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Paper for House Committee meeting on 8 October 2010

**Subcommittee on the three
Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with
respect to Taxes on Income) Orders gazetted on 2 July 2010**

Purpose

This paper reports on the deliberations of the Subcommittee on the following three Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) Orders gazetted on 2 July 2010 -

- (a) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Brunei Darussalam) Order (L.N. 89 of 2010);
- (b) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Kingdom of the Netherlands) Order (L.N. 90 of 2010); and
- (c) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Republic of Indonesia) Order (L.N. 91 of 2010).

Background

2. Double taxation refers to the imposition of comparable taxes in more than one tax jurisdiction in respect of the same taxable income. The international community generally recognizes that double taxation hinders the exchange of goods and services, movements of capital, technology and human resources, and poses an obstacle to the development of economic relations between economies. As a business facilitation initiative, it is the Government's policy to enter into Comprehensive Agreements for Avoidance of Double Taxation (CDTAs) with Hong Kong's trading and investment partners.

3. Hong Kong adopts the territorial basis of taxation whereby only income sourced from Hong Kong is subject to tax. A local resident's income derived from sources outside Hong Kong would not be taxed in Hong Kong and hence would not be subject to double taxation. Double taxation may occur where a foreign jurisdiction taxes its own residents' income derived from Hong Kong. Although many jurisdictions do provide their residents with unilateral tax relief for the Hong Kong tax they paid on income derived therefrom, the existence of a CDTA will provide enhanced certainty and stability in respect of the elimination of double taxation. Besides, the tax relief provided under a CDTA may exceed the level provided unilaterally by a tax jurisdiction.

The three Orders

4. Under section 49(1A) of the Inland Revenue Ordinance (IRO) (Cap. 112), the Chief Executive in Council may by order declare that arrangements have been made with the government of any territory outside Hong Kong with a view to affording relief from double taxation in relation to income tax and any tax of a similar character imposed by the laws of that territory. L.N. 89 to L.N. 91 of 2010 are made by the Chief Executive in Council under section 49(1A) of the IRO to give effect to the following CDTAs respectively -

- (a) the Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China (HKSAR Government) and the Government of His Majesty the Sultan and Yang Di-Pertuan of Brunei Darussalam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed on 20 March 2010 (the Brunei Agreement);
- (b) the Agreement between HKSAR Government and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed on 22 March 2010 (the Dutch Agreement); and
- (c) the Agreement between HKSAR Government and the Government of the Republic of Indonesia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income signed on 23 March 2010 (the Indonesian Agreement).

5. Section 1 of all the three Orders provides that the Orders will come into operation on 18 November 2010.

6. According to the Legislative Council Briefs issued by the Administration on the three Orders, the above CDTAs set out clearly the allocation of taxing rights between Hong Kong and Brunei/the Netherlands/Indonesia and the relief on tax rates

for different types of income. It will help investors of the economies to better assess their potential tax liabilities from cross-border economic activities, foster closer economic and trade links between the places, and provide added incentives for enterprises of Brunei, the Netherlands and Indonesia to do business with or invest in Hong Kong, and vice versa. The benefits of the three CDTAs to the residents and enterprises of the contracting parties are elaborated in the respective Legislative Council Briefs.

The Subcommittee

7. At the House Committee meeting held on 9 July 2010, Members agreed to form a subcommittee to study the three Orders. Hon James TO was elected chairman of the Subcommittee, and the membership list of the Subcommittee is in the **Appendix**. The Subcommittee held one meeting on 13 September 2010 to meet with the Administration and scrutinize the Orders.

Deliberations of the Subcommittee

Progress and approach of the work on CDTA negotiations

8. The Subcommittee has sought information on the progress of the Administration's work on negotiating CDTAs, the approach adopted by the Administration in the negotiation work, and consultation with local stakeholders on the negotiations.

