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25 January 2011

Clerk to Establishment Subcommittee
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road
Central, Hong Kong
(Attn: Mr Stephen Lam)

Dear Mr Lam,

Establishment Subcommittee
Follow-up to meeting on 12 January 2011

Thank you for your letter dated 17 January 2011. The supplementary information requested is set out in the ensuing paragraphs.

Complexity of CDTA Negotiations

While the Organisation for Economic Cooperation and Development Model Tax Convention (OECD model) provides a reference for negotiations of comprehensive avoidance of double taxation agreements (CDTAs), it is a common practice for jurisdictions to modify the OECD model to suit their own domestic needs and policies. Hence, negotiations with treaty partners require intensive work with a view to concluding CDTAs which best suit the interest of Hong Kong vis-à-vis the positions put forward by treaty partners.

Major differences between the models of Hong Kong and our treaty partners

Definition of “resident”

The definition of “resident” is of importance as it determines the persons who are eligible for the CDTA benefits. Most jurisdictions adopt the general definition of “resident” as provided in the OECD model, i.e. persons who are liable to tax in the jurisdiction by reason of domicile, residence, place or management, etc. However, as Hong Kong levies tax on source principle instead of the residence concept, the definition of “resident” in the Hong Kong model is broader in the sense that it includes individuals who stay in Hong Kong for more than 180 days in a year and companies which are either incorporated or are normally managed or controlled in Hong Kong.

As all of our treaty partners which adopt residence taxation consider that the definition of “resident” in the Hong Kong model would entail more benefits to Hong Kong, we have to spend considerable efforts to persuade our treaty partners to accept our definition. We expect that this issue will recur in our future CDTA negotiations. For some jurisdictions, they will request for provisions on “Limitation of Benefits” (LoB) which aim to restrict the benefits of a CDTA to entities meeting certain requirements only. In such cases, we need to dissuade our negotiation partners from the need to insert such provisions as far as possible. If our negotiation partners insist to have such provisions, we will need to persuade them to agree to tune down the provisions to the effect that the provisions will have the least impact on Hong Kong. This often involves lengthy and tactful negotiations. For example, in the Hong Kong / Indonesia CDTA, we have successfully managed to adopt LoB provisions in the articles on dividends, interest, royalties and other income that would not unduly limit the benefits for Hong Kong. There are similar discussions on LoB provisions in the CDTAs that we will submit to the Legislative Council for ratification. We expect to encounter the same issue in our future negotiations with other trading and investment partners.

Exchange of information (EoI)

Treaty partners attach great importance to the EoI article. To safeguard the privacy of taxpayers and the confidentiality of information exchanged under the liberalized EoI regime, we have undertaken at the

Legislative Council to seek to impose restrictions on the scope of the EoI provisions over and above the OECD standard, including -

- (i) the CDTA only obliges the Contracting Parties to exchange information on request, i.e. no automatic or spontaneous exchange of information;
- (ii) the scope of information exchange is confined to taxes covered by the CDTA;
- (iii) disclosure of information is confined to the tax authorities but not their oversight body; and
- (iv) no retrospective effect.

As these restrictions are more stringent than the OECD model, none of our existing treaty partners could readily accept our position at the inception of our negotiations. It took our negotiation team considerable efforts to persuade our treaty partners to accept these restrictions. We expect the same situation will arise in future negotiations.

Tax benefits and taxing rights

Hong Kong adopts a low, simple and territorial tax system, while most of our treaty partners tax world-wide income of their residents and have complicated tax systems with high tax rates. This fundamental difference in tax systems results in different standpoints and often challenging negotiations on the issues of tax benefits and taxing rights. For example, on withholding tax on interest and dividends, we seek to negotiate for the lowest rates for Hong Kong. As for pensions, it often involves lengthy discussions with our treaty partners on the allocation of taxing rights. For other provisions that are peculiar to our treaty partners, we have to conduct necessary research before coming to a view on the appropriate allocation of taxing rights. As we expand our treaty network, we expect similar differences would continue to exist in our future negotiations.

