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Private and confidential
The Hon Paul Chan, MH, JP
Chairman of the Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2009
Legislative Council
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Your ref CB1/BC/10/08

Our ref AAM/GL

18 September 2009

Dear Mr Chan

Bills Committee on Inland Revenue (Amendment)(No. 3) Bill 2009 ("the Bill")

Thank you for your letter of 20 July 2009 inviting KPMG's views on the above Bill.

The Bill seeks to amend the Inland Revenue Ordinance ("IRO") to enable Hong Kong to adopt the latest international standard for Exchange of Information ("EoI") in future Comprehensive Avoidance of Double Taxation Agreements ("CDTA"). At the outset, we wish to emphasise our full support for this initiative as it reflects the global trend for international cooperation in tax matters.

Reasons for our support of the Bill

The Organisation for Economic Cooperation and Development ("OECD") is actively addressing harmful tax practices by focusing on improved transparency and co-operation between jurisdictional tax authorities. Specifically, the OECD advises:-

> *"Co-operation in tax matters... reflects the basic principle that participation in the global economy carries both benefits and responsibilities.*
>
> *. ... A key element of international co-operation in tax matters is exchange of information. It is an effective way for countries to maintain sovereignty over their own tax bases and to ensure the correct allocation of taxing rights between tax treaty partners...."*[1]

[1] Extracted from "Manual on the Implementation of Exchange of Information Provisions for Tax Purposes" which was approved by the OECD Committee on Fiscal Affairs on 23 January 2006.

This was highlighted at the G8 leaders meeting in L'Aquila on 8 July 2009 where it was stated:-

> "*We are making progress in promoting tax information exchange and transparency across the globe , which is helping to widen the acceptance of internationally agreed standards on the exchange of tax information ... all jurisdictions must now quickly implement their commitments ... an appropriate follow up framework is needed to fully benefit from this renewed emphasis on tax information exchange and transparency...*".

It is against this background that the current initiative on EoI needs to be viewed. Of note is that financial centres, such as Singapore, Switzerland and Luxembourg, previously identified as not complying with the latest EoI standard, have now announced/implemented plans to adopt the standard. Implementation of the EoI standard in conjunction with international co-operation on tax matters will not only enhance Hong Kong's status as an international financial centre but, more importantly, maintain a level playing field amongst the global financial centres.

An important consequence flowing from Hong Kong's adoption of the latest EoI standard will be its ability to enter into CDTAs (thereby building a comprehensive treaty network) with many developed economies. Further, it will mitigate the risk of Hong Kong being targeted for so-called defensive measures being considered by many countries to counteract harmful tax practices.

Hong Kong's current lack of a comprehensive network of CDTAs has been cited by international companies as a potential impediment to using Hong Kong as an investment holding jurisdiction or as a jurisdiction for locating operations, and in particular regional support functions. Having a comprehensive CDTA network will enhance Hong Kong's attraction as a location for regional headquarters. Moreover, such a network should help Hong Kong based companies to, *inter alia*, reduce the withholding tax costs on dividends, interest and royalties from agreement countries; secure exemption from capital gains in those countries; and minimise the incidence of double taxation particularly where the other country seeks to apply transfer pricing adjustments.

To Hong Kong employees travelling extensively, CDTAs will help to reduce the risk of such employees being taxable on their employment income in the foreign jurisdictions that have concluded a CDTA with Hong Kong.

A further advantage of a CDTA is that it provides a mechanism for corresponding adjustments where a transfer pricing adjustment or profit allocation has been made by an agreement country. In the absence of a CDTA, the Inland Revenue Department ("IRD") is not obliged to provide any relief from double taxation arising under such adjustments, which will result in an additional tax burden on their business. Currently, Hong Kong has only five CDTAs and relief

from double taxation is therefore limited to cases where a transfer pricing adjustment or profit reallocation is imposed by an agreement country. Several Asian countries in particular which are currently active in transfer pricing enforcement activities do not have CDTAs with Hong Kong and therefore the risk of double taxation arising from non-arm's length transactions or dealings with counterparties in these countries is high.

