立法會
Legislative Council

LC Paper No. CB(1)2552/10-11

Ref: CB1/SS/12/10

Paper for House Committee meeting on 24 June 2011

Report of the Subcommittee on Five Orders Made under Section 49 of the Inland Revenue Ordinance and Gazetted on 13 May 2011

Purpose

This paper reports on the deliberations of the Subcommittee on Five Orders Made under Section 49 of the Inland Revenue Ordinance and Gazetted on 13 May 2011. The five Orders are –

(a) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Japan) Order (L.N. 64);

(b) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income and Capital) (French Republic) Order (L.N. 65);

(c) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income and Capital) (Principality of Liechtenstein) Order (L.N. 66);

(d) Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (New Zealand) Order (L.N. 67); and

(e) Specification of Arrangements (Government of the Grand Duchy of Luxembourg) (Avoidance of Double Taxation on Income and Capital and Prevention of Fiscal Evasion) (Amendment) Order 2011 (L.N. 68).

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 five Orders

L.N. 64 to L.N. 67

4. L.N. 64 to L.N. 67 are made by the Chief Executive in Council under section 49(1A) of the Inland Revenue Ordinance (Cap. 112) (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 (HKSARG) and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income together with a protocol to the Agreement signed on 9 November 2010;

(b) the Agreement between HKSARG and the Government of the French Republic (France) for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion together with a protocol to the Agreement signed on 21 October 2010;

(c) the Agreement between HKSARG and the Government of the Principality of Liechtenstein (Liechtenstein) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital together with a protocol to the Agreement signed on 12 August 2010; and

(d) the Agreement between HKSARG and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income together with a protocol to the Agreement signed on 1 December 2010.

L.N. 68

5. Under the Specification of Arrangements (Government of the Grand Duchy of Luxembourg) (Avoidance of Double Taxation on Income and Capital and Prevention of Fiscal Evasion) Order (Cap. 112 sub. leg. BA) (the principal order), the arrangements in Articles 1 to 29 of the Agreement between HKSARG 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 (the Luxembourg Agreement) dated 2 November 2007 are declared to be double taxation relief arrangements under section 49 of the Ordinance.

6. The Government of Hong Kong and the Government of the Grand Duchy of Luxembourg entered into a protocol (the Luxembourg Protocol) to amend the Luxembourg Agreement on 11 November 2010. To give effect to the amendments effected by the Luxembourg Protocol, L.N. 68 amends the principal order by adding new provisions that declare the arrangements in Articles 1 to 5 of the Luxembourg Protocol to be additional double taxation relief arrangements. Article 2 of the Luxembourg Protocol, which adds a paragraph 5 to Article 24 of the Luxembourg Agreement, provides that unresolved issues between the competent authorities of the Contracting Parties shall be submitted to arbitration if the taxpayer who initially presented the case for mutual agreement procedure so requests. Article 25 of the Luxembourg Agreement on exchange of information (EoI) is also replaced by an updated one in Article 3 of the Luxembourg Protocol.

7. All the five orders will come into operation on 7 July 2011.

The Subcommittee

8. At the House Committee meeting held on 20 May 2011, Members agreed to form a subcommittee to study the five 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 8 June 2011 to meet with the Administration and scrutinize the five Orders.

Deliberations of the Subcommittee

9. In examining the five Orders, the Subcommittee has focused on whether and how Hong Kong residents and enterprises will benefit from the relevant CDTAs and the Luxembourg Protocol, and whether there are sufficient safeguards in these agreements to protect the privacy and confidentiality of local taxpayers' information.

Non-discrimination provisions

10. Paragraph 1 of Article 23 on "Non-discrimination" in the CDTA signed with Japan provides that –

> *"Persons who have the right of abode or are incorporated or constituted in the Hong Kong Special Administrative Region, or who are nationals of Japan, shall not be subjected in the other Contracting Party to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which persons who are in the same circumstances, in particular with respect to residence, and, where that other Contracting Party is the Hong Kong Special Administrative Region, have the right of abode or are incorporated or constituted therein or, where that other Contracting Party is Japan, are nationals of Japan, are or may be subjected. The provisions of this paragraph shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting Parties."*

11. The Subcommittee notes that a similarly worded provision carrying the same effect is also available in the CDTAs signed with Liechtenstein and New Zealand. However, for the CDTA signed with France, the last sentence of *"The provisions of this paragraph shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting Parties."* is not included. The Subcommittee has asked about the reasons for this difference and the effect of the difference.

