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Memorandum on Common Reporting Standards

- OECD's Multilateral Convention on Mutual Administration in Tax Matters

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1. Background

1.1 Pakistan government has commenced the implementation of OECD Multilateral Convention by incorporating relevant rules in tax laws. This is very significant and completely new paradigm, in relation to exchange of information by the financial institutions in Pakistan with respect to dissemination of certain information about clients to Pakistani regulatory authorities.

1.2 These brief notes provide an oversight on the newly proposed Rules in the Income Tax Rules 2002, by draft SRO 101(I)/2017 dated February 17, 2017 with respect to Common Reporting Standards (CRS). This will be followed by a presentation to the management of FI and their respective clients.

1.3 These CRS are to be adopted by jurisdictions in implementing the Multilateral Convention on Mutual Administration in Tax Matters commonly known as OECD Model Multilateral Treaty.

1.4 Pakistan signed the treaty in 2016 and our notes on that document were circulated through a memorandum dated September 26, 2016. This SRO for implementation of CRS is the first step in the implementation of various provisions of treaty. It will be followed by the agreements between Pakistan and members of Multilateral Convention, which may be bilateral or multilateral.

1.5 These rules have been framed under sections 107 and 165B of the Income Tax Ordinance, 2001, which allow FBR to seek information for the purpose of exchange of information, envisaged under Multilateral Convention, and to keep the information confidential, and use for tax and related purposes only. The relevant provisions seeks to override conflicting provisions of any law for the time being in force including but not limited to Banking Companies Ordinance, 1962 , the Protection of Economic Reforms Act, 1992 , the Foreign Exchange Regulation Act, 1947, any regulations made under the State Bank of Pakistan Act, 1956 and Freedom of Information Ordinance, 2002 (XCVI of 2002). Constitutional validity of these provisions is not the subject of these notes.

2. Pakistan's Perspective

2.1 This is the first provision introduced in the taxation laws of Pakistan whereby there will be any obligation for exchange of information about the client by the financial institutions. In this situation, it is highly necessary that such rules be taken up seriously and all related aspects be taken care of as, in addition to compliance, any error or omission may also effect the client relationship of that particular financial institution.

2.2 Unlike FATCA, these regulations proposed through SRO 101 require furnishing of information to Pakistan tax authorities. This obliges the financial institution to be extra vigilant as the respective client will be directly exposed to enquiry under the respective Pakistani corporate, anti-money laundering, 'benami', and fiscal laws which are now being reasonably and adequately amended to cater for the ultimate objective of curtailing tax evasion.

3. Overview

3.1 The rules as prescribed require the banks and other financial institutions, as defined, to provide certain information or to undertake certain due diligence with respect to certain financial accounts. CRS is aimed is to reduce tax evasion by taxpayers using offshore financial accounts held both directly and indirectly through enhanced information reporting.

3.2 CRS reflects the approach described in the OECD Report of 18 June 2013 (A Step Change in Tax Transparency). Reporting financial institutions, which effectively includes all banks and NBFI's etc. will report financial account information on certain account holders to Federal Board of Revenue. FBR will, in turn, provide information to other competent authorities in a partner jurisdiction under a systematic and periodic transmission of "bulk" taxpayer information - an "automatic exchange" of information, etc. The information to be exchanged will cover all types of investment income

3.3 The overall process for obtaining customer classifications is broadly the same as the FATCA but the nature of those classifications is based on 'residency' rather than citizenship or nationality.

4. Expected timing for adoption of the standard

SRO 101 will be effective after 15 days of the release of the draft through a separate notification. These provisions are effectively applicable from July 1, 2017 except wherever indicated from December 31, 2017.

