who reside in a jurisdiction of which they do not hold a passport, should the FI require any evidence regarding their right to abode in that jurisdiction?

(c) How should an FI assess the certification of a non-HK entity that claims it is a resident of HK for tax purposes? Should the FI require a Certificate of Resident Status from the Inland Revenue Department? Should it require a statement from the entity regarding the facts that support the self-certification?

(d) In general, how should an FI assess self-certification of an entity that claims it is a resident of a jurisdiction different to the jurisdiction where it was incorporated?

(e) In cases of conflicting indicia or uncertainty regarding the reasonableness, FIs may request the customer to obtain professional advice to support self-certification. To what extent can an FI rely on such professional advice? In what circumstances it is recommendable for FIs to ask for professional advice?

(f) How should an FI assess the reasonableness of a self-certification that an entity is a Passive or Active NFE?

Controlling Persons

29. The definition of "Controlling Persons" of Passive NFEs in the CRS does not include specific rules required to identify the Controlling Persons, such as rules regarding calculation of an indirect interest, aggregation of interests held by related parties, control through an FI, etc[2]. The FATF Recommendations do not provide sufficient guidance on this term either. The OECD Commentary on the CRS provides more guidance but it is still incomplete.

30. The Hong Kong CRS rules regarding Controlling Persons can be modelled after the FATCA Regulations' rules concerning "Substantial US Shareholders" with the applicable adaptations (e.g., the ownership threshold should be 25% and not 10%).

31. Therefore, we recommend that the legislation should include clear rules regarding who a Controlling Person is.

[2] Under the CRS, the term "Controlling Persons" is defined as: "the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term "Controlling Persons" must be interpreted in a manner consistent with the Financial Action Task Force Recommendations."

Proposed Sanctions

32. The Consultation Paper suggests imposing specific AEOI penalties on both FIs and employees of FIs in cases of:

    (a) failure to comply with the requirements for carrying out due diligence procedures, furnishing returns to IRD, or any other obligations that facilitate effective implementation of AEOI without reasonable excuse.

    (b) furnishing incorrect returns due to failure to observe in full the due diligence requirements.

    (c) willfully making a return to mislead or deceive.

33. However, we hold the view that these situations are already covered by existing / similar penalties in the IRO. Therefore, there is no need for enacting new AEOI-specific sanctions.

34. Section 80 of the IRO imposes a fine at level 3 on any person who without reasonable excuse makes an incorrect return by omitting or understating anything in respect of which he is required by the IRO to make a return, either on his behalf or on behalf of another person.

35. Section 82 of the IRO imposes up to 3 years of imprisonment on any person who willfully, with intent to evade or to assist any other person to evade tax, makes any false statement or entry in any return made under the IRO.

36. We support the imposition of reasonable sanctions against Account Holders who provide a false self-certification. Self-certification forms a vital component of an effective framework for the AEOI and it is important that Account Holders have an incentive to apply due diligence in completing the self-certification. However, the circumstances in which the penalties may be applied should take into account of the fact that determining the tax residence of an Account Holder can be a complex matter. Accordingly, we recommend that there should first be a demonstrated level of culpability by an Account Holder before the sanctions are applied.

37. The applicability of any penalties to employees of an FI should be tightly circumscribed, only applied in the case of conscious and willful acts, and the burden of proof should rest with the government.

38. As the current framework already provides the Hong Kong Government with sanctions applicable to offences relating to compliance with AEOI, there is no need for AEOI-specific sanctions. Moreover, there should be no difference between offences relating to AEOI and any other tax non-compliance matters. It is more appropriate to address these situations with the sanctions that regularly

apply to tax-related offences, without creating a special and unnecessary category for AEOI offences.

39. Therefore, we recommend using the existing tax-related offences and sanctions to ensure compliance with the AEOI requirements, without enacting any AEOI-specific sanctions.

Proposed Search and Seizure Rules

40. The Consultation Paper proposes to empower the IRD to gather information on reportable accounts, access the business premises and the computer systems of FIs under some conditions, and use the information obtained from FIs.

41. We hold the view that the comprehensive search and seizure powers of the IRD under the IRO should apply to the enforcement of the AEOI obligations. Enforcement of AEOI matters should be done under the same rules that apply to all tax matters.

42. Therefore, we recommend using the existing search and seizure rules to ensure compliance with the AEOI requirements, without enacting any AEOI-specific search and seizure rules.

Notification and Review Requirements

43. The Consultation Paper notes that the current Disclosure Rules, including the notification and review mechanism, could not be directly applicable to the AEOI regime as it would be extremely difficult, if not impossible, to notify every account holder as and when the information is exchanged. The proposed AEOI regime would rely on the existing "customer relationship" mechanism between FIs and account holders to update and check information so as to ensure that the information to be exchanged is accurate and updated. FIs will need to inform both new and existing account holders on the possible use of their personal data for the purposes of AEOI. The account holders will update their own personal data and financial account information to ensure its accuracy and can always request to review the relevant information from the FIs. Moreover, FIs will conduct ongoing due diligence procedures to maintain updated client information.

44. We recommend that any existing and new account holder will be notified that his information may be exchanged if it is found that he is a tax resident of another jurisdiction. This notification can be part of the Terms and Conditions of a Financial Account. Account holders will have the right to review their information and correct inaccuracies at any time. However, FIs should not be required to send account holders any notification with the specific information to

be exchanged.

45. Therefore, the AEOI regime should require general notifications to account holders based upon customer account terms and conditions, including the Personal Information Collection Statement ("PICS"), whilst allowing them to review and correct their personal and financial data during business-as-usual account servicing processes, but without requiring FIs to provide each account holder with the specific information to be exchanged unless the account holder wants to review this information.

Remarks

46. We would be glad to continue our dialogue regarding this important matter and to further discuss the details of the implementation of AEOI in Hong Kong.

The Law Society of Hong Kong
7 July 2015