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Paper for the House Committee

**Report of the Subcommittee on the Three Orders Made under Section
49(1A) of the Inland Revenue Ordinance and Gazetted on 4 October 2013**

Purpose

This paper reports on the deliberations of the Subcommittee on the Three Orders Made under Section 49(1A) of the Inland Revenue Ordinance and Gazetted on 4 October 2013 ("the Subcommittee").

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. The Three Orders 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:

- (a) L.N. 148 - Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Guernsey Order) – the Guernsey Agreement, which is made between the Government of the Hong Kong Special Administrative Region of the People's Republic of China ("HKSAR") and the Government of Guernsey and signed on 22 April 2013, and its relevant protocol;
- (b) L.N. 149 - Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Italian Republic) Order – the Italian Agreement, which is made by the Government of the HKSAR and the Government of the Italian Republic and signed on 14 January 2013, and its relevant protocol; and
- (c) L.N. 150 - Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (State of Qatar) Order – the Qatar Agreement, which is made by the Government of the HKSAR and the Government of the State of Qatar and signed on 13 May 2013, and its relevant protocol.

The three Orders will come into operation on 29 November 2013.

The Subcommittee

5. At the House Committee meeting held on 11 October 2013, members agreed to form a subcommittee to study the three Orders. The membership list of the Subcommittee is in **Appendix I**. Under the chairmanship of Hon James TO Kun-sun, the Subcommittee has held three meetings with the Administration to scrutinize the three Orders.

Deliberations of the Subcommittee

6. The Subcommittee supports the three Orders in principle. In examining the three agreements under the three Orders, the Subcommittee has focused on the benefits to be brought to Hong Kong residents and enterprises, and whether sufficient safeguards are provided in the three agreements to protect the privacy and confidentiality of local taxpayers' information. The major deliberations of the Subcommittee are set out in the ensuing paragraphs.

Benefits of the three agreements on Hong Kong residents and Hong Kong enterprises

7. The Subcommittee notes that the three agreements have set out clearly the allocation of taxing rights between Hong Kong and the relevant jurisdictions and the relief on tax rates on different types of income. Where the right to tax income is allocated exclusively to one contracting party under an agreement (the resident jurisdiction or the source jurisdiction), there is no double taxation. Where both tax jurisdictions are given the right to tax the same item of income, the resident jurisdiction is required 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). Hence, the general benefits of the three agreements are to help investors of the two economies to better assess their potential tax liabilities from cross-border economic activities, foster closer economic and trade links between the two places, and provide added incentives for enterprises of the other contracting party to do business with or invest in Hong Kong, and vice versa. On the method for providing the double taxation relief, the Subcommittee notes that the three agreements have adopted the credit method for providing the required relief, i.e. where income taxable in the source jurisdiction is subject to tax in the resident jurisdiction the tax levied in the source jurisdiction is credited against the tax levied in the resident jurisdiction on such income.

Benefits of the Italian Agreement

8. In respect of the benefits of the Italian Agreement, the Administration has explained that the benefits include double taxation relief on income tax for Hong Kong residents and on profits of Hong Kong companies doing business through a permanent establishment in Italy, exemption for Hong Kong residents from Italian income tax if the income derived from their employment exercised in Italy is not paid by (or on behalf of) and borne by an Italian entity provided that their aggregate stay in Italy in any relevant 12-month period do not exceed 183 days. In particular, there will be benefits for Hong Kong residents and companies receiving passive income of interest, royalties and dividends from Italy. The Administration has advised that in the absence of the Italian Agreement, Hong Kong residents receiving interest from Italy are subject to Italian withholding tax, which is currently at 20 per cent. Under the Italian Agreement, such withholding tax rate will be capped at 12.5 per cent. The Italian withholding tax on royalties, currently at 22.5 per cent, will be capped at 15 per cent. The Italian withholding tax on dividends, currently at 20 per cent, will be capped at 10 per cent. Members of the Subcommittee welcome such benefits. They note that with development in economic and trade ties between Hong Kong and Italy, some Italian companies have been listed in Hong Kong. With the Italian Agreement, Hong Kong residents and companies investing in these Italian companies will benefit from a lower withholding tax on dividends generated from the companies. The Administration has taken note of

members' view to enhance publicity on the Italian Agreement so as to apprise Hong Kong residents and companies of such benefits and the relevant claiming procedures. Furthermore, the Administration has advised that Hong Kong residents and companies have to apply to the Italian tax authority for a tax rebate on the dividend income and the relevant procedures are available in the website of the Inland Revenue Department ("IRD").