5. Set-up of Provisions

SRO 101 includes all the provisions of the standard CRS as prescribed by OECD commentary. Nevertheless for local regulatory purposes the same has been classified as under:

Rule	***Nature***
78C	General Reporting Requirement
78D	General Due Diligence Requirements
78E	Due Diligence Procedures for Pre-existing Individual Accounts
78F	Due Diligence for New Individual Accounts
78G	Due Diligence for Pre-Existing Entity Accounts
78H	Due Diligence for New Entity Accounts
78I	Special Due Diligence

6. Summary of CRS

CRS contains the reporting and due diligence standards in following broad categories:

A. Reporting:

(i) Financial institutions who are liable to report
(ii) Account holders to report
(iii) Financial information to report

B. Due diligence procedure to be performed by financial institutions for:

(i) Individual accounts

- Pre-existing
- New

(ii) Entity accounts

- Pre-existing
- New

7. Reporting requirements

7.1 Financial institutions to report

The CRS is applicable to reporting financial institutions. This definition is quite wide and covers custodial institutions, depository institutions, investment entities and specified insurance companies unless they present a low tax evasion risk and are excluded from reporting. Non-reporting financial institutions include:

- Government entities, international organizations and central banks;
- Broad participation retirement funds, narrow participation retirement funds, qualified credit card issuers and pension funds of government entities, international organizations and central banks;
- Entities that present a low risk of tax evasion and have certain characteristics;
- Exempt collective investment vehicles
- Trusts, if the trustee is a reporting financial institution that reports all necessary information on behalf of the trust

7.2 Account holder to report

7.2.1 The list of accounts covered by the CRS includes depository accounts, custodial accounts, cash-value insurance contracts, annuity contracts and certain equity or debt interests in a financial institution. There are specific classes of account that are excluded from the definition, including certain retirement or pension accounts, certain tax favored savings accounts, certain life insurance contracts, estate accounts and other accounts that present a low risk of being used to evade tax.

7.2.2 The CRS will impact a greater number of accounts than FATCA. Instead of purely identifying US citizens or residents, a financial institution will be required to identify the residency of all their reportable customers. On account of FATCA requirements USA has been placed as non-reportable jurisdiction. Financial institutions will therefore be required to report significantly higher volumes of information to their competent authority. This means that financial institutions may need to reappraise their approach to compliance - particularly where a "tactical" rather than "strategic" solution has been adopted for FATCA.

7.2.3 The OECD models do not provide for any form of withholding tax in the event that a financial institution is in a non-reporting jurisdiction.

7.2.4 The incentive for governments to sign up for the standard will allow the ability to access information. In addition, jurisdictions may not wish to be seen as non-compliant in terms of their ability and willingness to automatically exchange information.

7.3 Financial information to be reported

The draft rules require reporting of different types of investment income including interest, dividends and similar types of income, and also address situations where a taxpayer seeks to hide capital that itself represents income or assets on which tax has been evaded (e.g., by requiring information on account balances).

8. Due Diligence requirements

8.1 The due diligence requirements distinguish between pre-existing and new accounts and between individual accounts and entity accounts. For all accounts, financial institutions may not rely on certifications or documentary evidence if the financial institution (or, in the case of certain high-value accounts, a relationship manager) knows or has reason to know the certification or documentary evidence is incorrect or unreliable. This will require financial institutions to have processes to cross-validate information received against the information held for Know Your Customer / Anti-Money Laundering purposes.

8.2 Pre-existing individual accounts

8.2.1 As per the draft SRO, pre-existing individual account means a financial amount maintained by a reporting financial institution on or before June 30, 2017.

It distinguishes between high-value accounts (over US$ 1 million in value as of June 30, 2017 or December 31 of any subsequent year) and lower-value accounts (where account balance does not exceed US$ 1 million in value as of June 30, 2017).

8.2.2 For pre-existing lower-value accounts, if a financial institution has a current residence address for an account holder, it may treat the account holder as tax resident at that address. If no such address is held, a search of electronic records for one of six defined indicia must be performed.

8.2.3 The CRS provides the indicia that would be considered as indicating the account holder is a resident for tax purposes of a reportable jurisdiction. The indicia are:

a) Identification of the account holder as a resident of a reportable jurisdiction;

b) Current mailing or residence address (including a post office box) in a reportable jurisdiction;

c) One or more telephone numbers in a reportable jurisdiction and no telephone number in the jurisdiction of the reporting financial institution;

d) Standing instructions (other than with respect to a depository account) to transfer funds to an account maintained in a reportable jurisdiction;

e) Currently effective power of attorney or signatory authority granted to a person with an address in a reportable jurisdiction

f) A "hold mail" instruction or "in-care-of" address in a reportable jurisdiction if the reporting financial institution does not have any other address on file for the account holder

8.2.4 For pre-existing high-value accounts, a paper records search for these indicia and a relationship manager inquiry are also required. However, such a paper-based search is not required if the electronic record contains sufficient information in electronically searchable format to cover all the indicia.

