JOINT LIAISON COMMITTEE ON TAXATION

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HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
THE INTERNATIONAL FISCAL ASSOCIATION - HONG KONG BRANCH
THE LAW SOCIETY OF HONG KONG
THE TAXATION INSTITUTE OF HONG KONG
14th Floor, Hutchison House, Central, Hong Kong.
Telephone: (852) 2846 1716
Fax: (852) 2842 0529

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Ms Amy Lee
For Clerk to Bills Committee
Legislative Council
Central
Hong Kong

Dear Ms Lee,

Inland Revenue (Amendment)(No. 3) Bill 2009

I refer to your letter dated 20 July 2009 inviting the Joint Liaison Committee on Taxation to give its views on the above-mentioned Bill.

We thank you and the Chairman of the Bills Committee for giving us this opportunity.

Our submission is divided into four categories.

1. The need for this legislation.
2. Benefits that Hong Kong derive from such legislation.
3. The drafting of the Bill.
4. A timing concern.

We address these issues in turn.

1. The Need For This Legislation

The Hong Kong Inland Revenue Department (IRD) has traditionally not provided information about taxpayers to foreign tax authorities. This state of affairs can no longer continue in view of increasing international pressure on Hong Kong – and virtually every other jurisdiction – to increase the flow of taxpayer information between jurisdictions.

This pressure is a result of increasingly negative perceptions of so-called tax havens. The pressure for change is being led principally by the OECD, G20, EU and the US government. What these institutions object to is not the fact that certain offshore jurisdictions impose zero or low rates of tax, but that such jurisdictions do not provide information to other countries about taxpayers' affairs, and thus may serve as witting or unwitting abettors of tax evaders who seek to divert profits from their own higher-tax jurisdictions to the offshore jurisdictions concerned.

These institutions are now putting pressure on offshore jurisdictions to make information available to them to enhance the proper administration of their own tax laws, including the detection of tax evaders.

In addition, the US Congress has already proposed legislation which is specifically designed to impose sanctions on US companies that conduct business with, or hold investments in, so-called "tax secrecy jurisdictions". These sanctions would be very penal so far as US investments in Hong Kong are concerned and will affect not only US companies but also Hong Kong banks and companies that do business with them. Even if the current US proposals are not finally enacted, they only foreshadow what we believe is inevitable.

This process of transparency commenced around a decade ago, and in our view it is no longer feasible for jurisdictions such as Hong Kong to resist these global pressures. The threat of sanctions is considerable. The OECD when it began its project to bring perceived tax havens (not including Hong Kong) into line foreshadowed sanctions aimed at deterring the residents of OECD countries from investing in and carrying on business with those offshore jurisdictions that did not commit to apply the new standards of information exchange. These steps included denying deductions for payments made to uncooperative jurisdictions, or imposing withholding taxes on such payments. Transactions involving such jurisdictions would be subjected to greater scrutiny. In the case of the Financial Action Task Force in the context of anti money laundering, the most extreme threatened sanction was to exclude financial institutions in uncooperative jurisdictions from maintaining banking correspondent relationships with banks in other jurisdictions. Such sanctions if imposed would likely eliminate Hong Kong's continued role as a respected financial centre.

Obviously, it is in Hong Kong's interests to avoid becoming the target of such sanctions.

In light of these pressures, all the tax havens that were initially identified by the OECD have now committed to implement information exchange procedures along the lines set out in the 2004 version of the OECD's model double tax treaty ('the 2004 standard'). As a result of these successes, the international institutions concerned have now turned their sights on other offshore jurisdictions including Hong Kong. Because of these developments, it is simply not possible for Hong Kong to refuse to include itself in this process. Hong Kong will inevitably invite criticism and sanctions in the longer term if it fails to do so.

We believe that the Hong Kong government has been nimble in anticipating these trends, participating in the relevant global fora and agreeing to be cooperative. That being said, the international organizations concerned no longer accept Hong Kong's position that its internal legislation does not permit it to collect and exchange information relevant to foreign taxation. International pressure is now on Hong Kong to take the additional step of amending her tax laws to authorize the IRD to collect and exchange taxpayer information even if the information requested is not relevant for the purposes of enforcing Hong Kong's own tax laws.

It is for this reason that the Bill has been submitted to the Legislative Council. We see no alternative to enacting appropriate legislation if Hong Kong is to avoid sanctions. For this reason, we agree that there is a legitimate need for a Bill along these lines to be enacted, in order to enable the Hong Kong government to commit to the exchange of information in the tax context according to the 2004 standard.