12. The Administration has advised that the aforesaid sentence specifying the application of the non-discrimination provision for persons who are not residents of one or both of the contracting parties is included in the Organization for Economic Cooperation and Development Model Tax Convention on Income

and on Capital (OECD Model Tax Convention). That sentence, however, may or may not be included in a CDTA at the discretion of the contracting parties. At the request of the French government, that sentence is not included in the CDTA signed with France. The CDTA signed between Hong Kong and Luxembourg in November 2007 also does not include that sentence. The effect of the absence of that sentence is that a person who is not a resident of Hong Kong or the other contracting party will not enjoy the non-discrimination entitlement.

13. The Administration has also advised that as Hong Kong adopts the territorial basis of taxation whereby only income sourced from Hong Kong is subject to tax, Hong Kong applies the same taxation and connected requirements on a person irrespective of whether the person is or is not a resident of a contracting party of a CDTA which Hong Kong has entered into. Hence, the presence or otherwise of the aforesaid sentence will not have implication on Hong Kong's taxation policies and practices.

Mutual agreement procedure

14. An Article on "Mutual agreement procedure" is included in the four CDTAs signed with Japan, France, Liechtenstein and New Zealand. The Article provides, among other things, the procedure for handling a case presented by a taxpayer to the competent authority of either contracting party on account that the actions of one or both of the contracting parties result or will result for him in taxation not in accordance with the provisions of the CDTA concerned. Under paragraph 1 of the Article, it is specified that *"The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Agreement."*

15. The Subcommittee has enquired about the relevant date of the "first notification". The Administration has advised that in most cases, the date of the "first notification" would be the date of a notice of assessment, official demand or other instrument for the collection of levy or tax. For Hong Kong, under section 58(3) of IRO, any notice sent by post shall be deemed, unless the contrary is shown, to have been served on the day succeeding the day on which it would have been received in the ordinary course by post.

16. The Administration has also advised that according to the Commentaries on the Articles of the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital (OECD Commentaries), the provision fixing the starting point of the three-year time limit as the date of the “first notification” as specified in the Article on "Mutual agreement procedure" should be interpreted in a way most favourable to the taxpayer concerned.

17. Under paragraph 5 of the Article on "Mutual agreement procedure" in the CDTAs signed with Japan and Liechtenstein and in the Luxembourg Protocol, if the competent authorities of the contracting parties are unable to reach an agreement to resolve a case presented under paragraph 1 of the Article within two years from the presentation of the case by a competent authority to the other contracting party, any unresolved issues arising from the case shall be submitted to arbitration if the taxpayer who initially presented the case so requests.

18. The Subcommittee has enquired about the relevant date of the "presentation of the case to the competent authority of the other contracting party". The Administration has advised that according to the OECD Commentaries, a case would only be considered to have been presented to the competent authority of the other contracting party if sufficient information has been presented to that competent authority to allow it to decide whether the objection underlying the case appears to be justified.

19. The Subcommittee notes that unlike the CDTAs signed with Japan and Liechtenstein and the Luxembourg Protocol, the Article on "Mutual agreement procedure" of the CDTAs signed with France and New Zealand do not provide for arbitration or any other method of dispute resolution in the event that the competent authorities of the contracting parties are unable to resolve a case by mutual agreement.

20. The Administration has advised that the provisions for arbitration were added to the OECD Model Tax Convention in 2008, and the HKSARG will be prepared to include provisions for arbitration in negotiating for a CDTA. In the case of the CDTAs signed with France and New Zealand, such provisions were eventually not included in the Agreements reflecting the result of the negotiations. 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. To date, the Inland Revenue Department (IRD) has not received any request from Hong Kong taxpayers for mutual agreement.

