

[TEXT OF THE FATCA COMMENT LETTER SUBMITTED BY
HSBC BANK USA]

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Re: Comments in response to *Notice 2011-34*

Dear Ms. Corwin and Messrs. Musher and Danilack,

HSBC Bank USA (“HBUS”) appreciates the continued opportunity to comment on and provide input into the regulations being developed to implement the Foreign Account Tax Compliance Act (“FATCA”) provisions of the Hiring Incentives to Restore Employment Act of 2010 (“HIRE Act”). These comments focus on the matters addressed in *Notice 2011-34* (the “Notice”) and are filed on behalf of HBUS, its US affiliates, and its ultimate parent, HSBC Holdings plc and all its subsidiaries (together referred to as “HSBC”). Certain questions specifically posed in the Notice will be addressed in these comments. Comments and recommendations included in our submissions dated November 1, 2010 and January 12, 2011 (and other communications) that relate to matters not addressed in the Notice

generally will not be repeated in these comments as we understand that those matters are still being considered by Treasury and the IRS.

HSBC submits these comments to aid Treasury and the IRS in their continuing effort to eliminate offshore tax evasion through the implementation of a new reporting and withholding regime which, through a risk based approach, effectively identifies US persons investing offshore (either directly or through foreign entities) while assuring that the burden imposed on foreign financial institutions (“FFIs”) is not heavier than necessary to accomplish these goals. This risk based approach is evident in the Notice’s revamped process for identifying preexisting accounts of US individual customers. HSBC commends the IRS and Treasury for this shift in approach and, in these comments, provides suggestions for making this process more workable.

However, HSBC is concerned about the unlimited scope of the passthru payment approach presented in the Notice as well as the complexity of the calculations necessary to apply this approach and makes recommendations below to significantly reduce the scope and complexity of the approach. In addition, while we do not include detailed comments on the chief compliance officer certification requirement described in the Notice, we respectfully request that further guidance be provided regarding the scope and parameters of that requirement. Finally, we continue to be concerned about the conflicts between the FATCA requirements and certain local law requirements (dealt with in detail in our January 12, 2011 comments) which is an issue that was not addressed in any significant way in the Notice.

HSBC is one of the largest banking and financial services organizations in the world. It serves customers worldwide from approximately 8000 offices in more than 80 countries and territories in Europe, the Asia-Pacific region, the Americas, the Middle East and Africa. Some of HSBC’s operations take the form of legal entities while others are branches of banks incorporated in other countries. The HSBC US group has over 200 legal entities, the largest of which is HBUS. HSBC employs over 300,000 employees globally and has over 100 million customers worldwide, approximately 70 million of which are outside the US. HSBC is an active participant in the US Qualified Intermediary (“QI”) program.

Overview

HSBC addresses the following topics in these comments:

1. Process for identifying preexisting US individual accounts: Recommendations to further target the approach to those accounts presenting a risk of tax evasion and to limit the scope of the required searches in order to minimize the burden on participating foreign financial institutions (“PFFIs”). Recommendations also for a simplified process for insurance companies;
2. Process for identifying preexisting U.S. individual and entity accounts: Need for an additional year to complete identification and documentation procedures;

3. New Accounts: Expand the scope of the \$ 50,000 exclusion to cover new non depository accounts (as well as depository accounts) and allow the exclusion to be applied without aggregation of accounts unless the FFI's systems aggregate the accounts for other purposes already;

4. Passthru Payments: Recommendations to restrict the definition of passthru payment treatment to payments of investment type income and to simplify the passthru payment methodology;

5. Deemed Compliant FFIs: Recommendations for additional categories of deemed compliant FFIs (DCFFIs) which meet the policy underlying the criteria set forth in the Notice and recommendation of an appropriate due diligence process for assuring the criteria are and continue to be met;

6. Affiliated Group Proposal: Recommendations to reduce the burden imposed on the lead FFI by simplifying the information required to be provided regarding each affiliate in the FFI Group; and

7. Insurance: Defer implementation date of FATCA for insurance companies. In addition, other insurance related comments are incorporated as part of the detailed comments below.

1. Identifying Preexisting US Individual Accounts

A. Private Banking Accounts

The Notice introduces new step by step procedures for identifying preexisting individual US accounts. These procedures focus on private banking accounts, accounts with US indicia (identified through an electronic search) and high value accounts (those with balances or values of \$ 500,000 or more). The goal of the revised procedures is to reduce the burden on FFIs by targeting high risk accounts and thereby reduce the number of preexisting individual accounts which an FFI must research, identify and document. However, as discussed below, due to the breadth of the description of "private banking department" and "private banking relationship", ordinary retail accounts which are not higher risk will be captured and thus the burden on FFIs will not be reduced as intended.

Certain of the new procedures apply to “private banking accounts”, “Private banking accounts” are defined as accounts in the “private banking department” or which are part of a “private banking relationship”. Notice, section I.A.1(2). Under these definitions, a “private banking department” includes a department which services accounts which exceed certain thresholds as well as one which provides personalized banking services or gathers certain personal, professional and financial information about individual clients. Notice, section I.A.1(3). A “private banking relationship” exists when one or more bank officers provide these services or obtain such personal, professional and financial information. Notice, section I.A.1(4).