2. Benefits That Hong Kong Can Derive From Such Legislation

If Hong Kong plays her cards correctly, there can be benefits to Hong Kong as a result of enacting the Bill.

As you know, Hong Kong has been seeking to enter into comprehensive double taxation agreements (CDTAs) which would have the effect of encouraging foreign investment in Hong Kong, as well as providing Hong Kong investors significant tax reliefs when investing in its CDTA partner jurisdictions (which are principally higher-taxed jurisdictions).

It is, of course, in Hong Kong's interests to enter into a greater number of comprehensive double tax agreements with other countries, as a means of enhancing Hong Kong's attraction as a centre for regional headquarters operations. A comprehensive tax treaty network would enable Hong Kong based companies to receive dividends, interest and royalties out of other countries at reduced withholding tax rates; to secure exemptions from capital gains when they dispose of assets in other countries; to avoid exposure to tax in other countries where they conduct certain activities that would otherwise expose them to taxation in those countries; and to secure protection against double taxation, particularly in the event of a transfer pricing adjustment made by another tax administration. Tax treaties would also protect employees who travel to other countries on work assignments from being exposed to personal taxation in those countries. Presently, Hong Kong companies are severely disadvantaged because of Hong Kong's lack of tax treaties, compared to the case of Singapore which has over 70 such tax treaties.

Hong Kong persons who invest in other countries with which Hong Kong has concluded CDTAs will benefit from reduced withholding taxes on the dividends, interest and royalties that they receive from their foreign investments.

Although the benefits of CDTAs are significant, the reality is that Hong Kong has not been able to negotiate more than a handful of CDTAs because, so far, it has not been able to agree to exchange information according to the 2004 standard. Instead, Hong Kong's information exchange obligations under its existing CDTAs are relatively limited and reflect much earlier standards of information exchange which are no longer acceptable under prevailing global standards. This earlier standard is consistent with the IRD's existing statutory powers to collect and exchange taxpayer information, and is as far as Hong Kong can commit under existing tax laws.

Indeed, other countries have limited incentives to negotiate CDTAs with Hong Kong, because Hong does not impose the full range of taxes from which CDTAs typically grant relief. The primary incentive that many countries would have to enter into CDTAs with Hong Kong is the promise of information exchange according to the 2004 standard which, so far, the Hong Kong government has been unable to agree to in the absence of the necessary statutory powers. This is the situation that the Bill seeks to redress.

It is, of course, impossible to predict how many CDTAs Hong Kong would secure by agreeing to more comprehensive exchange of information. However, it seems to be intuitively correct that many countries would be willing to enter into tax treaties with Hong Kong if such treaties contain wider exchange of information provisions than Hong Kong is currently able to agree to. More concretely, we are aware that tax treaty negotiations with some countries have floundered on this very point. The OECD is confident that its members would enter into CDTAs with Hong Kong providing for information exchange under the 2004 standard. It is therefore apparent that greater exchange of information would result in more tax treaties for Hong Kong.

If this Bill is passed, Hong Kong will be able to agree to abide by the 2004 standard, and this in turn will enable Hong Kong to enter into a more extensive array of CDTAs. This will inevitably be to Hong Kong's benefit. Thus, even those people who view the 2004 standard as undesirable will at least have the consolation of knowing that Hong Kong will get something positive in exchange.

3. The Drafting Of The Bill

In our view, the Bill goes no further than is necessary for the purpose of enabling Hong Kong to comply with the current (2004) OECD exchange of information standard under a CDTA. We agree that this is the appropriate approach.

That being said, we have a number of comments on the Bill itself, and on the Legislative Council Brief that has been presented to you by FSTB.

(a) On a drafting point, we note that the proposed amendment to section 49 involves the enactment of a new sub-section (1A) which largely duplicates the existing sub-section (1). Indeed, the wording of both sub-sections is the same down the end of sub-sub-section (a), the only difference being that a new sub-sub-section (b) is added to the proposed sub-section (1A). It appears to us that it would have been simpler to add the proposed sub-sub-section (b) to the existing sub-section (1), and thus avoid unnecessary duplication.

