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**Subcommittee on the Three Orders Made under Section 49(1A) of the
Inland Revenue Ordinance and Gazetted on 18 November 2011**

Background Brief

Purpose

This paper sets out background information on the three Orders made under section 49(1A) of the Inland Revenue Ordinance (Cap. 112) (IRO) and gazetted on 18 November 2011. The paper also summarizes the views and concerns expressed by Members when the relevant subject of Comprehensive Agreements for Avoidance of Double Taxation (CDTAs) was discussed by the committees of the Legislative Council (LegCo).

Background

Comprehensive Agreements for Avoidance of Double Taxation

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 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.

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

4. A CDTA would normally include an article that provides for the exchange of information (EoI) necessary for the carrying out of the agreement between the two contracting parties. To enable Hong Kong to adopt the latest international standard for EoI under CDTAs, i.e. the Organisation for Economic Cooperation and Development (OECD) 2004 version of the Exchange of Information (EoI) Article, the Administration introduced the Inland Revenue (Amendment) (No.3) Bill 2009 into the Legislative Council (LegCo) on 29 June 2009. The Bill was passed on 6 January 2010, and the Inland Revenue (Amendment) Ordinance 2010 came into operation on 12 March 2010.

5. The 2004 version of the OECD EoI Article categorically states that the lack of domestic tax interest does not constitute a valid reason for refusing to collect and supply the information requested by another contracting party. Before enactment of the Inland Revenue (Amendment) Ordinance 2010, the Inland Revenue Department (IRD) could only collect taxpayers' information for the ascertainment of liability, responsibility and obligation under the domestic tax law. In other words, IRD could not collect any tax information unless such information was for domestic tax purposes. This constraint had reduced the number of Hong Kong's potential CDTA partners, and restricted the progress of the negotiations for CDTAs. Upon the commencement of operation of the Inland Revenue (Amendment) Ordinance 2010, IRD is authorized, among other things, to collect information concerning tax of a foreign territory for the purpose of EoI under a CDTA, and supply such information to the other contracting party of a CDTA.

Previous orders made under section 49(1A) of the Inland Revenue Ordinance

6. Since the enactment of the Inland Revenue (Amendment) Ordinance 2010, the Chief Executive in Council has made a total of 13 orders (discounting L.N. 155 to L.N. 157 of 2011) under section 49(1A) of IRO to give effect to the following CDTAs signed or upgraded based on the 2004 version of the OECD EoI Article -

- (a) three CDTAs signed between Hong Kong and Brunei, the Netherlands and Indonesia (relevant orders gazetted on 2 July 2010);
- (b) four CDTAs signed between Hong Kong and Hungary, Austria, the United Kingdom and Ireland and the Third Protocol to the arrangement between the Mainland of China and Hong Kong for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (relevant orders gazetted on 15 October 2010); and
- (c) four CDTAs signed between Hong Kong and Japan, France, Liechtenstein, and New Zealand; and the protocol signed between Hong Kong and Luxembourg to amend the Agreement between Hong Kong and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital (relevant orders gazetted on 13 May 2011).

L.N. 155 to L.N. 157 gazetted on 18 November 2011

7. L.N. 155 to L.N. 157 are made by the under section 49(1A) of the IRO to give effect to the CDTAs signed between Hong Kong and Portugal, Spain and Czech respectively. The orders will come into operation on 12 January 2012.

Members' concerns and views

Panel on Financial Affairs

8. The Administration briefed the FA Panel on 4 May 2009 before introducing the legislative amendments (paragraph 4 and 5 above) to enable Hong Kong to adopt the 2004 version of the OECD EoI Article in signing CDTAs. The following views were expressed by members at the Panel meeting:-

- (a) giving the uniqueness of Hong Kong's small and open financial market and the possible number of EoI requests from the contracting parties, the proposed extension of IRD's powers to gather information from taxpayers and provide the information to contracting parties should be examined with extra caution;

- (b) EoI under CDTAs should be limited to the information on a specific taxpayer in a case, but not those on his business counterparts and associates; and
- (c) there should be measures and mechanisms to protect the confidentiality of the information exchanged and the privacy of the taxpayers concerned.