9. The Administration has advised that the Administration has actively engaged Hong Kong's trading partners in negotiating CDTAs. Since the Inland Revenue (Amendment) Ordinance 2010 came into operation in March 2010¹, the Government has already signed / upgraded 10 CDTAs based on the 2004 version of the exchange of information (EoI) article of the Organization for Economic Cooperation and Development (OECD) model text, and another five CDTAs are expected to be signed in the near future. The Administration's strategy is that Hong Kong would attempt first to conclude a CDTA with an identified jurisdiction in each major region, such as the northern Asian region, the Asian Pacific region, in Europe and the Middle East, so that other countries in the same region would make reference to that CDTA and be more prepared to negotiate a CDTA with Hong Kong. The Administration has also worked hard on other fronts to take forward CDTA negotiations. For example, during their overseas duty visits, senior officials would endeavour to promote trade relationship and seek to start CDTA discussions with other jurisdictions.

¹ The Inland Revenue (Amendment) Ordinance 2010 was enacted on 6 January 2010 to empower the Inland Revenue Department (IRD) to collect and transfer information that relates to a person to a competent authority under a CDTA having effect under the new section 49(1A) of the Inland Revenue Ordinance (Cap. 112), even if IRD has no domestic tax interest in such information. The Amendment Ordinance also enables Hong Kong to adopt the latest international standard for exchange of tax information in CDTAs, i.e. the 2004 version of EoI article of OECD.

10. As regards the approach adopted by the Administration in the negotiation work, the Administration has advised that OECD has provided a model text for CDTAs, and negotiations are generally based on this model. In the negotiation process, the Administration will bear in mind the need to safeguard the overall interests of Hong Kong, and will ensure that Hong Kong's residents and enterprises will benefit from such agreements.

11. Regarding consultation with the local community on CDTA negotiations, the Administration has advised that relevant sectors have been made aware of the Administration's work on CDTA negotiations, which are publicized on IRD's website. In taking forward the negotiation work, the Administration pays heed to the views of local stakeholders on tax issues of their concern. The Administration has assured the Subcommittee that it will step up efforts in soliciting views from the relevant sectors for the ongoing and future CDTA negotiations.

Financial and economic implications

12. On members' concern about the financial and economic implications of the three CDTAs under scrutiny, the Administration has advised that the impact of the CDTAs on Hong Kong's loss of Government revenue would be minimal since Hong Kong adopts the territorial basis of taxation whereby only income sourced from Hong Kong is subject to tax. As regards the extent of benefits that would be gained by Hong Kong enterprises and residents under the CDTAs, the Administration has advised that precise information in this regard is not available, because the enterprises and residents would not provide such information to the Government unless they have to provide such information to IRD in seeking taxation relief.

EoI Article under the CDTAs

13. The Subcommittee has noted that during the scrutiny of the Inland Revenue (Amendment) (No. 3) Bill 2009, the Administration presented a sample EoI Article to the Bills Committee². According to the Administration, the EoI Article in both the Brunei Agreement and the Indonesian Agreement has adopted all the safeguards in the sample EoI Article. In respect of the Dutch Agreement, the EoI Article therein has adopted some of the safeguards in the sample EoI Article. In relation to the disclosure of information concerning tax covered by the Agreement, the Dutch side is permitted to submit information on tax cases to the oversight bodies of the tax authorities³, whereas in the sample EoI Article, disclosure of information is confined to the tax authorities and cannot be provided to their oversight bodies.

² vide LC Paper No. CB(1)106/09-10(02) or Annex B to the Legislative Council Briefs on the three Orders.

³ Under paragraph 2 of Article 25 of the Dutch Agreement, the tax information exchanged shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes referred to in paragraph 1 of the Article, or the oversight of the above.

14. The Administration has explained that based on the OECD model CDTA, oversight bodies are allowed access to the tax information exchanged. However, during the scrutiny of the Inland Revenue (Amendment) (No. 3) Bill 2009, in view of the concern of the Bills Committee about the confidentiality of the information exchanged, the Administration undertook to seek to confine disclosure of information to the tax authorities but not their oversight bodies when negotiating individual CDTAs. During the negotiations on the Dutch Agreement, the Dutch side insisted that the reference to "oversight body" in the EoI Article is necessary to cater for submission of information relating to cases being considered by the Dutch oversight bodies, i.e. "de Algemene Rekenkamer" (the Court of Audit) and "de Nationale Ombudsman" (the National Ombudsman). The Administration considered this a justifiable request and had therefore accepted the Dutch proposal.