To attract customers, banks offer product groupings based on account thresholds. While certain of these thresholds may be high thresholds intended to attract high net worth individuals, others are modest and constitute minimum account requirements for certain services. Due to KYC and fiduciary/consumer protection requirements, bank officers (including those who sit on the banking floors in retail branches) are required to obtain personal information from customers to assure that products offered are appropriate to the customer’s financial situation. Banks may describe standard retail products as personalized in marketing materials or may assign bank officers to large groups of accounts for sales purposes. Such assignments could cover several hundred accounts. Clearly, the activities just described are not the type of activities which the Notice is intending to capture within the private banking accounts definition. However, due to the breadth of the definitions of private banking department and private banking relationship contained in the Notice, ordinary retail bank activities and the resulting accounts are captured. These accounts therefore would be required to be subjected to the intense review process described in the Notice, thereby defeating the purpose of the new targeted procedures.

There are several appropriate ways to modify the definitions provided in *section 1.A* of the Notice so that only the desired accounts will be covered. One approach would be to make all the following modifications:

- Adjust the definition of “private banking department” in *section 1.A.1(3)* by including an account threshold of \$ 500,000 in subsection (B) of that definition;
- Delete subsection (D) (regarding the provision of personalized services and gathering of certain customer information) altogether; and
- Adjust the definition of “private banking relationship” in *section 1.A.1(5)* to refer to the servicing of clients described in *section 1.A.1(3)(B)* as modified above.

As an alternative to deleting subsection (D), the text of that subsection could be made a part of subsection (B), so that such subsection then would encompass accounts over \$ 500,000 for which personalized services are provided or personal information is gathered.

Further, the regulations implementing the modified private banking account review process should be drafted to make clear that only accounts held at an FFI, and not accounts held at US financial institution (“USFI”) affiliates, are covered. Specifically, the definition of “private banking account” in Notice *section 1A.1(2)* should be amended to provide that only accounts maintained and serviced “by an FFI” should be considered private banking accounts.

B. Associated Accounts

Section 1.A of the Notice uses the word “associated” in two different contexts within the new preexisting individual account identification process. No definition of “associated” is provided. The term appears (1) in the discussion of accounts required to be aggregated to determine whether certain thresholds are exceeded and (2) to describe the scope of the accounts required to be investigated by the relationship manager as part of his or her “diligent review” of customer files. It appears that the term has a different meaning in each context.

(1) With regard to the first context, only accounts which have partial or complete common ownership and which are associated with each other under the FFI’s existing systems are required to be aggregated. Notice, *section 1.A.2* (p. 8). As confirmed in subsequent presentations by IRS and Treasury officials, only accounts which are already aggregated on the FFI’s systems need to be aggregated for purposes of determining whether certain thresholds are exceeded. The fact that a system may allow for aggregation (or has the potential to do so) does not create an obligation to so aggregate for purposes of applying the FATCA account thresholds. The FFI need only aggregate accounts (and treat them as associated) if its system is actually aggregating them.

This approach to account aggregation is sensible and practical as it respects the limitations of the FFIs’ systems as well as the regulatory and legal prohibitions and impediments to FFIs’ sharing of account information. It should be clarified in this way in the regulations. Further, we recommend that the regulations specifically provide that accounts should only be considered associated under the FFI’s systems if the account information relevant to the threshold (i.e., account balance or value) is aggregated by the system.

(2) Pursuant to Step 3 of *section 1.A.2* of the Notice, the relationship manager is required to review account files to identify each client (including his or her “associated” family members) with US indicia and to treat accounts “associated” with a client with US indicia as US accounts. Treasury and IRS officials have stated publicly that “associated” in this context means accounts that fall within the client’s private banking relationship as reflected on the records of the FFI. This interpretation also should be reflected in the regulations.

C. Scope of Diligent Review

The Notice requires that a relationship manager perform a “diligent review” of “paper and electronic files and other records” regarding each client to determine whether the client has US indicia (Notice, *section 1.A.2*, Step 3(A)(ii)). With respect to accounts with balances or values of \$ 500,000 or more, the

FFI must perform a “diligent review” of the “account files associated with the account” (Notice, *section 1.A.2, Step 5*). In both cases, the scope of the review is not prescribed. If all items in FFI files and records regarding the client must be reviewed (regardless of the complexity of the client’s financial holdings, the length of time the client has been a customer, and the locations of the files), the burden of performing these reviews for both private banking and high value accounts would be huge, involving a costly and time-consuming manual review of paper files, and thus inconsistent with the Notice’s objective of reducing the costs associated with identifying preexisting US accounts.