One of the key benefits to Hong Kong concluding more CDTAs is the positive impact it may have on attracting more Chinese enterprises to use Hong Kong as an investment holding jurisdiction. A comprehensive network of CDTAs would allow Hong Kong to capitalise on outbound investment from the Mainland. The Mainland currently has more than 80 CDTAs. In order for Hong Kong to establish itself as a "window" for outbound investment by mainland enterprises , investments made through Hong Kong must be entitled to the same (if not additional) tax benefits.

Our comments on the proposed legislation

We would now like to comment on a number of aspects of the proposed legislation.

Right to privacy and confidentiality information

Members of the business community have expressed concerns that Hong Kong's adoption of the latest EoI standard would result in the IRD gathering more information on their tax affairs, which in some cases may lead to increased tax burdens. For example, before the CDTA with the Mainland was concluded, there were fears that because of the large volume of cross-border transactions, there would be a large number of requests for information from the Mainland authorities. Since the conclusion of that CDTA, subsequent events have proved those fears to be unfounded. As noted in the Legislative Council Brief, Hong Kong has only received 21 requests (paragraph 12 refers) since the inception of the CDTA programme.

Concerns have also been expressed about EoI infringing privacy rights. In this regard, we note and welcome the prudent safeguards to be adopted to protect an individual's right to privacy and confidentiality of information exchanged. In particular, we endorse the proposal that only information requests that are clear, specific, relevant, and consistent with the EoI article will be acceded to. Requests that are frivolous or spurious in nature or by way of "fishing expeditions" would not be entertained. Further, safeguard is proposed to be put in place to ensure that the requesting party must not share the information with any third party (including a third jurisdiction or another government department of its own jurisdiction). We consider that these measures should serve to allay concerns about Hong Kong adopting the latest EoI standard.

Safeguards mechanism

We would also like to offer comments on how the safeguards are to be implemented. The Legislative Council Brief outlines the following three levels of safeguards:-

(i) in the CDTA entered into by Hong Kong with an agreement country;

(ii) in subsidiary legislation pursuant to section 49(6) of the IRO; and

(iii) in a Departmental Interpretation and Practice Note ("DIPN") to be issued by the IRD.

Whilst we take no issue with the first two levels, we believe that a DIPN may not be an appropriate place to implement the required procedures. Our view stems from the fact that a DIPN does not have any binding force in law and that it usually serves only as an explanatory guide for taxpayers and tax practitioners on how the IRD administers the IRO. In this regard, we suggest that consideration could be given to incorporating the procedures in legislation, preferably as a schedule to the IRO. A precedent for this approach is the advance ruling amendments introduced in 1998 (section 88B and Schedule 10 of the IRO refer). We consider that this approach has the advantage of certainty and may be preferred to the current proposal. In this connection, we note that Singapore has adopted a similar approach in the Income Tax (Amendment) (Exchange of Information) Bill (Clause 20 – insertion of Eighth Schedule).

Request for correction to information

It is noted that one rule to be introduced under section 49(6) of the IRO, is where the IRD refuses to accept a proposed correction to information that has previously been made available to the IRD, for the matter to be reviewed by a higher authority, which is currently proposed to be the Financial Secretary. We suggest that an alternative could be for any such review to be made by a District Judge. This follows the approach adopted in section 77 of the IRO whereby the IRD has to satisfy a District Judge for the issue of a departure prevention direction to the Director of Immigration and the Commissioner of Police. A District Judge, we consider, may be better placed to hear evidence and issue a ruling on the information to be provided.

Drafting point

We consider that the addition of sub-section (1A) to section 49 (clause 3 of the Bill) renders sub-section (1) otiose. Accordingly, we recommend that section 49 be amended by substituting the proposed sub-section (1A) for the current sub-section (1).

* * * * *

In closing, we would like to thank the Bills Committee again for giving us the opportunity to comment on the Bill and to re-iterate our support for the proposed legislation.

Yours sincerely

Ayesha Macpherson
Partner in charge, Tax Services
Hong Kong SAR
KPMG China

cc: Ms Amy Lee, Clerk to Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2009