15. In this connection, the Subcommittee has noted that in Hong Kong, whilst the Financial Services and the Treasury Bureau is the administrative oversight body of IRD, under the Inland Revenue Ordinance (Cap. 112), the Bureau is not given access to the tax information exchanged.

Article on "Resident"

16. The Subcommittee has noted that in all the three CDTAs under scrutiny, Article 4 on "Resident" specifies the meaning of the term "resident of a Contracting Party" for the purposes of the respective Agreement, and in the case of the Hong Kong Special Administrative Region (HKSAR), the term means the following -

- (a) any individual who ordinarily resides in HKSAR;
- (b) any individual who stays in HKSAR for more than 180 days during a year of assessment or for more than 300 days in two consecutive years of assessment one of which is the relevant year of assessment;
- (c) a company incorporated in HKSAR or, if incorporated outside HKSAR, being normally managed or controlled in HKSAR;
- (d) any other person constituted under the laws of HKSAR or, if constituted outside HKSAR, being normally managed or controlled in HKSAR; and
- (e) the HKSAR Government.

17. Members have enquired about the bases for the definitions in paragraph 16(a) to (d) above. The Administration has advised that the Article on "Resident" is a standard article in Hong Kong's CDTAs. A "resident" as defined under paragraph 16(a) is an individual who ordinarily resides in the contracting parties' territory, taking into account the location of the individual's normal residence, his social relationships such as friends and relatives, and job and capital investments, etc. The definition is

based on the concept of "ordinary residence" as developed in case law in relation to taxation and immigration cases. As regards the length of stay mentioned in paragraph 16(b), i.e. more than 180 days during a year of taxation assessment or more than 300 days in two consecutive years of assessment, the requirement is modelled on the relevant provision in the IRO. With regard to paragraph 16(c) concerning corporations, the definition is based on the provisions in the IRO for taxing shipping enterprises. Paragraph 16(d) is a catch-all provision and is meant to cover entities such as partnerships.

18. The Administration has further advised that it would seek to include the same provisions for defining Hong Kong residents, but some other negotiation partners may not be prepared to accept all those provisions and this is one area in which Hong Kong may have to revise her position in future.

Article on "Interest"

19. The Subcommittee has noted that it is specified in both Article 11 of the Indonesian Agreement and Article 11 of the Brunei Agreement that the interest arising in a Contracting Party is exempt from tax in that Party, if the interest is paid to the government or certain entities specified in the Article. In the Indonesian Agreement, the specified entities include the following -

- (a) in the case of the Hong Kong Special Administrative Region:
 - (i) the Government of the Hong Kong Special Administrative Region;
 - (ii) the Hong Kong Monetary Authority; and
 - (iii) a statutory body, institution, or financial establishment appointed by the Government of the Hong Kong Special Administrative Region and mutually agreed upon by the competent authorities of the two Contracting Parties;
- (b) in the case of Indonesia:
 - (i) the Government of the Republic of Indonesia;
 - (ii) Bank Indonesia (the Central Bank of Indonesia);
 - (iii) Pusat Investasi Pemerintah (the Centre for Government Investment);
 - (iv) Lembaga Pembiayaan Ekspor Indonesia (the Indonesia Eximbank); and

- (v) a statutory body, institution, or financial establishment appointed by the Government of the Republic of Indonesia and mutually agreed upon by the competent authorities of the two Contracting Parties.

20. The Subcommittee has sought information on the nature of the entities set out in paragraph 19(b)(iii) and (iv) and the rationale for inclusion of the entities for exemption of tax on interest. In this connection, members have also enquired whether organizations in which either government of the contracting parties have equity holdings would enjoy tax exemption.