Benefits of the Guernsey Agreement

9. Some members of the Subcommittee are of the view that there are limited benefits for Hong Kong in signing the Guernsey Agreement, as in view of the relative small economy of Guernsey few Hong Kong people will live in Guernsey and the number of Hong Kong companies doing business in Guernsey will also be small.

10. The Administration has advised that Guernsey is one of the four overseas jurisdictions which were newly approved by the Stock Exchange of Hong Kong Limited ("SEHK") in 2011 to become acceptable overseas jurisdictions for the listing of overseas companies on the SEHK. Members of the Joint Liaison Committee on Taxation have expressed support for the conclusion of the Guernsey Agreement given the reasonably well-developed financial sector in Guernsey. Given that a considerable number of mutual funds are domiciled in Guernsey, the tax certainty provided by the Guernsey Agreement may attract more Guernsey resident companies and mutual funds to extend their businesses to Hong Kong, thus facilitating the flow of financial capital and services between the two places. In response to the Subcommittee, the Administration has provided information on the benefits that would accrue to Hong Kong residents under the Guernsey Agreement which is set out in **Appendix II**. The Subcommittee notes that such double taxation relief covers income received through a permanent establishment in Guernsey, income from employment exercised in Guernsey and income from operation of aircrafts and ships in international traffic.

Treatment for payments received by students under the three agreements

11. The Subcommittee notes that each of the three agreements have included taxing arrangement for payments received by students who are residents of a contracting party and studying in the other contracting party¹. The essence of these articles are that payments provided solely for the purpose of education or maintenance for a Hong Kong student studying in Guernsey, Italy, or State of Qatar will be exempted from taxes in the three jurisdictions provided that such payments arise from sources outside the three jurisdictions. On whether the method for making the payments would cover arrangements

¹ Article 19 of the Guernsey Agreement, Article 20 of the Italian Agreement, and Article 20 of the Qatar Agreement.

other than remittance from sources outside the jurisdictions, for example a pre-arranged agreement to offset the education or maintenance payments by payments of other purposes, the Administration has advised that while such situation should be exempted from tax in the jurisdictions as "payments arise from outside" would have a wide scope, the merit of each case must be determined based on the relevant facts and circumstances pertaining to the case. The Subcommittee has suggested that the Administration should consider setting out the arrangements eligible for double taxation relief in respect of payments for students in a clearer manner in CDTAs to be signed with other jurisdictions in future. The Administration has pointed out that in general a CDTA will include an article on mutual agreement procedure² which provides for procedures for resolving dispute cases by mutual agreement, and handling unresolved cases through arbitration. Disputes in relation to treatment of various taxes covered under the CDTAs would be resolved through such procedures.

Exchange of information provisions in CDTAs

Exchange of information mechanism

12. A CDTA normally includes an article that provides for the exchange of information ("EoI") necessary for the carrying out of the agreement between the two contracting parties. Hong Kong adopts for its CDTAs the 2004 version of the EoI Article in the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital ("OECD Model Tax Convention") except for certain modifications to address local needs. The Administration has confirmed that the three agreements have included the following prudent safeguard measures in order to protect taxpayers' privacy and confidentiality of the information exchanged:

- (a) information will only be exchanged with the contracting party upon receipt of requests and no information will be exchanged on an automatic or spontaneous basis;
- (b) the information sought should be foreseeably relevant, i.e. there will be no fishing expedition;
- (c) information received by the CDTA partners should be treated as confidential;
- (d) information will only be disclosed to the tax authorities and not for release to their oversight body unless there are legitimate reasons given by the CDTA partners;

² Article 23 of the Guernsey Agreement, Article 24 of the Italian Agreement, and Article 24 of the Qatar Agreement.

- (e) information requested shall not be disclosed to a third jurisdiction;
- (f) there is no obligation to supply information under certain circumstances, for example, where the information would disclose any trade, business, industrial, commercial or professional secret or trade process, or which would be covered by legal professional privilege, etc.; and
- (g) the scope of EoI is confined to taxes covered by the respective CDTAs.