In an analogous situation, external auditors of QIs are required to review the contents of “account holder’s files” to identify whether the account has been appropriately characterized by the QI as a foreign account and/or as entitled to the treaty withholding tax rate applied by the QI. *Rev. Proc. 2000-12, Sec. 10.03(A)(5)*. *Rev. Proc 2002-55* (regarding QI Audit Guidance) defines “account holder file” as “the account opening statement, any other account documents or memoranda and any correspondence associated with the account”. Section 10.03(A)(5).1, (step 9). (In practice, the external auditors will review the customer’s Form W-8 and compare it to the customer’s master data file (e.g., static data such as name, address, etc..)) *Announcement 2008-98* (which has yet to be fully implemented) expanded this audit requirement to include an inquiry into whether a US person has control over a foreign account through a grant of “signature or other authority” including a power of attorney and defined “account holder’s file” as including account opening documentation and KYC/AML information and documents gathered for tax and legal requirements. *Announcement 2008-98, Sec. 10.03(A)(5), Step 9*.

HSBC recommends that the FATCA regulations similarly should prescribe the account documents which need to be reviewed in order for the search to be considered a diligent review. PFFIs should be required to review documents gathered in the account opening process and for KYC purposes and which are likely to reflect client US indicia, if any exist.

For example, the following documents (and the US indicia category to which they relate) could be specified as requiring review for purposes of the diligent review requirement:

Indicia Categories 1 & 2, *Notice 2011-34, p. 14*; US place of birth, residence or correspondence address or other US resident or citizen identification

- Completed account opening form
- Copies of KYC documents taken from customer at account opening (including passports and other government issued identification, other IDs, copies of utility bills or other documents reflecting residence)
- Current address evidence
- Tax documentation (Forms W-8, W-9, other country tax documentation)

Indicia Category 3, id: standing instructions to transfer funds to US account

- Standing instructions in file

Indicia Category 4, id.: “in care of or hold mail addresses and powers of attorney or other signatory authority

- Power of Attorney
- Authorized signatories
- Hold mail or “in care of addresses held in file

Further, HSBC recommends that FFIs be permitted to assign the task of performing the required diligent reviews to the appropriate employees rather than to the relationship managers themselves. While in certain departments at certain FFIs, the relationship manager may be the best person to handle this review, each FFI should be permitted to assign this task to operations, risk, legal or compliance staff, as it deems appropriate, or to make it a collective function of several departments. Relationship managers are client facing employees and do not handle back office (or regulatory/compliance) functions like file review projects, or have the time to do so. Such projects may be more appropriately assigned to operational areas which support the private banking business.

D. Simplified Preexisting Individual Account Process for Insurance

The *Notice at p. 19* requests comments as to whether the new private banking account review in the proposed revised process for documenting preexisting individual accounts be applied to non-bank FFIs, in particular insurance companies.

In its representations to date, the insurance industry has consistently requested that pre-existing insurance policies be excluded from the scope of FATCA on the basis that they represent a low risk from a tax evasion perspective. This reflects the view that a significant proportion of policies with cash value or annuities issued by overseas insurers do not represent suitable vehicles for tax evasion due to local source taxation, local information reporting regimes or the general absence of unrestrained access to the funds without penalty. Further, due to regulatory restrictions and other considerations, such insurance policies are not marketed to US residents and are not generally targeted at non resident US persons. Consistent with this, the indicative numbers of such policies owned by US persons is miniscule.

There are a number of further factors unique to the insurance context that would render the burden of identifying and redocumenting preexisting accounts hugely disproportionate to any potential benefit in terms of increased US tax collection from identified US persons. Unlike banks, insurers do not typically have frequent contact or regular transactions with their policyholders. Based on industry experience, when contact with customers is needed for an insurance business reason, response rates are notoriously low (typically around 10-20%), making a redocumentation exercise particularly burdensome and un-

productive. In addition, insurance policies are long term contracts, potentially decades old, and often administered on such old legacy systems that modifications such as those required for FATCA may be impossible or, if possible, only with significant cost.

For the reasons above, we support the industry recommendation that pre-existing insurance policies, including annuities, be excluded from the scope of FATCA as presenting a low risk of tax evasion. n1

To the extent that preexisting insurance policies are not excluded, we suggest that the proposed revised process be adjusted as it applies to insurance companies and insurance policies. Our suggestions outlined below should obviously only apply to those insurance policies with cash value and annuities ultimately determined to be financial accounts and those insurance companies (or relevant business lines within insurance companies with multiple products) which issue these policies.

Because insurance companies do not have private banking departments, as a practical matter, stand alone insurance companies and insurance company groups will simply ignore Step 3 of the revised process. However, whether Step 3 is required to be followed by an insurance company which is part of a larger financial group which includes FFIs is not clear. How to apply this step is also problematic. The private banking clients of the banks in the group may buy insurance policies from the insurance company. Yet, the insurance company may not segregate or accurately identify these clients on its policy administration systems ~ the very systems upon which it would depend to maintain and report information for FATCA purposes. Therefore, Step 3 will introduce more process change, burden and complexity for just this particular subset of the insurance industry: insurance affiliates in larger financial groups. Since any higher risk insurance contracts will be covered by Step 5 of the process, this application to insurance affiliates seems unfair and unnecessary. We therefore propose that the prescribed process for preexisting insurance policies specifically exclude Step 3 regarding private banking accounts.

In furtherance of the risk based approach, and in recognition of the fact that insurance policies are not issued by the same legal entities nor administered on the same systems as banking or custody products, we suggest that a separate \$ 50,000 exclusion be provided for preexisting insurance policies with no requirement to aggregate policies outside of the legal entity issuing them.