Exchange of information

21. The Subcommittee notes that 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 tax information exchanged under CDTAs. To address the Bills Committee's concerns, the Administration presented a sample EoI Article to the Bills Committee 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. Besides, the Administration undertook to put in place domestic safeguards through a set of rules to be made under section 49(6) of the IRO[1], and through procedural guidelines for the Inland Revenue Department for its processing of EoI requests.

22. According to the Administration, the CDTAs signed with Japan, France, Liechtenstein and New Zealand and the Luxembourg Protocol have adopted all the safeguards in the sample EoI Article.

Disclosure of information to Office of the Ombudsmen under the CDTA signed with New Zealand

23. The Subcommittee notes that in Paragraph 4(b) of the Protocol to the CDTA signed with New Zealand, it is provided that the New Zealand competent authority may disclose information to the Office of the Ombudsman in the investigation of complaints against the administrative actions of the New Zealand Inland Revenue Department. The Administration has advised that as undertaken by the Administration during the scrutiny of the Inland Revenue (Amendment) Ordinance 2010, as a safeguard to taxpayers, the Administration sought the agreement of the New Zealand side during the negotiations that the information exchanged would only be disclosed to the tax authorities and would not be released to their oversight body. In accepting the proposal, the New Zealand delegates explained that the Office of the Ombudsmen would need to examine the tax information relating to the relevant taxpayer in the course of their investigation on any complaint against the New Zealand Inland Revenue Department. The Administration considered this a justifiable request and therefore accepted the New Zealand side's proposal to include in Paragraph 4(b) of the Protocol to the CDTA signed with New Zealand that the New Zealand competent authority may disclose the information exchanged to the Office of the Ombudsmen in the investigation of complaints against the administrative actions of the New Zealand Inland Revenue Department. In fact, similar arrangement has been made in the CDTA signed with the United Kingdom.[2]

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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(6) of IRO.

2 The CDTA signed with the United Kingdom was given effect by the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains) (United Kingdom of Great Britain and Northern Ireland) Order (L.N. 126 of 2010), which was gazetted on 15 October 2010 and came into operation on 9 December 2010.

Automatic or spontaneous exchanges of information

24. The Subcommittee notes that in the CDTAs signed with Japan and Liechtenstein, neither the EoI Article nor the Protocol to the Agreement expressly provides that there shall be no automatic or spontaneous exchanges of information between the contracting parties. The upgraded EoI Article under the Luxembourg Protocol also does not contain such express provision. On the other hand, paragraph 10 of the Protocol to the CDTA signed with France and paragraph 4 of the CDTA signed with New Zealand expressly provide that the EoI Article in the respective Agreements does not create obligations on the contracting parties to exchange information on an automatic or a spontaneous basis.

25. The Administration has advised that the respective EoI Article, as presently drafted in the CDTAs under scrutiny and in the Luxembourg Protocol, does not impose any obligation for "spontaneous or automatic exchange". The Administration is obliged to comply with the Inland Revenue (Disclosure of Information) Rules (Cap. 112 BI) (the Rules) which prevent spontaneous or automatic exchange by requiring case-specific information to be provided by Hong Kong's treaty partners before IRD can accede to their EoI requests. In each of the EoI Article, there is a paragraph specifying that the provisions in the Article shall not be construed as to impose on a contracting party the obligation to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other contracting party. Accordingly, any EoI obligation on Hong Kong arising from the EoI Article shall not be at variance with the Rules, which are subsidiary legislation.

26. The Administration has further advised that in the negotiation process, Hong Kong will attempt to include express provisions in the CDTAs, as far as possible, to forbid automatic and/or spontaneous exchange of information. Depending on the stance of the particular treaty partner, the issue may or may not be dealt with in the Protocol. In respect of the CDTAs under scrutiny, the Administration has explained the legal requirements of the Rules to all the treaty partners, and as a matter of practice has provided them with copies of the Rules during the course of negotiation. The Administration is confident that there is no misunderstanding between Hong Kong and the treaty partners on this issue.

27. The Chairman considers 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 is 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 agreed

minutes of meetings, the mutual understanding that there shall be no automatic and/or spontaneous exchange of information under the CDTA. The Administration has accepted the Chairman's suggestion.