One effect of the current drafting is that the IRD would not have power to collect information for the purpose of providing such information under Hong Kong's existing tax treaties. This is because such treaties were declared under sub-section (1), and therefore the amendment ordinance will not apply to them unless and until they are renegotiated and declared under the new sub-section (1A). We have no objection to this provided that government is confident that it will nevertheless be able to comply with OECD requirements within specified time frames and avoid Hong Kong being placed on the OECD's black list or grey list.

(b) It appears odd to us that, in the draft sub-sub-section (a), the word "despite" is used, whereas the existing sub-section (1) uses the word "notwithstanding". It appears to us that the drafting should be consistent. Otherwise, the natural inference would be that the Legislative Council intended these two words to bear different meanings (which we assume is not the case).

(c) The Council Brief states that certain procedural safeguards will be set out in a new IRD practice note, and that other safeguards will be set out in subsidiary legislation enacted pursuant to section 49(6) of the IRO.

It appears to us that it is not possible to comment fully on the information exchange proposal without seeing the whole package of the rules and the practice note. We urge that the regulations, and the practice note, be made available to the Bills Committee for scrutiny. It seems proper that all interested parties should have all of this information before them when scrutinizing the proposals.

(d) Along the same line, we do not understand why some safeguards will be in subsidiary legislation whereas other safeguards will be contained only in a practice note. By its nature, a practice note is not legally binding, and can be amended at any time by the IRD. At worst, the IRD is entitled to ignore its practice notes, and taxpayers have no remedy if this occurs. (Indeed, many tax advisers take the view that the IRD's assessors often depart from practice notes.) It appears to us that the types of safeguards that are intended to be contained in the practice note could just as easily be contained in the subsidiary legislation.

(e) On a general point, we agree with the safeguards that have been proposed by the Administration in the Council Brief.

(f) In the House Committee meeting held on 10 July 2009, we note that a statement was made that the IRD would be obliged to respond to an information request within 90

days. We do not know where this 90 days period comes from. It is not set out in the OECD model treaty, nor in the OECD commentaries that seek to interpret and apply the information exchange provisions. It appears to us that, within limits of good faith, the IRD can take as long as it needs to reply to a request from a foreign tax authority after ensuring that the stipulated procedural safeguards have been complied with.[1]

(g) In this regard, we do not understand the position taken in the Council Brief which suggests that the undertaking to inform taxpayers of information requests, and to give them an opportunity to correct the information to be supplied, could be subject to an "exceptional circumstance". Of course, the position might be different if the taxpayer cannot be contacted or if the taxpayer, after having been consulted, is dilatory in providing comments to the IRD. Subject to this, we cannot envisage what "exceptional circumstances" could prevent the IRD from notifying the taxpayer in the first place.

In an attempt to explain this, para 10(b) of the Council Brief refers to the situation "where notification would prevent or unduly delay the effective exchange of information or where prior notification would otherwise undermine the chances of success of the investigation conducted by the requesting party. With respect, we do not understand the issue of "delay" in this context, because delay is inherent in all cases where prior notification is to be given and typically consists of nothing more than posting a letter to the taxpayer's last known address and giving the taxpayer a month to reply. It is difficult to see how this would "prevent or unduly delay" the exchange of information beyond what is already inherent in the proposal. Likewise, notification always has the potential to "undermine the chances of success of the investigation conducted by the requesting party", and so this exception appears to us to be expressed broadly and subject to potentially wide interpretation by the Hong Kong authorities.

(h) There is another aspect of the Council Brief about which we are not clear. The 2004 standard requires information exchange with respect to all taxes, and not merely in respect of those taxes that are typically the subject of a CDTA (namely, income taxes or, in the case of Hong Kong, profits tax, salaries tax and property tax). Thus, under the OECD 2004 model, foreign governments could ask the IRD to collect and turn over information relevant to the administration of laws relating to taxes other than income tax such as VAT, GST, death duties and inheritance taxes, stamp duties and customs duties.

We note from the Council Brief that the Administration will restrict exchange of information to "only information on taxes covered by the CDTA, mainly income taxes (*including* profits tax, salaries tax and property tax) ..." It proposes to do this by negotiating along these restricted lines in the case of each CDTA, or by setting out such a limitation in documents of record between the two contracting parties.

We have two immediate comments on this.

First, such a limitation contradicts the 2004 standard, and so this proposal might not be possible in all cases. We would expect that a number of potential CDTA partners would reject entering into a CDTA with Hong Kong if such a limitation were imposed. It appears to us to be inevitable that this aspiration will not be achievable in all cases.