2. Additional Year to Complete Documentation of Preexisting Accounts

In our November 2010 Comments on *Notice 2010-60*, we requested that, in light of the number and complexity of the tasks which an FFI must complete by the end of the second year after the effective date of its FFI agreement in order to document preexisting individual and entity accounts, Treasury defer the target date for completing one of these tasks (the documentation of accounts over \$ 1 million) to the end of the third year. *Notice 2011-34*, while reducing the burden on retail banks in years 3-5, adds significant additional private banking identification and documentation tasks to the tasks required to be completed by the end of the second year.

As discussed in detail in our November comments, each of these identification and documentation requirements is a separate work stream, must progress simultaneously with the others and will require

either permanent or temporary staffing. All file analyses and account identification and documentation will need to be reviewed by supervisors and the results captured in the applicable systems. Customer files will need to be updated electronically and manually to reflect the results of the various reviews. Therefore, we again request that the Treasury spread the preexisting accounts identification and documentation process over three years (rather than two).

3. \$ 50,000 Exclusion for all New Accounts

Unless an FFI elects otherwise, individual customer deposit accounts with an aggregate balance or value of \$ 50,000 or less are considered non US accounts and excluded from FATCA. *Section 1471(d)*. Further, certain payments are excluded from FATCA if the Secretary identifies the beneficial owner as posing a low risk of tax evasion. *Section 1471(f)*. Presumably utilizing the authority granted in the latter section, *Notice 2011-34* extends the scope of the \$ 50,000 exclusion to preexisting accounts other than deposit accounts (except in the case of previously documented US accounts). Thus, a preexisting individual customer whose account or accounts (both deposits and custodial and insurance accounts, aggregated to the extent the FFI already aggregates such accounts for other purposes) are \$ 50,000 or less need not be documented by the FFI. Further, as discussed above, *Notice 2011-34* provides that only accounts which are already aggregated on the FFI's systems need be aggregated for purposes of applying this \$ 50,000 exclusion.

HSBC respectfully requests that the above expansion of the \$ 50,000 exclusion be applied to new accounts as well. As with preexisting accounts, new accounts with balances below the threshold are de minimis and present a low risk of tax evasion. Therefore, requiring FFIs to document and report the holders of such accounts is not worth the burden of doing so. If the holder's accounts exceed the threshold in a later year, the FFI should document and report the holders, as required.

Similarly, a FFI should not be required to aggregate a customer's new accounts (or new and old accounts) for purposes of applying the \$ 50,000 exclusion except to the extent that these accounts are already aggregated on the FFI's own systems. This approach to aggregation is sensible since it respects systemic limitations as well as local legal and regulatory limitations on sharing customer information across legal entities and countries. It should be noted that if Treasury were to require further aggregation, such aggregation could not occur without extensive system modifications requiring significant additional time to design and implement. Importantly, due to local legal and regulatory limitations, aggregation would only be possible within legal entities.

4. Passthru Payments

Notice 2011-34 provides the first guidance on the scope and application of the passthru payment concept and the calculation of the portion of payments which are "attributable to withholdable payments". The Notice explains that a broad application of this concept is necessary to assure that PFFIs do not become FATCA blockers for non participating FFIs ("NPFFIs") and to encourage FFIs to become PFFIs. As explained in the Notice and in subsequent presentations by IRS and Treasury officials, an administrable process is also the goal.

The passthru payment concept (as described in the Notice) applies to “any payment” by a FFI to a recalcitrant customer or NPFPI. APFPI is required to determine the amount of “any payment” subject to withholding by calculating its own passthru payment percentage (“PPP”) each quarter based on the proportion of its US assets to its total assets and applying that percentage to the payment (other than custodial payments which are subject to the PPPs of the issuers of the underlying custodial assets). To determine its US assets, a FFI must analyze each of its assets to determine whether the asset is issued by a US corporate issuer, nonfinancial foreign entity (“NFFE”), or FFI. If the asset reflects an investment in or loan to PFFI (or DCFFI), the FFI must obtain the PPP of the PFFI issuer and apply it to the investment or loan to determine how much of this asset is a US asset.

The Notice requests comments on various aspects of its passthru payment proposal, including suggestions for exemptions from the definition of passthru payments and adjustments to make the methodology more administrable without eliminating its effectiveness as a “stick” to encourage FATCA compliance.

As is discussed at length in comments Filed (or to be filed) by various financial industry groups, the complexity and burden of applying this methodology to even a relatively simple situation, such as a fund which invests in securities of corporate issuers and other funds, is enormous. Except as relevant to specific proposals below, we do not intend to repeat these concerns in these comments. However, we share these industry concerns.

In their comments, several industry groups have recommended that (in light of the complexity of the proposed passthru payment methodology and the burden of applying it, in particular, to active banks and securities companies) only FFIs which constitute funds or other investment vehicles referenced in *section 1471(d)(5)(C)* be required to apply this methodology fully. All other PFFIs should only be required to withhold on withholdable payments (i.e., including payments on custodial assets which are US assets) or passthru payments on custodial assets which are interests in FFIs described in *section 1471(d)(5)(C)*). The industry proposal is sensible since funds and investment vehicles are better positioned to apply the methodology. Fund portfolios are inherently less complicated than those of active banks and securities companies. As these groups argue, when the passthru concept is applied to funds, the link between the passthru payments and the underlying withholdable payments is clearer since an investment in a fund is, in effect, an investment in the underlying assets. HSBC supports the industry recommendation.