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

9. During the deliberations of the Bills Committee on the Inland Revenue (Amendment) (No. 3) Bill 2009, members were mainly concerned about the adequacy of safeguards to protect taxpayers' right to privacy and confidentiality of the information disclosed to the requesting party in the EoI under CDTAs. In this connection, apart from scrutinizing the Bill, the Bills Committee also examined the various safeguards to be provided in the form of subsidiary legislation and departmental guidelines. The major concerns of members and the Administration's responses are summarized in the **Appendix**.

Subcommittees formed to study the previous orders made under section 49(1A) of IRO

10. Subcommittees had been formed to study all the three batches of orders mentioned in paragraph 6 above. The major issues studied by these subcommittees include the following -

- (a) progress of the Administration's work on negotiating CDTAs;
- (b) approach and strategy adopted by the Administration for the negotiation work;
- (c) consultation with the local community on CDTA negotiations;
- (d) financial and economic implications of CDTAs;
- (e) scope of taxes covered by the CDTAs;
- (f) adequacy of safeguards under the respective EoI Articles to protect taxpayers' right to privacy and confidentiality of the tax information exchanged;

- (g) taxation arrangements for the interest income paid to the government or certain specified entities discharging government functions of the Contracting Parties;
- (h) taxation arrangements in respect of pensions paid to Hong Kong people.
- (i) allocation of taxing rights in respect of income from employment and profits from operation of international transport;
- (j) withholding tax on passive incomes;
- (k) the non-discrimination provisions in the CDTAs;
- (l) the mutual agreement procedure in the CDTAs; and
- (m) determination of the resident status of a taxpayer under the CDTAs.

11. The advice given by the Administration on the general or policy issues during the deliberations of the subcommittees is summarized in **Appendix II**.

Relevant papers

12. Relevant papers are available at the following links:

Papers relevant to the five Orders made under section 49 of the Inland Revenue Ordinance and gazetted on 13 May 2011

http://www.legco.gov.hk/yr10-11/english/hc/sub_leg/sc12/general/sc12.htm

Papers relevant to the five Orders made under section 49(1A) of the Inland Revenue Ordinance and gazetted on 15 October 2010

http://www.legco.gov.hk/yr10-11/english/hc/sub_leg/sc02/general/sc02.htm

Report of the Subcommittee on the Five Orders Made under Section 49(1A) of the Inland Revenue Ordinance and Gazetted on 15 October 2010

<http://www.legco.gov.hk/yr10-11/english/hc/papers/hc1112cb1-390-e.pdf>

Report of the 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

<http://www.legco.gov.hk/yr09-10/english/hc/papers/hc1008cb1-2975-e.pdf>

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

<http://www.legco.gov.hk/yr08-09/english/bc/bc10/reports/bc100106cb1-755-e.pdf>

LC Paper No. CB(1)106/09-10(02) on sample EoI Article

<http://www.legco.gov.hk/yr08-09/english/bc/bc10/papers/bc101027cb1-106-2-e.pdf>

The Administration's paper for the meeting of the Panel on Financial Affairs on 4 May 2009

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0504cb1-1408-3-e.pdf>

Minutes of Panel meeting on 4 May 2009 (paragraphs 8 to 26)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090504.pdf>

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Major concerns raised by members of the Bills Committee on Inland Revenue (Amendment) (No. 3) Bill 2009 and the Administration's responses

Approach for setting out the EoI safeguards

Some members and deputations considered that the fundamental safeguards on the scope and usage of information exchanged should be provided in the primary legislation. The Administration explained that according to available information and its enquiries, other jurisdictions did not provide standard OECD EoI safeguards in their primary legislation. Instead, the following safeguards would be put in place –

- (a) incorporating the most prudent safeguards acceptable under the OECD Model Article in individual CDTAs, which would be implemented as subsidiary legislation subject to the negative vetting procedure, or in documents of record between the two contracting parties;
- (b) putting in place domestic safeguards through a set of rules (known as the Inland Revenue (Disclosure of Information) Rules) to be made under section 49(6) of the Inland Revenue Ordinance¹; and
- (c) setting out the procedural guidelines for IRD in the processing of EoI requests in a Departmental Interpretation and Practice Note (DIPN).