8.2.5 If any of the indicia are found, the financial institution will be required to treat the account holder as a resident for tax purposes in each jurisdiction for which the indicia is identified, unless it elects to solicit self-certification and the required documentary evidence to rebut the residency status.

8.2.6 Review of Pre-existing High Value Individual Accounts shall be completed by December 31, 2017 and for Low Value Accounts, by December 31, 2018. For subsequent years, any account that becomes a high-value account must have the relevant review completed within the calendar year following the year in which the account became a high-value account. Once the review is complete, no further action will be required until there is a change of circumstances or the Account Holder ceases to be a Reportable Person.

9. New individual accounts

For new individual accounts, the CRS requires the financial institution to obtain a self-certification from the account holder in order to determine where the individual is tax resident. The financial institution must then confirm the reasonableness of the self-certification based on the information obtained by it in connection with the opening of the account, including any documentation collected pursuant to AML/KYC procedures. Once the review has been completed, no further action is required until there is a change of circumstances.

10. Pre-existing entity accounts

10.1 For classification of entity accounts, the CRS focuses on self-certification and other information, such as that collected for local Anti-Money Laundering/Know Your Customer purposes. However, a 'de-minimis' threshold of US$ 250,000 applies, below which pre-existing entity accounts do not need to be classified. If the account balance exceeds this value in subsequent years, a classification will then be required.

10.2 If a pre-existing entity account is held by a non-financial entity (NFE), a financial institution will be required to determine if the entity is active or passive. If the entity is a passive NFE, the financial institution will be required to identify the "controlling persons" of such an entity and to determine the residency of such persons. The identification of the controlling persons can be done through a review of documentation obtained under existing AML/KYC procedures. In determining the residency of the controlling persons, for accounts with a value of less than US$lm, the financial institution may rely on information collected under its AML/KYC procedures. For accounts with a value of over $lm, a self-certification from the Controlling Persons will be required. If any controlling person of the NFE is a resident of another jurisdiction, the account shall be treated as Reportable for that jurisdiction, as well as the jurisdiction in which the Entity itself is also a tax resident.

10.3 Review of Pre-existing Entity Accounts with an aggregate account balance or value that exceeds US$ 250,000 as of December 31, 2017 shall be completed by December 31, 2018. Review of Pre-existing Entity Accounts with an aggregate account balance or value that does not exceed US$ 250,000 as of December 31, 2018, but exceeds US$ 250,000 as of December 31 of a subsequent year, shall be completed within the calendar year following the year in which the aggregate account balance or value exceeds US$ 250,000. However, once the classification has been completed, no further action is required until there is a change of circumstances.

11. New entity accounts

Self-certification will be required from all 'new entity accounts'. The financial institution may then treat the account holder as a 'Financial Institution', 'Active Non-Financial Entity', or 'Passive Non-Financial Entity' based on the disclosure made to that effect by the Entity. Once the entity has been classified, no further action is required until there is a change of circumstances.

12. Realignment

12.1 Draft rules have incorporated various definitions in alphabetic order. This alignment may be correct in some aspect, however considering the complexity of the subject and nature of the matter under discussion; it is suggested the definition clause should be re-aligned in accordance with the alignment of definitions as contained in Section VIII: Defined Terms of the Commentary of Common Reporting Standards, all the definition have been placed under 5 broad groups;

1) Reporting Financial Institution
2) Non-Reporting Financial Institution
3) Financial Account
4) Reportable Account
5) Miscellaneous

13. Key issues requiring amendment in draft Rules / Clarification from FBR.

- The date June 1, 2017; provided under Section 78(B)(aa) for a 'New Account' that is opened with a Reporting Financial Institution, appears to be inconsistent with the date June 30, 2017; for a 'Pre-existing Account' as provided under Section 78(B)(z). The date for 'New Account' should be revised to read 1st July, 2017 and the definition should further clarify if the same is only applicable for Individuals, or for Individuals and Entities both.