HSBC understands the motivation behind the passthru payment approach reflected in the Notice. However, the approach is not administrate as presented. We believe that it should be simplified and its scope reduced. Needed adjustments can be made without impeding the passthru payment regime’s effectiveness at accomplishing the goal of FATCA compliance. We recommend the following adjustments.

A. Limit Scope of Passthru Payments

The Notice states that the term “passthru payment” includes “any payment.” Therefore, even payments which are not payments of income (under any country’s tax or accounting regime) such as wire trans-

fers, death benefits on insurance policies or repayments of loan principal are potentially subject to FATCA withholding. Further, payments of service fees or to purchase assets and other ordinary business payments are also potentially covered.

The Joint Committee explanation of the FATCA provisions states that the Secretary may exclude from the definition of withholdable payments amounts that are payments for goods, services and the use of property if pursuant to an arm's length transaction in the ordinary course of the payor's trade or business. n2 Further, *Notice 2010-60* (p. 60) indicates that, at least with respect to *section 1472*, Treasury is considering whether FATCA withholding should apply to payments in the ordinary course of a withholding agent's trade or business. Numerous commenters on that Notice (including HSBC in its November 2010 comments) proposed more generally that only investment type payments (and not payments for goods and services) should be considered withholdable payments. If such ordinary business payments should not be considered withholdable payments, they should also not be considered passthru payments.

Payments which do not constitute income at all also should not be passthru payments potentially subject to the FATCA withholding tax. Wire transfers, death benefits, principal payments on loans, and other non income payments are not subject to US tax information reporting or withholding because they do not constitute income (see, e.g., *Code section 6041*). Similarly, these payments should not be treated as passthru payments. Further, treating non income payments as passthru payments seems outside the scope of *section 1471(b)(1)(D)(ii)* which requires that a PFFI withhold a 30% tax on passthru payments to recalcitrant customers only to the extent such payments are "attributable" to withholdable payments. *Section 1471(d)(7)*. Withholdable payments are defined as payments of US source income and gross proceeds from the disposition of US securities. *Section 1473(1)*. Therefore, payments which do not constitute income at all seem outside the statutory language and should not be subject to withholding.

For the reasons discussed above and as discussed in its November 2010 comments, HSBC recommends that only investment type payments should be considered passthru payments.

B. Fixed Percentage Rather than FFI PPPs

Most importantly (and regardless of whether the recommendations described above are adopted), the IRS and Treasury should rethink the PPP methodology. Even to an investment fund with a relatively simple portfolio applying this methodology would be an unreasonably arduous task. Such funds hold in their portfolios investments in multiple other funds which in turn invest in multiple other funds. The calculation of the PPP for each fund in the chain would be a continuous manual exercise requiring tracing through layers of investments and checking websites and other sources to determine PPPs and then recalculating the PPPs quarterly. Additional staff would be required to perform these tasks and then to continuously update PPP calculations on the fund's ever changing portfolio, apply these PPPs to payments to shareholders who are constantly buying and selling shares, entering and exiting the fund, and calculate the tax due. If a bank or securities company is required to apply this methodology, the burden increases exponentially due to the complexity of its portfolio and business and its sheer size. Many PFFIs have balance sheets with gross assets totaling billions or even trillions of dollars including loans to, securities issued by and deposits in numerous other FFIs (as well as investments and loans to

US and foreign corporations, partnerships and trusts). (For example, the HSBC group had more than \$ 2.5 trillion in gross assets on its balance sheet as of March 31, 2011. More than \$ 200 million in assets involve loans to, deposits or investments in other financial institutions.)

As Treasury has repeatedly stated, the purpose of the FATCA withholding requirements is to act as a “stick” to encourage FATCA compliance, not to collect tax on withholdable (or passthru) payments. The goal is to obtain information on US tax evaders. Further, the withholding tax is not intended to be a proxy for actual US income tax due but rather a penalty for failure to comply. The IRS and Treasury have proposed the PPP methodology in an attempt to make it easier to determine the portion of a passthru payment attributable to withholdable payments. However, the methodology is not easy to apply. Moreover, the relationship of passthru payments as calculated using the FFI’s PPP to actual US income earned by the FFI is approximate at best, even in the case of investment funds. In the case of a bank or securities company which earns substantial portions of its income from activities other than yield on its assets, the relationship between the passthru payment as calculated and the US source income of the FFI becomes even more attenuated. Employing such a complex calculation to arrive at such a “rough justice” result does not seem appropriate or justifiable. A simpler alternative is necessary.