2. To address members' concerns, the Administration presented a sample EoI Article to the Bills Committee (LC Paper No. CB(1)106/09-10(02) and undertook to set out clearly all the safeguards adopted in individual CDTAs and any deviation from the sample text in its submissions to LegCo on subsidiary legislation to implement CDTAs. The Administration also agreed to subject the proposed Inland Revenue (Disclosure of Information) Rules (the Rules) to the positive vetting procedure, rather than the negative vetting procedure as originally proposed.

No retrospective effect of EoI arrangements under CDTAs

3. Members considered that the EoI arrangements under CDTAs should have no retrospective effect, i.e. IRD would not entertain any request for

¹ At the Council meeting on 3 March 2010, LegCo approved the Inland Revenue (Disclosure of Information) Rules by way of a resolution made under section 49 of the Inland Revenue Ordinance (Cap. 112).

information relating to a period before the effective date of the respective CDTAs. The Administration advised that a standard article would be included in all CDTAs setting out that all provisions under the CDTA should have effect from a stipulated date as agreed and should only apply to taxes after the effective date, and IRD would not disclose any information in response to a disclosure request unless the information did not relate to any period before the relevant CDTA came into operation.

4. Having considered members' views, the Administration agreed to add a provision in the Rules stipulating that there shall be no retrospective effect for EoI arrangements under CDTAs, and that no information existing at any time prior to the effective date of a CDTA shall be disclosed.

Scope of information exchanged

5. Under the 2004 version of the EoI Article, the requesting party should satisfy IRD that the information requested was "foreseeably relevant" for the carrying out of the CDTAs or to the administration or enforcement of the requesting party's local tax laws. Members were concerned whether the term "foreseeably relevant" could adequately restrict the scope of information exchanged. The Administration explained that the term "foreseeably relevant" was recommended by OECD and adopted internationally in the EoI article of CDTAs to guard against "fishing expeditions".

6. To provide greater clarity in the restriction of the scope of information exchanged, the Administration agreed to make reference to the Eighth Schedule of the Income Tax (Amendment) (Exchange of Information) Act of Singapore, and set out in the Rules the information that should be provided in an EoI request. Moreover, the Administration would expand the relevant part of IRD's DIPN to set out the principle that the test of relevancy should be based on the information provided by the requesting party in the EoI request, and that the EoI request must contain information on the relevance of the information to the purpose of the request.

Confidentiality and usage of information exchanged

7. Members expressed concern about the disclosure of information exchanged to a third party such as the oversight body of the tax authorities and/or another jurisdiction. The Administration advised that as part of the safeguards in CDTAs, the requesting party should be restricted from sharing the information provided with any third party (including a third jurisdiction or another government department of its own jurisdiction). Some of the additional measures such as confining disclosure of information to the tax

authorities but not their oversight bodies would need to be worked out during the negotiation of individual CDTAs.

Notification of disclosure of information

8. On the mechanism for notifying the relevant taxpayers, the Bills Committee noted that the Administration would prescribe in the Rules the notification procedures that the Commissioner of Inland Revenue shall follow before any information was disclosed. The person concerned might request a copy of the information, make a request for amendments to the information, and apply to the Financial Secretary for a review of the IRD's decision on the request for information amendments. To address the concern of the Bills Committee, the Administration agreed to extend the time allowed for the person concerned to submit proposed amendments to the Commissioner of Inland Revenue from 14 days to 21 days. IRD would also send out the first notice as soon as practicable upon its decision to proceed with the EoI request.