21. The Administration has advised that it is common international practice for parties to a CDTA to provide exemption for specific entities of a Contracting Party from being taxed on interest income derived from the other Contracting Party on the basis that such entities and their activities are of governmental nature. Pusat Investasi Pemerintah, which is also known as the Government Investment Centre, is an Indonesian Government-owned fund engaged in equity, debt and infrastructure investment, and is managed by the Ministry of Finance; whereas Lembaga Pembiayaan Ekspor Indonesia (or the Indonesia Eximbank) is the export financing agency of the Indonesian Government. It is a statutory body to facilitate national export growth. The Administration has further advised that Hong Kong would seek to restrict the list of entities eligible for tax exemption in any CDTA to government bodies, central banks, and statutory or public entities discharging government functions, and would seek to exclude state-owned enterprises that are engaged in purely commercial activities. The lists of entities agreed and adopted in the CDTAs with Indonesia and Brunei for exemption from interest tax represent the negotiated outcome with respective treaty partners which took into account the overall package of the agreements and their benefits to Hong Kong.

Articles on "Pensions"

22. The Subcommittee has noted that under the Brunei Agreement and the Indonesian Agreement, non-government pensions made under a public scheme which is part of the social security system of the source jurisdiction or under a retirement scheme which is recognized for tax purpose in the source jurisdiction are taxable only in the source jurisdiction. Besides, employment income and pensions paid by the government of a Contracting Party are, in general, taxable only in that Party (source jurisdiction). However, under the Dutch Agreement, while employment income and pensions paid by the government of a Contracting Party are, in general, taxable only in that Party (source jurisdiction), non-government pensions may be taxed by both Contracting Parties⁴. In other words, a Hong Kong ex-civil servant retiring in the

⁴ Under all the three CDTAs, where both tax jurisdictions are given the right to tax the same item of income, the resident jurisdiction is required under the Agreement to give double taxation relief to its resident for any income doubly assessed (i.e. the source jurisdiction has the primary right to tax and the resident jurisdiction is left with a secondary right).

Netherlands who receives pensions paid by the HKSAR Government may only be taxed by the HKSAR Government, but for a Hong Kong resident retiring in the Netherlands and receiving benefits accrued from his Mandatory Provident Fund Scheme or other non-government retirement schemes, he may be taxed by both Contracting Parties. Members enquired about the Government's policy in this regard.

23. The Administration has advised that in negotiating CDTAs, the Administration would seek to secure exclusive taxing right for Hong Kong on retirement benefits for Hong Kong people but may not be successful in securing such right in each and every CDTA. Some negotiating partners may hold a strong view that as substantive public resources were spent on services for resident retirees, the resident jurisdiction should have taxing right on their income.

Drafting matters

24. The Subcommittee has noted that in paragraph 3(a)(iii) of Article 11 of the Brunei Agreement, "基金會" is used as the Chinese rendition of "foundation", whereas "協會" is used in paragraph 3(b)(v) of the same Article. The Administration has explained that "基金會" is used as the Chinese rendition of "foundation" in paragraph 3(a)(iii) in accordance with Hong Kong's legislation. The word "foundation" in paragraph 3(b)(v) is rendered as "協會" because while the term "基金會" has an established meaning equivalent to "foundation" in the context of Hong Kong, it is not certain whether "基金會" has been so used to convey the same meaning in the context of Brunei Darussalam. Thus, "協會", which is a more general term, is used. The Administration has further advised that the difference has no bearing on the legal effect of the Article because in both provisions, "foundation" is given as an example of the institutions intended to be covered only; the determinant for both provisions is "set up by the Government of Hong Kong/Brunei Darussalam under statutory law", which meaning is not restricted in any sense by the examples which follow.

25. Considering that using the same term "基金會" in the two provisions will not have the effect of restricting the scope of the institutions intended to be covered by the provisions, the Subcommittee considers it appropriate to use the same term "基金會" as the Chinese rendition of the word "foundation" in the two provisions. Having considered members' views, the Administration agrees to amend the term "協會" in the Chinese text of paragraph 3(b)(v) of Article 11 of the Brunei Agreement to "基金會" for consistency with paragraph 3(a)(iii) of the same Article.

Recommendation

26. The Subcommittee supports the three Orders and the amendment proposed by the Administration to the Inland Revenue (Double Taxation Relief and Prevention of

Fiscal Evasion with respect to Taxes on Income) (Brunei Darussalam) Order as mentioned in paragraph 25 above.

Advice sought

27. Members are requested to note the deliberations and recommendation of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
6 October 2010

**Subcommittee on the three
Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with
respect to Taxes on Income) Orders gazetted on 2 July 2010**

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