In light of the above, HSBC proposes that, in lieu of the PPP methodology, Treasury establish a fixed withholding tax rate (say, 10%) to be applied by a PFFI to passthru payments it makes to recalcitrant customers and NPFIs. This flat rate would also be imposed on income earned by such customers on custodial assets representing investments in other PPFIs. Payments on investments in PPFIs which in turn invest in other PPFIs also would be subject to the fixed withholding rate only once and there would be no need to look below the top tier FFI investment. A fixed rate would be relatively easy to apply, eliminating much of the complexity and burden discussed above. Further, this simpler approach would accomplish the stated purpose of providing a “stick” to encourage compliance while reducing the burden on PPFIs.

Although the passthru payment concept in the statute is fairly general which allows Treasury and the IRS significant leeway to define it in a workable way, if viewed as necessary under the statute, the rate could be tied to a relevant economic indicator reflecting broadly the proportion of FFI transactions and business which is done through US financial institutions and other US entities (e.g., perhaps, 30% of the percentage of global GDP which is from the US).

The IRS and Treasury should consider applying the fixed rate to all passthru payments made on custodial accounts regardless of the assets held in the account. This approach seems particularly appropriate if the rate is tied to an economic indicator. If the PFFI holding the custody account is also a QI, additional tax may need to be withheld pursuant to IRC Chapter 3 from payments on US securities to certain recalcitrant customers who have also not provided a Form W-9.

5. Deemed Compliant FFIs (“DCFFIs”)

Section 1471(b)(2) authorizes Treasury to treat certain FFIs as DCFFIs if they comply with procedures which assure that they have no US accounts and if they satisfy requirements with respect to accounts of their FFI customers. Treasury may also treat other FFIs as DCFFIs if they are within a category of FFIs

with respect to which Treasury determines PFFI treatment is not necessary to carry out the purposes of FATCA.

Notice 2011-34 proposes three categories of DCFFIs: (1) purely local DCFFIs which are part of a purely local DCFFI group, (2) local DCFFIs which are part of a PFFI group and (3) certain investment vehicles. Notice, section III.A. and B. The Notice further states that Treasury may issue guidance providing that certain foreign entities all the interests in which are publicly traded (such as exchange traded funds) would be treated as DCFFIs.

Treasury requests suggestions for other categories of DCFFIs which (1) would meet the requirements of *section 1471(b)(2)(A)* (no US customers) due to their characteristics and/or policies and procedures; and (2) the designation of which would be consistent with a key purpose of the passthru payment regime ~ to assure that NPFFIs cannot use DCFFIs as FATCA blockers.

A. Additional DCFFI Categories

HSBC recommends the following four additional DCFFI categories. These categories all meet the requirements stated above. We recommend that in order for a FFI which is part of a larger affiliated group to qualify as a DCFFI in these categories, that affiliated group must be a group all the members of which are either PFFIs or other DCFFIs.

1. Publicly Held Parent Holding Companies of FFI

groups: Many FFI groups are structured as a publicly held parent holding company with direct and indirect subsidiaries which are operating FFIs and other financial or non financial companies. Pursuant to *section 1471(d)(5)(C)*, these parent companies may be FFIs. However, since the shares, debt and other securities issued by the parent holding company are publicly held and regularly traded on an established securities market, these holding companies do not have financial accounts. *Section 1471(d)(2)(C)*. Further, their only activities are holding the stock of subsidiaries, borrowing to fund these subsidiaries and other shareholder oversight functions. Thus, these holding companies meet the description (Notice p. 32) of the type of foreign entity which like an exchange traded fund should be a DCFFI. Like exchange traded funds, the shares of such holding companies change hands frequently and are usually held by transfer agents and other financial intermediaries. Further, transactions in such shares occur through licensed brokers which would themselves be PFFIs and subject to FATCA.

Interestingly, *Notice 2010-60* provided that holding companies the primary purpose of which is to act as a holding company for a subsidiary or group of subsidiaries that engage in other than a financial business should not be treated as FFIs (and required to enter into a FFI agreement with Treasury) but rather as NFFEs. Presumably, Treasury did not believe that investments in such entities could present opportunities to avoid FATCA. Similarly, a parent holding company for a FFI group does not present such an opportunity. Therefore, such holding companies should be categorized as DCFFIs.

2. FFIs without accounts which are wholly owned directly or indirectly by Publicly Held Parent Holding Companies: Many FFI groups are composed of banks and securities companies described in *section 1471(d)(5)(A)* and (B) as well as FFIs described in *section 1471(d)(5)(C)*. The latter FFIs have no accounts but rather hold portions of the assets of affiliated operating banks and securities companies or function as holding companies for affiliated subgroups of operating FFIs and other entities (including potentially NFFEs). Like their parents, these FFIs have no accounts (*section 1471(d)(2)*) and no customers of any type. Their shares are wholly owned internally by their parent company (or other affiliate), and their borrowing, if any, is from affiliates. Therefore, there is no potential for them to have US accounts or customers. NPFFIs cannot invest in their shares or debt and thereby avoid FATCA. Such subsidiaries (or subgroup holding companies) should be DCFFIs.

3. Regional FFIs: These FFIs would meet the same criteria for local members of participating FFI groups discussed in *Notice 2011-34* (or as hopefully relaxed in regulations) except on a regional basis. Such FFIs would similarly not maintain operations or solicit accounts outside their geographic region (e.g., Asia or Europe). Like a local DCFFI, additional assurance that the FFI would not have US customers would come from the regional nature of the FFI's business.