As pointed out in the paper to the Establishment Subcommittee (EC(2010-11)15)(ESC paper), with an increasing number of CDTA negotiations, the existing makeshift arrangement for the two Deputy Commissioners of Inland Revenue and the five Assistant Commissioners of

Inland Revenue to take turns to lead our negotiation team would be ineffective as they need to keep each other informed of the latest strategies and positions of our negotiation partners. Hence, there is an imminent need to have a dedicated directorate officer to take the lead in various CDTA negotiations, thereby ensuring a built-up expertise and focused skills on CDTA. In fact, heads of delegations of our negotiation partners are dedicated officials given that international tax is a very specialised area.

Increasing Efforts / Complexity in the Implementation of CDTAs

As explained in the ESC paper, tax practitioners and taxpayers from time to time raise questions on the application of different CDTA provisions in individual cases. For any unresolved issues, the concerned taxpayer can request the two concerned tax administrations to raise the disputed case for discussions by virtue of the Mutual Agreement Procedure (MAP) article under CDTA. With more CDTAs coming in force, it is expected that cases requiring MAP will increase. According to OECD, at the end of 2009, the total number of open MAP cases reported by OECD member countries was 3,842, a 21.3 % increase as compared to 2008 and the average time for completion of MAP cases with other OECD member countries was around 23 months in 2009.

Furthermore, in the HK/Netherlands and HK/Japan CDTAs, if a disputed case arises and cannot be resolved by MAP, it will be submitted for arbitration. We expect similar requests from our future treaty partners for inclusion of arbitration provisions in the CDTAs. According to OECD, arbitration entails lengthy procedures ranging from agreeing on the issues to be resolved in three months' time to forming an arbitration panel by mutual agreement and reaching a decision on the issues within a year after receipt of all relevant information. The entire process could take around two years.

Increasing Caseload

During the period from March to December 2010, we signed 13 new CDTAs and upgraded the EoI arrangements in our two existing CDTAs to the latest standard. Four of these CDTAs/upgrades have entered into force. Following the completion of legislative processes on both sides, we expect most of the other new CDTAs/upgrades will enter into force in 2011.

For the five CDTAs signed before 2010, we experienced in the past four years quite substantial increase in the number of applications for certificate

of residency from 22 in 2006-07 to almost 1,000 in 2009-10. The number of tax credit claims also recorded a growth trend, rising from 293 applications in 2006-07 to more than 400 in 2008-09¹. As more CDTAs will enter into force from 2011 onwards, we expect the growth trend will accelerate, thus calling for additional directorate input in supervising and ensuring the quality of the work of the Tax Treaty Section of the Inland Revenue Department.

Peer Review

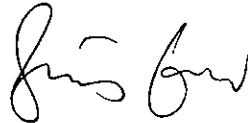
As set out in the ESC paper, Hong Kong will be subject to the two-phase peer review of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes on our compliance with the international EoI standard. The first-phase review (by mid-2011 for Hong Kong), comprising a comprehensive study by OECD assessors on Hong Kong's legal and regulatory framework, will be conducted intensively over four months. During the process, we need to file Hong Kong's responses to OECD's questionnaire, address queries from OECD assessors, review and provide comments on the draft report prepared by OECD, as well as suggest necessary fine-tuning of the draft report for the benefit of Hong Kong. The review will cut across different policy areas such as registration and information transparency of entities such as companies and trusts, anti-money laundering regime, and regulatory requirements of different professional sectors, etc. It is essential to have a dedicated officer at directorate level to co-ordinate and formulate Hong Kong's responses and to attend the Peer Review Group meeting to articulate Hong Kong's position.

After the first-phase review, we will need to consolidate our position, co-ordinate and formulate timely follow-up actions on identified areas for improvement, including necessary legislative amendments to the existing legal and regulatory framework in the light of OECD's report. The second-phase review (in the latter half of 2012 for Hong Kong) will take around three months, including responding to OECD's questionnaire, facilitating on-site visit and inspections by OECD assessors and providing comments on the draft report prepared by OECD. That process is expected to be engaging and complex.

¹ The finalised figure for tax credit claim for year 2009-10 will only be fully reflected after 2011-12.

As the peer review report will attract high-level political attention at the international level, any negative perceptions on the transparency of our tax regime would tarnish Hong Kong's reputation as an international financial centre and might lead to sanctions by other economies.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Shirley Kwan', written in a cursive style.

(Ms Shirley Kwan)
for Secretary for Financial Services and the Treasury

c.c. Commissioner of Inland Revenue (Attn: Mr Wong Kuen-fai)