- Clarification is sought on the date which determines a 'Pre-Existing Entity Account' since different dates have been mentioned in various paragraphs under Section 78(G). Section 78(G)(1) and 78(G)(2) refer to the date December 31, 2018 with reference to Entity accounts that should be subject to review, whilst Section 78(G)(5)(a) referring to the timing of review for Pre-Existing Entity Accounts states December 31, 2017; along with a requirement to complete the review by December 31, 2018.

- Section 78(I)(3)(d) states that all dollar amounts are in U.S. dollars and shall be read to include equivalent amounts in other currencies, as determined by domestic law. In case account balances are held in a currency other than US$ (e.g., PKR), clarification is required on the reference rate which shall be used to translate those balances into equivalent US$ with respect to account aggregation for due diligence of pre-existing accounts, and for reporting financial information to the FBR.

- Consider an extension in the timelines stipulated within the draft regulations with respect to a 'New Account' and 'Enhanced Review Procedures for High Value Individual Accounts', considering practical limitations and challenges for Reporting Financial Institutions in light of enhancements to processes and systems vis a vis data capture, due diligence and training to meet stringent regulatory requirements at such short notice.

- In addition to the above mentioned, clarification is required with respect to the following since the draft regulations remain silent on these aspects:

  - Whether separate registration with FBR is required for each Reporting Financial Institution in Pakistan for transmission of financial information under CRS?

  - The timelines by which all Reporting Financial Institutions in Pakistan be required to report financial information of Reportable Persons to the FBR with respect to each calendar year and when will the same be submitted to respective regulators?

  - Will Reporting Financial Institutions be required to report financial information using the electronic format following the schema referred to under the CRS? When is FBR planning to roll-out the IT interface to provide the information?

14. Critical aspects and challenges for financial institutions to consider:

I. General

Due diligence, on-boarding, and reporting processes under current US FATCA model will need to be evaluated, and considerably enhanced to accommodate CRS requirements. Financial Institutions (FIs) will be required to have the capability to identify and report for ***over 100 jurisdictions*** that have committed to the information exchange. They will have to:

- Engage in certain due diligence procedures laid out in Section 78(E) to 78(H) of the draft regulations, for the ***identification of reportable accounts*** held by:
  i. Residents of a reportable country; or
  ii. Certain passive entities that have controlling persons that are resident in a reportable country.

- Obtain self-certification from ***all Individual and Entity customers*** at the time of their ***onboarding***

  Such self-certification will have to be made an integral part of the account opening documentation and as such may require enhancements to the Account Opening Form and documentation checklist.

- Establish the ***tax residence*** (and not citizenship) status of ***all*** customers

  Under Section 78(F)(1), 78(F)(3), and 78(H)(1)(a)(i) of the draft regulation, FIs are required to confirm the validity, and reasonableness of such self-certification based on the information obtained in connection with the account to be opened.

This requires enhanced diligence on part of the customer handling personnel at branches for the timely identification of conflicting information between the self-certification and other information collected from customers at the account opening stage, and at the time of subsequent amendments in account particulars, which may relate to residential and mailing addresses, telephone numbers, date and place of birth, NTN, authorised signatory address, etc.

- ***Instill dynamic processes*** to establish any changes in customer circumstances that are to also result in a change in the tax residency of customers. Resultantly, Account Holders would be required to provide a self-certification form - even if one has already been obtained from them at the time of account opening, or due to indicia triggers in the case of a pre-existing account, etc.

  This may entail changes to change request/ subsequent amendment forms, processes, and system functionalities in place at FIs related to the capture of current residence or mailing address, telephone numbers, and introduction of; or changes in third party mandate holders, etc.

- Enhance system functionalities and IT architecture to:

  i. Capture ***more than one*** classification for a customer with ***multiple tax residencies***,
  ii. Accommodate ***new countries joining*** the Standard,
  iii. Aggregate all accounts maintained by a single customer at the FI (if possible under the FI's existing capabilities),
  iv. Monitor customer data to track all ***changes in customer status or residence,*** generate triggers/ records for any change in customer circumstances, that may affect tax residency of customers, both of which should be reviewed for accuracy and completeness by competent authorities

- Make arrangements for secure and compatible methods for ***data encryption and transmission*** to FBR through necessary technological enhancements.

