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31 December 2010

Clerk to Panel
Panel on Financial Affairs
Legislative Council Secretariat
Legislative Council Building
8 Jackson Road
Central, Hong Kong
(Attn: Mr Noel Sung)

Dear Mr Sung,

Panel on Financial Affairs
Follow-up to meeting on 1 November 2010

I refer to your letter dated 3 November 2010. In response to item 3 on the list of follow-up actions, we would like to provide supplementary information in the ensuing paragraphs.

Current and Anticipated Workload in relation to Comprehensive Avoidance of Double Taxation Agreements (CDTAs)

CDTA negotiations require strategic planning and immense preparatory work which is both technical and resource-demanding. Prior to a negotiation, the Tax Treaty (TT) Section of the Inland Revenue Department (IRD) has to conduct detailed research on the tax system and tax treaty policy of the negotiation partner. There is a need for directorate leadership in setting the

broad directions for research, reviewing the adequacy of research conducted and formulating our negotiation strategies on the basis of the research findings. Taking into account the time required for preparatory work, the duration of negotiations, the need for internal consultation as well as the time required for reviewing the negotiation outcome for fine-tuning of our negotiation position if necessary, on average, the proposed Chief Assessor (CA) would need to dedicate at least three to four weeks' time before one round of negotiations could be concluded, not to mention the efforts required in corresponding with the negotiation partner in writing to exchange views and to seek necessary clarifications. The conclusion of a CDTA may take several rounds of negotiations. After conclusion of a CDTA, the TT Section needs to work in close collaboration with the treaty partner to translate the CDTA and to prepare for formal signing and ratification. The proposed CA can oversee all the work of the TT Section.

To cope with the increasing efforts/complexity in the implementation of CDTAs

With the expansion of the CDTA network, the workload at the implementation stage will increase correspondingly. For the five CDTAs signed before 2010, we experienced in the past three years quite substantial increase in the numbers of requests for exchange of information (EoI), applications for certificate of residency and claims for tax credit. As more CDTAs will take effect 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 TT Section.

In particular, the workload generated by the anticipated increase in EoI requests will be more prominent. According to our informal enquiries with a number of our treaty partners with more extensive CDTA network than ours, each of them receives an average of over 100 EoI requests each year. To safeguard the privacy of taxpayers and the confidentiality of information exchanged, the Inland Revenue (Disclosure of Information) Rules require that the decision on whether to accede to an EoI request has to be made by an authorised directorate officer personally. For EoI requests made under the latest standard, IRD may not possess the required information in the existing tax files and hence would need to make extra efforts to collect and scrutinise the information. Given the international practice that EoI is completed within 90 days upon request, there is a need for prompt and close supervision by a

dedicated directorate officer on the proper statutory procedures before the requisite information is sent out. Additional directorate input is also essential to keep under constant review the effectiveness of our EoI regime.

The global trend that CDTAs are becoming increasingly sophisticated also necessitates stronger steer from the directorate level in the course of implementation. As more CDTAs will take effect from 2011 onwards, we expect the numbers of double taxation claims as well as disputed cases from taxpayers will increase. Besides, tax practitioners and taxpayers from time to time raise questions on the application of different CDTA provisions in individual cases. Hence, there is a need for enhanced directorate leadership for the TT Section so as to ensure that relevant issues are settled expeditiously. 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. MAP is a time-consuming process and will often require face-to-face negotiations. In addition to the standard MAP provisions, some of the CDTAs that we concluded recently even contain provisions on arbitration mechanism. Under such mechanism, when a disputed case arises and cannot be resolved by MAP, an independent arbitration board comprising members from revenue authorities of both sides will be set up to handle the case. Arbitration can be a long and complicated process. IRD will need to be represented by a directorate officer on such arbitration boards given the expertise and seniority required.

To prepare for peer review by the Global Forum on Transparency and Exchange of Information for Tax Purposes under the Organisation for Economic Cooperation and Development

The newly established Global Forum on Transparency and Exchange of Information for Tax Purposes under the auspices of the Organisation for Economic Cooperation and Development (OECD), of which Hong Kong is a member, will conduct a two-phase peer review on Hong Kong by mid-2011 and by end-2012 respectively to assess whether Hong Kong meets the international standard on EoI. The peer review report will attract high-level political attention at the international level. It is of paramount importance that Hong Kong passes the peer review to avoid being labelled as a “tax haven” or else Hong Kong will be under severe criticism. Any negative perceptions on the transparency of our tax regime would tarnish Hong Kong’s reputation as an

international financial centre and could lead to sanctions by other economies. As the issues under review straddle across different bureaux/departments, it is imperative that IRD devotes dedicated manpower support at the directorate level to co-ordinate input from relevant bureaux/departments, formulate Hong Kong's responses and act as a focal point for effective communications with the Global Forum during the entire peer review process.