9. Some members were concerned that on request of the requesting party, IRD might give no notification or prior notification to the person concerned, thus depriving the person of the protection of the right of being notified. In this connection, the Administration explained that a requesting party who made such a request must provide explanations and evidence relating to the making of such a request. The Administration agreed to elaborate further on the details to be provided by the requesting party in this aspect in the Schedule to the Rules.

Review of decision of IRD

10. Under the Rules, where the Commissioner partially approves or refuses a request for amendments, the person concerned may request the Financial Secretary (FS) to direct the Commissioner to make the amendments. Given the standard 90-day response time set by OECD for EoI, members were concerned whether the information would have been transmitted to the requesting party before completion of the review procedure. The Administration advised that it would be stipulated in the DIPN that the relevant information would not be transmitted to the requesting party before completion of the review procedure, if a review was requested.

11. There were views that an independent tribunal/appeal panel/the Board of Review should be authorized to review IRD's decisions on disclosure of information under a CDTA, and that the Financial Secretary (FS) be empowered to review the question of law on the decisions of IRD on collection or disclosure of information, in addition to the power to review the question of fact, i.e. the accuracy of the information to be disclosed by IRD.

12. The Administration advised that FS, as the oversight body under the law, would review submissions on factual accuracy of the information. If a person thought that IRD had not properly discharged its responsibility to ensure that the information requested was within the scope of the relevant CDTA or the law, he could challenge IRD's decisions/actions through judicial review. The Administration agreed to report to the Panel on Financial Affairs on the effectiveness of the proposed notification and appeal system 18 months after implementation.

Precedence effect of arrangements in CDTAs

13. Members were concerned that the proposed section 49(1A)(a) of IRO, which stipulated that arrangements specified in CDTAs "shall have effect in relation to tax under this Ordinance despite anything in any enactment", might result in excessive overriding effect on provisions concerning protection of fundamental human rights in other ordinances.

14. The Administration explained that CDTAs allocated taxing rights between two treaty partners. A company that would otherwise be subject to tax at a certain rate under Hong Kong laws might be entitled to a lower rate (or not taxed at all) because of a piece of subsidiary legislation that implemented a CDTA. In such a case, that piece of subsidiary legislation would take precedence over the said Hong Kong laws. The effect of any CDTA and its implementing subsidiary legislation would be limited to "tax under the IRO" and any precedence effect would be accordingly limited.

Appendix II

Summary of the advice given by the Administration on general or policy issues during the deliberations of the relevant subcommittees

Approach and strategy for the negotiation work

1. The Government's strategy in negotiating CDTAs is that Hong Kong would attempt first to conclude a CDTA with an identified country in each major region, such as the northern Asian region, the Asian Pacific Region, 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.

Consultation with the local community

2. The Administration would bear in mind the need to assure the overall interests of Hong Kong, pay heed to the views of local stakeholders on tax issues of their concern and ensure that Hong Kong's residents and enterprises would benefit from such agreements. The Administration would step up efforts in soliciting views from the relevant sectors for the CDTA negotiations.

Financial and economic implications

3. 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 was subject to tax. There is no precise information with regard to the extent of benefits that would be gained by Hong Kong enterprises and residents under the CDTAs, 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.

Scope of taxes covered by CDTAs

4. The taxes covered by CDTAs are "income taxes" and "capital taxes" (as appropriate) in the broad sense. In each CDTA, there is an Article on "Taxes Covered" and the provisions therein specify the types of taxes to which the Agreement should apply.

Exchange of information

5. Based on the OECD model text for CDTAs, oversight bodies of tax authorities of the contracting parties 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, the Administration undertook to seek to confine disclosure of information to the tax authorities but not their oversight bodies when negotiating individual CDTAs.