[1] We are aware that some stand-alone information exchange agreements (Tax Information Exchange Agreements, or TIEAs, discussed further below) impose a 90 days period. However, this period is not mentioned in any CDTAs of which we are aware.

Secondly, we are not sure whether we have understood the Administration's point correctly. It could be asserted at a later time that, because of the way in which the 2004 standard is drafted, *all* taxes are in fact automatically "covered by the CDTA" for information exchange purposes. Furthermore, we wonder if the intention is indeed to restrict information exchange solely to profits tax, salaries tax and property tax (which is the case of a traditional CDTA), because the use of the word "including" in the Council Brief suggests that the Administration is contemplating that other taxes can be brought within the framework of a CDTA. We suggest that the statement in the Council Brief is potentially ambiguous, and this could usefully be made clearer.

(i) We note that one of the safeguards proposed by the Administration, to be incorporated either in the terms of the CDTA or in a document or record between the two contracting parties, is that the foreign tax authority will agree that it will not share the information with any third party, including a third jurisdiction under which that foreign country has a separate exchange of information provision.

We strongly support this limitation, not only on privacy grounds, but because any such leap-frog procedure would undermine Hong Kong's ability to secure tax treaties of its own with such third jurisdictions. The OECD's own commentary on the 2004 standard accepts such a limitation. It states that disclosure to a third party country may not be made unless there is an express provision to that effect in the relevant CDTA.

That being said, because the 2004 standard is not clear on this point, we agree that this restriction must be expressly discussed in treaty negotiations in order to confirm that the other jurisdiction shares this understanding. We also urge that an express restriction along these lines be added to the tax treaty itself rather than to a mere document or record between the two parties. Incorporating this provision in the CDTA will guard against future changes to the OECD commentary that might seek to alter any understanding that is not contained in the CDTA itself.

4. Timing Issue

There is one additional point we wish to make concerning the timing of the enactment of this Bill.

The OECD has set a target for each jurisdiction to enter into at least twelve tax agreements which conform to the 2004 standard. Currently, Hong Kong has no treaty that complies with the 2004 standard. (All current CDTAs comply with an older standard.) Hong Kong is therefore behind on this issue and will need to catch up very quickly if it is to avoid being placed on any black or grey list and if it wishes to avoid the sanctions that could possibly flow from such state of affairs.

We therefore urge that it is in Hong Kong's interests to take these steps sooner rather than later and to enact this Bill as soon as possible.

There are two reasons for this.

First, the OECD is regularly expanding the exchange of information provision in its model CDTA. The sooner that Hong Kong "locks in" to the 2004 version, the less likely it is that it will be forced to accept more extreme versions in the short to medium term.

Secondly, we believe it is imperative that Hong Kong is able to resist the trend, followed by many low and zero tax jurisdictions, of entering into stand-alone tax information exchange agreements (TIEAs) rather than full scale CDTAs. The disadvantage of a TIEA is that it would not give Hong Kong any benefit in return. A CDTA, on the other hand, does give Hong Kong a meaningful quid pro quo for agreeing to exchange information. As mentioned above, exchange of information is the primary inducement that Hong Kong can offer to other countries to enter into CDTAs, and it is important that

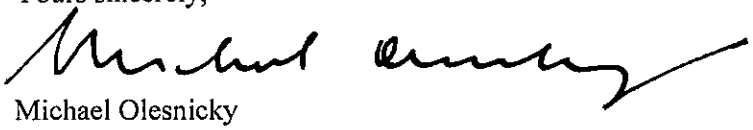
the government be given the authority to negotiate CDTAs using the 2004 standard now, rather than being pressured to accept TIEAs later.

5. Conclusion

The reality is that exchange of information under the 2004 standard has progressively become more common around the world. No jurisdiction can realistically expect to insist on a lower standard without suffering the threat of sanctions or other retribution from foreign governments and inter-governmental authorities. It is not in Hong Kong's interest to resist this trend, because this would isolate Hong Kong and detract from her status as a responsible member of the global community. We therefore support the Bill and the reasoning behind it, and urge the Legislative Council to proceed accordingly, as quickly as possible.

Should you have any questions or wish to discuss this matter further, please feel free to call me at 2846 1716.

Yours sincerely,



Michael Olesnicky
Chairman
For and on behalf of
The Joint Liaison Committee on Taxation