4. FFIs with a global business but no US customers:

In order to facilitate an FFI group's compliance with FATCA, the group may decide to restructure its US customer business by concentrating US customers in only certain members of the FFI group. Thus, other FFIs within the restructured group would close existing US customer accounts and/or transfer these accounts to PFFI affiliates. Such FFIs would not solicit US customer business. If US customers did seek accounts with these FFIs, they would be referred to a PFFI affiliate. To qualify as DCFFIs, these FFIs should be required to perform a diligent review of their preexisting files and to close and/or as appropriate transfer existing US accounts and accounts of NPFFIs to PFFI affiliates.

B. Insurance Companies

As discussed above, insurance companies are very different from other FFIs and insurance policies are not like bank or custody accounts. Insurance policies encompass a bundle of rights and obligations between the insurer and the policyholder that are fundamentally different from those between a bank and a depositor or between a custodian and an investor and may differ between insurers and jurisdictions. Policies are typically long term and may preclude cancellation. Importantly, individual policies, for among other contractual and regulatory reasons, cannot be transferred from one insurer to another (because they are part of a larger book of business supported by a pool of assets) and generally cannot be terminated without significant negative tax consequences to the holder. Therefore, unlike bank and custodial accounts, a customer's individual policy cannot be transferred freely to an insurance affiliate nor can the customer's account be closed without consequence and the customer referred to an affiliate to open a new account with similar features. Also, as discussed above, contact or transactions with customers are infrequent.

Industry comments have explained that due to regulatory restrictions and other considerations, insurance policies generally are not marketed to US persons. Policies in many overseas jurisdictions are not suitable vehicles for tax evasion either due to local source taxation in the jurisdiction of issuance, local information reporting regimes or the general absence of unrestrained access to funds without penalty. Industry evidence, which is consistent with HSBC's own experience, further suggests that existing US person policy numbers are miniscule

In light of the above, just as the FATCA requirements developed for banks and custodians do not generally fit insurance companies and therefore, special rules covering insurance companies are required separate categories of DCFFI should be developed for insurance companies. The criteria for qualifying for these DCFFI categories (and the due diligence required to assure compliance) should reflect the low tax avoidance risk of such products, the local characteristics of insurance company customer bases, and the barriers to transferring policies between insurers and should be appropriately less prescriptive.

HSBC further suggests that DCFFIs in categories 3 and 4 above (as well as the local DCFFI categories proposed in the Notice) be permitted to service excepted NFFEs that are not organized and operating in the same jurisdiction (or region) as the DCFFI. NFFEs with other than totally local businesses require banking services outside their local jurisdictions in order to transact business. Perhaps most importantly, as excepted NFFEs are not subject to FATCA, it should not matter where their operations and places of organization are located.

C. Verification of Compliance with DCFFI Requirements

The Notice (p. 31) requests recommendations as to how FFIs should demonstrate that they meet the DCFFI requirements. HSBC believes that verification of compliance with the DCFFI requirements should vary depending on the category of DCFFI. DCFFIs with no accounts (like categories 1 and 2 above) and whose DCFFI status is based on the existing structure of their affiliated group and limited activities should be required to certify compliance upon application. The Lead or Compliance FFI should be required to adopt policies and procedures which assure that such DCFFIs disclose changes in their structure and position in the FFI group and that they continue to be compliant with FATCA. With regard to categories 3 and 4 above (as well as the local DCFFI categories in the Notice), the Lead or Compliance FFI should be required to certify that these DCFFIs are meeting their DCFFI obligations (with regard to US and NPFFI customers) and that they are not being used by the group to avoid FATCA.

HSBC has submitted detailed recommendations with regard to an internal verification process for assuring compliance with FATCA. (See HSBC's letter dated January 12, 2011.) Assuring DCFFI compliance should be part of this internal verification process as well.

6. Affiliated Group Proposal Simplified Application Requirements

Notice 2011-34 provides that FFIs which are members of an affiliated FFI group will be required to apply for PFFI or DCFFI status together as a group. A lead FFI will be designated by the group to manage the application process and to act as the point of contact for the IRS. In the application, among other requirements, the lead FFI must identify and provide certain information regarding each affiliate in the FFI group including its name, address and country of organization, the type of FFI, whether the FFI seeks to be a PFFI or DCFFI, types of accounts maintained, whether it has a private banking business, and whether the affiliate is a QI, etc. No de minimis exception is provided. Every affiliate must be listed and described. For a FFI group with hundreds or thousands of entities, this is an extremely burdensome task. (For example, HSBC has more than 1400 legal entities in its group.)

To reduce the burden, the lead FFI should be permitted to group entities sharing similar characteristics and provide the requested information for these entities as a subgroup. The lead FFI should be able to divide the group as it desires. For example, subgroup treatment could be appropriate for a group of DCFFIs with no accounts, or a group of either PFFIs or DCFFIs with similar characteristics which are owned or controlled by a common parent, within the same country or region, at the same address,

within the same business line, or managed by a single management team. While reflected in the FFI application as a subgroup, each PFFI (or DCFFI) in the subgroup would be responsible for its own FATCA compliance and due diligence on its own accounts. Each PFFI or DCFFI in the subgroup should receive its own FFI EIN (or be permitted to use a FFI EIN granted to the subgroup). Whether the required information is provided for each member separately or as part of a subgroup, the lead FFI will be responsible for assuring that all members are reflected.