6. In the negotiation process, Hong Kong would attempt to include express provisions in the CDTAs, as far as possible, to forbid automatic and/or spontaneous exchange of information. The inclusion of such provisions would depend on the stance of the particular treaty partner. The Administration would explain the legal requirements of the Rules to the treaty partners, and provide them with copies of the Rules during the course of negotiation.¹

Taxation arrangements for the interest income paid to the government or certain specified entities discharging government functions of the Contracting Parties

7. 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. In negotiating CDTAs, Hong Kong would seek to restrict the list of entities eligible for tax exemption to government bodies, central banks, and statutory or public entities discharging government functions.

Taxation arrangements in respect of pensions paid to Hong Kong people

8. In negotiating CDTAs, the Administration would seek to secure exclusive taxing right for Hong Kong on Hong Kong people's pensions

¹ The Subcommittee on Five Orders Made under section 49 of the Inland Revenue Ordinance and Gazetted on 13 May 2011 considered that the Administration should seek to include an express provision to forbid automatic and/or spontaneous exchange of information in all CDTAs, so as to avoid possible misunderstanding between the contracting parties on the issue. Where such express provision was not included in a CDTA because of the stance of the treaty partner, the Administration should seek to put on record in official negotiation documents, such as the minutes of meetings, the mutual understanding that there should be no automatic and/or spontaneous exchange of information under the CDTA. The Administration accepted this suggestion.

but might not be successful in securing such right in each and every CDTA. Some negotiating partners might hold a strong view that as substantive public resources were spent on services for resident retirees, say those from Hong Kong, the resident jurisdiction should have taxing right on their income.

Profits from operation of international transport

9. According to the OECD model text for CDTAs, the main consideration for allocation of taxing right for profits of enterprises from the operation of ships or aircraft in international traffic is the place of effective management. Hong Kong would seek to secure exclusive taxing right in respect of profits of Hong Kong enterprises from operation of shipping and air transport services, as this arrangement in general is more beneficial to the relevant Hong Kong enterprises.

Withholding tax

10. A tax treaty between two jurisdictions normally results in reduced tax rates on passive incomes such as dividends, interest and royalties. In the relevant Articles on dividends, interest and royalties, the respective maximum tax rates which a source jurisdiction could apply to the dividends, interest or royalties earned by a resident of other jurisdiction were specified. The provisions of these Articles do not lay down the mode of taxation on passive incomes in the source jurisdiction but only provided for the agreed applicable rates. The source jurisdiction is therefore free to apply its own laws and in particular, to levy the tax either by deduction at source by way of withholding tax or require individual assessment. In many jurisdictions, non-resident withholding tax on dividends, interest and royalties is a final tax, i.e. treated as discharging the recipient's tax liability, and no tax return or additional tax is required if the only income derived by the non-residents from that jurisdiction is from dividends, interest and royalties. Where a treaty partner has charged withholding tax on the passive income of a Hong Kong resident at the rate provided in the CDTA, the Hong Kong resident should be regarded as having fulfilled his tax payment obligation in that jurisdiction with respect to that passive income.

Mutual agreement procedure

11. The provisions for arbitration were added to the OECD Model Tax Convention in 2008, and the HKSARG would be prepared to include provisions for arbitration in negotiating for a CDTA. Without the

arbitration provisions, it is theoretically possible that a case remains unresolved for an indefinite period if it cannot be settled by mutual agreement between the contracting parties.

Definition of "resident"

12. In all the CDTAs Hong Kong has entered into, paragraph 1 of the Article on "Resident" provides the definition of the term "resident of a Contracting Party" for the purposes of the respective Agreements. Where by reason of the provisions of paragraph 1 of the Article an individual was a resident of both contracting parties, the status of the resident would be determined according to the criteria set out in paragraph 2 of the Article. If based on those criteria the status of the individual remains unresolved, the matter would have to be settled through mutual agreement of the Contracting Parties.²

² The Chairman of the Subcommittee on Five Orders Made under section 49 of the Inland Revenue Ordinance and Gazetted on 13 May 2011 suggested that the Administration should get prepared and draw up relevant policy guidelines for the determination of the resident status of a taxpayer in case the issue might have to be settled in future through mutual agreement of the Contracting Parties.