13. As regards the impact of the Inland Revenue (Amendment) Ordinance 2013 ("2013 Ordinance") enacted by the Legislative Council ("LegCo") in July 2013 which will enable Hong Kong to enter into standalone Tax Information Exchange Agreements with other jurisdictions and enhance EoI arrangements in respect of tax types and limitation on disclosure under CDTAs, the Administration has advised that the changes brought by the 2013 Ordinance are not reflected in the three agreements as they were signed prior to the enactment of the 2013 Ordinance.

Handling of EoI requests

14. The Subcommittee notes that to respond to EoI requests from a CDTA partner (i.e. the requesting jurisdiction), it may be necessary for IRD (i.e. the requested jurisdiction) to gather information from the subject person or a relevant third party (i.e. the information holder) who holds the relevant information or documents. For this purpose and in conformity with the law, IRD will issue a notice asking the information holder to produce such information or documents. The formal notice that IRD issues to the third party generally includes the following information :

- (a) a reference to IRD's access powers provided under IRO;
- (b) a general description of the information requested;
- (c) a detailed list of the information requested;
- (d) the time limit to produce the information;
- (e) a reference to the sanctions provided under IRO for failure to comply with the formal notice; and
- (f) the name of the subject person for identification purposes when the information holder is not the subject person.

15. Some members of the Subcommittee are concerned that the third party concerned will not be provided with information on the identity of the requesting jurisdiction when IRD handles an EoI request. They consider that such information may be necessary for the said third party to identify the required information relating to the subject person of the EoI request and to protect its interests. For instance, without knowledge of which jurisdiction has made the EoI request, the third party concerned would not be able to take appropriate actions with the relevant jurisdiction, such as taking legal action (e.g. against self-incrimination) to defend its rights by refusing to produce the information or documents that were sought by the requesting jurisdiction concerned. Therefore, the Subcommittee has requested the Administration to consider disclosing to the relevant third party information of the requesting jurisdiction or the name of the relevant CDTA pertaining to an EoI request in the formal notice issued by IRD. It is also necessary for the Administration to examine the international standards/practices regarding the disclosure of information on the requesting jurisdiction to the third parties.

16. The Administration has responded that when seeking information from the information holders, IRD will disclose certain information contained in the EoI request to the extent necessary to enable the information holders to identify and produce the requested information for the purpose of complying with the notice. The extent of information that IRD will disclose to the information holders depends on the circumstances of each case, including, for example, the type or form of information requested, and the person from whom the information is sought. The requesting jurisdiction may have concern about its investigation on the tax matter related to the EoI request being undermined if the third party concerned knows the identity of the requesting jurisdiction.

17. As far as international standards/practices of EoI for tax purposes are concerned, the Administration has advised that they are primarily reflected in the EoI Article of the OECD Model Tax Convention and its Commentary upon which the EoI Article of Hong Kong's CDTAs is also based. The EoI Article states as a basic proposition that any information received by a jurisdiction in the context of EoI must be treated as confidential or secret, and shall be disclosed only to persons or authorities (including courts and administrative bodies) in the jurisdiction of the Contracting Party concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Agreement. Such persons or authorities shall use such information only for such purposes. They may disclose the information in public court proceedings or judicial decisions. The Commentary of the OECD Model Tax Convention provides that the confidentiality rules contained in the EoI Article apply to all types of information received through such exchange, including both information provided in an EoI request and information transmitted in response to an EoI request. Hence, the confidentiality rules cover, for instance, competent authority letters, including the letter requesting information. At the same time,

it is understood that the requested jurisdiction can disclose the minimum information contained in a competent authority letter (but not the letter itself) necessary for the requested jurisdiction to be able to obtain or provide the requested information to the requesting jurisdiction, without frustrating the efforts of the requesting jurisdiction.

18. The Administration has advised that taking into account the Government's policy to strike a balance between CDTA partners' expectation in line with the international standards/practices and information holders' interest, and without unduly delaying effective EoI and compromising the practical operation of the EoI regime in Hong Kong; IRD is prepared to disclose the information of the requesting jurisdiction to the information holder concerned upon the holder's request provided that such is agreeable to all interested parties. Should the competent authority of the requesting jurisdiction have no objection, IRD will then disclose the information of the requesting jurisdiction to the information holder concerned.