Scope of information subject to exchange

28. Paragraph 7 of the Protocol to the Japanese Agreement provides that *"With reference to paragraph 1 of Article 25 of the Agreement, a Contracting Party is not obliged to exchange information concerning taxes other than those covered by Article 2 of the Agreement for the purposes of carrying out the provisions of the Agreement or of the administration or enforcement of the domestic laws of the other Contracting Party until the Governments of the Contracting Parties agree, through an exchange of notes, to exchange information concerning those taxes. Such agreement shall enter into force after the completion of procedures required by the respective laws of the Contracting Parties for entry into force of the agreement."*. The Subcommittee has asked about the reason for not including a similar provision in the other CDTAs under scrutiny and in the Luxembourg Protocol, and what safeguard is available to ensure that the scope of information subject to exchange will be confined to taxes covered by the CDTAs.

29. The Administration has explained that in the OECD Model Tax Convention, the last sentence of paragraph 1 of the sample EoI Article reads "The exchange of information is not restricted by Articles 1 and 2". To achieve the effect of confining the scope of information subject to exchange under a CDTA to taxes covered by the Agreement, the contracting parties may simply agree to remove "Article 2" from the last sentence of paragraph 1 of the EoI Article. In fact, paragraph 1 of the EoI Article of all the CDTAs under scrutiny and in the Luxembourg Protocol is drafted in this same manner as the sample EoI Article submitted to the Bills Committee during the scrutiny of the Inland Revenue (Amendment) (No. 3) Bill 2009.

30. The Administration has further explained that the provision in paragraph 7 of the Protocol to the CDTA signed with Japan is included at the request of the Japanese side, and is intended to cater for possible future expansion of the scope of information subject to exchange under the Agreement. Such intention is revealed in the later part of the paragraph beginning with *"until the Governments of the Contracting Parties agree …."*. In any event, any future expansion of the scope of the information subject to exchange under the Agreement will in the case of Hong Kong, have to be implemented by way of subsidiary legislation, which is subject to negative vetting procedure.

Withholding tax

31. The Subcommittee notes from the relevant Legislative Council Briefs that under the CDTAs signed with Japan, France and New Zealand, a Hong Kong resident will enjoy reduced withholding tax rates for dividends, interest and royalties received from these countries where such incomes are not attributable to any permanent establishment the Hong Kong resident may have in such countries. The Subcommittee has sought clarification as to whether Hong Kong residents having been charged withholding tax by the treaty partners will be regarded as having completely fulfilled their tax payment obligation with respect to the relevant income. The Chairman and Ms Audrey EU have expressed concern that Hong Kong residents may also be obliged to undertake other procedures such as submitting tax returns, and that the amount of withholding tax charged may not be the amount of tax that a Hong Kong resident is obliged to pay.

32. The Administration has advised that 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 can apply to the dividends, interest or royalties earned by a resident of other jurisdiction are specified. The provisions of these Articles do not lay down the mode of taxation on passive incomes in the source jurisdiction but only provide 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.

Definition of "resident"

33. The Subcommittee has enquired about the tax obligations of a Hong Kong resident who also possesses the right of abode or national status of the jurisdiction with which Hong Kong has signed a CDTA.

34. The Administration has advised that 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 is a resident of both contracting parties, the status of the resident will 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 will have to be settled through mutual agreement of the Contracting Parties.

35. While noting that the Administration has not yet encountered any case of unresolved status of a taxpayer under the CDTAs that have been in force, the Chairman considers that the Administration should get prepared and draw up relevant policy guidelines for the determination of the resident status of a taxpayer who may satisfy the definitions of resident of both contracting parties.

Recommendation

36. The Subcommittee supports the five Orders. The Subcommittee and the Administration have not proposed any amendment to any of the Orders.

Advice sought

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

Council Business Division 1
Legislative Council Secretariat
23 June 2011

Appendix

Subcommittee on Five Orders Made under Section 49 of the Inland Revenue Ordinance and Gazetted on 13 May 2011

Membership list

Chairman	Hon James TO Kun-sun
Members	Hon Audrey EU Yuet-mee, SC, JP Hon Paul CHAN Mo-po, MH, JP
	(Total: 3 Members)
Clerk	Ms Anita SIT
Legal Adviser	Mr Timothy TSO