- Report those reportable accounts, along with financial information about those accounts, to the FBR within timelines to be provided by them, for exchange with the relevant reportable country.

- Take adequate steps to ensure that the additional regulatory and due diligence requirements do not create a significantly adverse impact on customer experience.

  This does not only call for streamlined processes and automation to prevent unnecessary delays in account opening and change request processing TATs, but also the need to educate staff and clients on additional KYC, due diligence and reporting requirements.

II. Pre-Existing Individual Accounts – Lower Value

Under Section 78(E)(2), on screening Pre-Existing Lower Value Individual Account Holders, FIs have the option to determine whether the Account Holder is a Reportable Person, based on the current residence address information on record, ***for over millions of records***. This will become a cumbersome, time consuming exercise which will have to be conducted for all pre-existing lower value accounts by December 31, 2018.

Reliance on the current residence address may be particularly questionable in the case of dormant account holders where the statements of account get returned. Resultantly, FIs will be required to devise workarounds in order to determine the 'current residence address' of the Account Holder for timely CRS compliance.

In case FIs opt to solicit the self-certification and documentary evidence for cases where tax residency is indicated through any indicia triggers through the systems, it may involve greater workload in terms of contacting customers and seeking necessary evidences.

The above will entail that a centrally governed and well-coordinated activity will have to be undertaken by specified teams across the organisation.

III. Pre-Existing Individual Accounts – High Value

Under Section 78(E)(3) of the draft regulations, on screening Pre-Existing High Value Individual Account Holders, FIs are required to conduct a paper record search for indicia that is not captured within their electronic databases.

It is important to note that out of the six indicia listed in Section 78(E)(2)(b), two such indicia; which relate to hold mail and standing instructions may not be applicable to FIs in Pakistan due to lack of automation historically. The remaining four which relate to the residence of the account holder, current residence or mailing address, telephone numbers, and grant of signatory authority to a person with an address in a Reportable Jurisdiction, may not have been captured historically in their entirety or accurately within the FI's electronic databases.

Under this situation, FIs will have to resort to a paper record search for the applicable indicia, and undertake the enhanced review procedures on an expedited basis by December 31, 2017; as required under Section 78(E)(4).

IV. Entity Accounts

In the case of entity accounts, FIs are required to undertake a two-stage test to first determine if the entity is tax resident in a Reportable Jurisdiction, and then to ascertain if the entity is a Passive Non-Financial Entity (NFE) with one or more Controlling Persons who are Reportable Persons.

If the Entity Account Holder is a Passive NFE with Controlling Persons who are Reportable Persons, the Entity Account Holder will not only be reportable to the jurisdiction in which it is tax resident, but also for jurisdictions in which its Controlling Persons are tax residents.

In such cases, FIs may be required to not only obtain self-certification forms from the Entity Account Holder but also from its Controlling Persons, since the jurisdiction of their tax residency will also determine the jurisdictions for which the Entity Account Holder is a Reportable Person.

This will prove to be difficult considering that such determination will be required not just at the time of customer on-boarding, or as a result of screening pre-existing entity accounts but also due to any change in circumstances that affect the tax residency of the Controlling Persons and consequently, the jurisdictions for which the Entity is Reportable.

15. Action Points

15.1 This new paradigm in reporting and due diligence requires:

(a) proper understanding aided by professional input;

(b) incorporating and aligning the systems and procedures with the institution to ensure compliance taking all encompassing approach; and

(c) assurance for adequacy of compliance requirements.

15.2 Our knowledge base of the client base and past reporting pattern, for tax and other purposes reveal that there a transition is required from a comparative non-reporting period to a regulated reporting environment. That transition should preferably be handled with adequate professional advice.

This update should not be considered as professional opinion/ advice on any matter as this note summarises the key matters and requirements of draft regulations of CRS for the guidance of the stakeholders in general. This update can also be accessed on our web-site www.pwc.com/pk.

If you have any query or need any clarification, please free to contact our CRS team comprising the following:

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