Permitting the lead FFI to group entities sharing similar characteristics and provide the requested information for these entities as a subgroup is consistent with the approach to consolidated audits under the QI program. Pursuant to *Revenue Procedure 2002-55* (“Audit Guidance for External Auditors of Qualified Intermediaries”), the IRS permits a consolidated audit of two or more QIs in an affiliated group in circumstances when the consolidated audit achieves the objectives which would be achieved in separate audits. A consolidated audit is permitted when (1) the QIs are members of a commonly owned affiliated group; (2) the QIs operate pursuant to uniform procedures and practices; (3) those procedures and practices are subject to uniform monitoring and control; and (4) under the terms of the applicable QI Agreements, the year to be audited for each QI is the same year.

HSBC further recommends that a FFI be permitted to apply to be a PFFI with respect to certain of its business lines and to be a DCFFI with respect to other business lines within the same legal entity. FFIs frequently have more than one business line within the same legal entity. For example, an FFI may have a private banking business, a retail business and a custodial business, each of which has a different customer base. One business may be regional while another may be local. Only one business may have any US customers, while the other may have no US accounts or US investments. However, because under the current proposed rules PFFI status applies to the entire legal entity, a FFI with such multiple lines of business will be required to comply with all the PFFI requirements for researching and documenting US accounts with respect to all its lines of business – even those for which PFFI status is not required. We suggest that just as a QI is able to designate accounts as QI accounts, a PFFI should be able to designate specific lines of business as having DCFFI status and that these designated lines of business would be exempt from the PFFI requirements. Only its lines of business with US customers or NPFFI counterparties would need to qualify as PFFI businesses. The PFFI would be responsible to ensure that its other lines of business satisfy the DCFFI requirements (e.g., regarding the absence of US accounts, etc.).

Permitting FFIs to target their FATCA compliance in this way would enable them to minimize the costs of FATCA implementation without reducing overall compliance.

7. Implementation of FATCA by Insurance Companies

In *Notice 2010-60*, Treasury stated that the regulations would exclude certain types of insurance contracts and companies from the definitions of financial accounts and financial institutions. Only life insurance contracts with cash value and annuity contracts and insurance companies issuing such contracts would be covered. Other contracts and lines of business (property and casualty insurance, term life insurance, reinsurance etc.) would be outside of FATCA. Companies issuing these contracts would not be FFIs but rather NFFEs.

Numerous commenters, while appreciative of the recognition that only certain types of insurance contracts present a risk of tax evasion, expressed concerns about the application of FATCA to insurance companies which issue both policies covered by FATCA and other types of contracts. These commenters recommended that such insurance companies should only be required to comply with FATCA with regard to the covered contracts and lines of business.

Comments submitted by the insurance industry also recommended further delineation of those products covered by FATCA. They also raised numerous other concerns regarding the application of the generally bank oriented FATCA requirements to insurance companies, citing the numerous differences between insurance companies and other financial institutions from product, customer relationship, potential for tax evasion, regulatory, etc. perspectives.

Notice 2010-60 requested comments on the application of FATCA to covered insurance companies and contracts. However, no further guidance has been issued. *Notice 2011-34* did not address insurance companies or products. Treasury and IRS personnel have recently acknowledged again at various conferences that insurance companies require special attention under FATCA and that unfortunately they have not yet been able to address the insurance area in a comprehensive way. They are under significant time pressure to issue comprehensive guidance on priority issues for more typical FFIs. Meanwhile, the insurance industry has received very little guidance as to how FATCA will apply to them, reducing their ability to even begin to prepare to implement these rules. Yet, these companies are subject to the same effective dates as other FFIs. Furthermore, insurers in Europe are in the process of implementing a comprehensive new regulatory capital and risk management regime (under the European Commission's Solvency II Directive) that is placing significant strain on systems and other resources that would be required for FATCA implementation. The implementation date for Solvency II is also January 1, 2013.

In light of the above, HSBC recommends that the regulations either reserve on the application of FATCA to insurance companies or defer the target dates for implementation of FATCA by insurance companies for at least a year beyond those provided for other FFIs. This deferral will provide Treasury and the IRS time to focus on and provide dedicated rules regarding the application of FATCA to insurance companies and products and will allow these companies the same phased in implementation times after the issuance of the regulations applicable to them.

Thank you for your consideration of these comments. We look forward to meeting and discussing them with you in the near future.

If you have any question regarding the above or would like additional information, please contact me at 312-357-3916 or faye.polayes@us.hsbc.com or Doron Loeser at 212-525-6170 or doron.loeser@us.hsbc.com.

Sincerely yours,

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FOOTNOTES:

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It is for these same reasons that the industry has recommended strongly that the definition of in-scope policies should be narrowly and precisely targeted to include only those limited policy types that present more than a low risk of tax evasion. We support this industry recommendation.

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Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” under Consideration by the Senate, JCX-4-10, February 23, 2010, p. 46.