19. While members of the Subcommittee recognize the need for the Administration to observe the confidentiality rules in handling EoI requests, they have re-iterated the importance of protecting the interest of the third party information holders, in particular, such parties are legally required to furnish IRD with the information under the EoI request. The Administration's proposal of seeking the consent of all interested parties for disclosure of the information on the requesting jurisdiction would cause difficulty to the third parties in obtaining the information.

20. In view of the Subcommittee's concern, after striking a balance between the international standards/practices and information holders' interest, the Administration has undertaken to adopt a pragmatic approach to deal with the situation. Specifically, where the information holder requests to know the name of the requesting jurisdiction upon receipt of IRD's formal notice for information, IRD would approach the competent authority of the requesting jurisdiction and put forward the information holder's request. Should the competent authority of the requesting jurisdiction raise any objection, IRD will then let the information holder know accordingly. If the information holder refuses to provide the information requested as he/she does not know the name of the requesting jurisdiction, IRD will, having considered the circumstances of the case, decline the EoI request for reason that it could not disclose to the information holder the name of the requesting jurisdiction, which is considered necessary to facilitate the gathering of the requested information.

21. The Subcommittee welcomes the Administration's new approach and has requested the Administration to give an undertaking on this during the relevant debate on the three Orders at the LegCo meeting of 27 November 2013. Noting that IRD has issued a Departmental Interpretation and Practice Notes ("DIPN") on the subject of exchange of information under CDTAs, the

Subcommittee has suggested IRD to include this matter in the DIPN so that any relevant third party would be aware of their right to request for information on the requesting jurisdiction, and to set out in the DIPN the relevant procedures to be followed by IRD officers in processing the request. The Administration has advised that IRD will update the DIPN accordingly.

Advice sought

22. The Subcommittee and the Administration will not move amendments to the three Orders.

23. The Chairman of the Subcommittee gave a verbal report on the Subcommittee's deliberations at the House Committee meeting on 15 November 2013. Members are invited to note the contents of this report.

Council Business Division 1
Legislative Council Secretariat
20 November 2013

**Subcommittee on the Three Orders Made under Section 49(1A) of the
Inland Revenue Ordinance and Gazetted on 4 October 2013**

Membership list

Chairman	Hon James TO Kun-sun
Members	Hon Dennis KWOK Hon SIN Chung-kai, SBS, JP (Total : 3 members)
Clerk	Ms Connie SZETO
Legal Adviser	Miss Evelyn LEE

**Benefits that would accrue to Hong Kong residents
under the Hong Kong/Guernsey CDTA**

	Types of income	Existing tax liability	Tax liability under the CDTA
1.	Income received through a permanent establishment in Guernsey	Income is taxed in Guernsey and may also be taxed in Hong Kong if the income is sourced from Hong Kong	Income will be taxed in Guernsey, but the tax so paid shall be allowed as a credit against Hong Kong tax payable (if any) in respect of the income
2.	Income received from operation of aircraft in international traffic	Income from Guernsey is taxed in Guernsey and not taxable in Hong Kong	Income from Guernsey will be exempted in Guernsey and be taxed in Hong Kong instead
3.	Income received from operation of ships in international traffic	Income from Guernsey is taxed in Guernsey and exempted from tax in Hong Kong	Income from Guernsey will be exempted in Guernsey whilst exemption in Hong Kong remains unchanged
4.	Income received from employment exercised in Guernsey -		
	(a) if the exemption conditions as provided in Article 14(2) of the CDTA are satisfied (i.e. stays in Guernsey for an aggregate period of not exceeding 183 days in any relevant 12-month period, etc. and the remuneration is taxable in Hong Kong)	Income is taxed in Guernsey and such income may also be taxed in Hong Kong if the employment is a Hong Kong employment and some services are rendered in Hong Kong as well	Income will be exempted in Guernsey whilst the tax position in Hong Kong remains unchanged

	Types of income	Existing tax liability	Tax liability under the CDTA
	(b) if the exemption conditions as provided in the CDTA are not satisfied	Income is taxed in Guernsey and such income may also be taxed in Hong Kong if the employment is a Hong Kong employment and some services are rendered in Hong Kong as well	Income will be taxed in Guernsey, but the tax so paid shall be allowed as a credit against Hong Kong tax payable (if any) in respect of the same income

(Source : Annex to LC Paper No. CB(1)215/13-14(02))