To deliver new area of work related to Advance Pricing Arrangement (APA)

There is an international trend for CDTA partners to enter into APAs. As at October 2009, the Mainland China concluded nine APAs with other jurisdictions and has 50 APA negotiations in the pipeline. APAs are unilateral or multilateral arrangements made between taxpayers and the tax authorities in advance on the set of criteria for determination of transfer pricing with respect to cross-border transactions between related companies. APAs can avoid double taxation in advance, resolve transfer pricing issues and provide predictability for taxpayers. With pre-set guidelines on the apportionment of profits arising from cross-border transactions laid down in advance, APAs are conducive to the protection of public revenue. A network of APAs would also be beneficial to Hong Kong's position as a regional headquarters for multinational companies and a platform for overseas investment into the Mainland.

Very often, APAs involve intensive and highly-technical negotiations with the taxpayer lodging APA request, one or more associated enterprises, and one or more tax authorities. In the coming years, IRD proposes to embark on the initiative of processing APA requests. In so doing, substantial information has to be collected and analysed, including comparable pricing information and methodology. Given the complexity of the issues involved, a dedicated officer at directorate level is necessary for providing high-level guidance in this area.

To continue active participation in international exchanges on taxation matters

Over the years, there has been a significant increase in IRD's involvement in international taxation matters. Active participation in international forum is instrumental to demonstrating our commitment to tax transparency and enhancing our international status. Liaison with the tax

authorities of our treaty partners is also becoming more frequent than ever. Given the high-level liaison work required, there is a need for dedicated directorate support to ensure effective international exchanges and to respond timely to any new developments on taxation matters at the global level.

CDTAs with Major Trading Partners

In the past, Hong Kong could not adopt the OECD latest version of EoI provision in our CDTAs due to the legal constraint on the information gathering power of the IRD. This was a major obstacle in our CDTA negotiations. Nevertheless, with the completion of the legislative exercise early this year, thus enabling Hong Kong to align its EoI arrangements with international standards, we have experienced a major breakthrough in our CDTA negotiations.

Currently, among the top 20 trading partners of Hong Kong, we have concluded CDTAs with ten of them and started CDTA negotiations with four of the remaining ten. In the coming three years, we plan to hold on average one to two round(s) of negotiations per month with a view to concluding at least ten more CDTAs. With dedicated directorate leadership, we will be better placed to identify potential treaty partners and set negotiation priorities strategically.

Benefits of CDTAs

Expansion of CDTA Network

It is our policy to expand Hong Kong's CDTA network with our major trading and investment partners as this will help improve the business environment and facilitate flows of trade, investment and talent between Hong Kong and the rest of the world. The expansion of CDTA network is of strategic importance to Hong Kong. It enhances Hong Kong's position as an international business and financial centre, and reinforces Hong Kong's unique status as a springboard for investment into and out of the Mainland.

Facilitating cross-border flows of trade, investment and talent

Although Hong Kong adopts the territorial concept of taxation and 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. Despite that many jurisdictions do provide their residents with unilateral tax relief for the Hong Kong tax they paid on income derived in Hong Kong, the existence of a CDTA will provide enhanced certainty and predictability over tax liabilities. The tax relief provided under a CDTA may also exceed the level provided unilaterally by a tax jurisdiction, thus reducing tax burdens on individuals and enterprises. All these benefits will help improve the business environment and facilitate cross-border flows of trade, investment and talent. It is well recognized internationally that CDTAs will induce foreign direct investment (FDI). However, it is difficult to quantify the magnitude of FDI brought about by a CDTA as FDI may also be affected by a host of other factors, such as cyclical changes in the domestic and global economies, business opportunities, cost of business, political stability, etc.

Reducing tax burdens on individuals and enterprises

In practice, CDTA provides tax savings to foreign companies doing business or foreign individuals working in Hong Kong. Under a CDTA, foreign companies or individuals in Hong Kong can claim tax credits in their home countries for profits or income earned and taxed in Hong Kong. Such benefit, coupled with our simple and low tax regime, provides added incentives for overseas companies to set up or expand their businesses and for overseas talent to work in Hong Kong. In the long run, with an increasing number of overseas companies and foreign employees in Hong Kong, our pool of taxpayers and tax revenue will grow in tandem.

On the other hand, under a CDTA, any overseas tax paid by a Hong Kong company or a Hong Kong resident shall be allowed as a deduction from the tax payable in respect of the same income in Hong Kong. The tax credit allowed by IRD increased from \$55.77 million in 2006-07 to \$104.47 million in 2009-10. Besides, income received by a Hong Kong resident from local employment exercised abroad will be exempted from overseas income tax if his aggregate stay in that overseas jurisdiction in any relevant 12-month period does not exceed 183 days. For the transport sector, Hong Kong airlines operating flights to our treaty partners will be taxed at Hong Kong's corporation tax rate, which is normally lower than that of our treaty partners.

Profits from international shipping transport arising in our treaty partner jurisdictions and earned by Hong Kong residents could also be taxed at a lower rate or even be exempted from tax.

Lower withholding tax rates on passive income

Where withholding tax is imposed on passive income like dividends, interest and royalties received by Hong Kong residents, under a CDTA, Hong Kong residents usually enjoy lower withholding tax rates on such income received from abroad.

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)