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Paper for the House Committee meeting on 28 November 2014

**Report of the Subcommittee on the Two Orders Made under
Sections 49 and 49(1A) of the Inland Revenue Ordinance
and Gazetted on 17 October 2014**

Purpose

This paper reports on the deliberations of the Subcommittee on the Two Orders Made under Sections 49 and 49(1A) of the Inland Revenue Ordinance and Gazetted on 17 October 2014 ("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 Avoidance of Double Taxation Agreements ("CDTAs") with Hong Kong's trading and investment partners.

3. Hong Kong adopts a territorial source principle of taxation whereby only income sourced from Hong Kong is subject to tax. A local resident's income derived from sources outside Hong Kong will not be taxed in Hong Kong and hence will not be subject to double taxation. Double taxation, however, may occur where a foreign jurisdiction taxes its own residents' income derived from Hong Kong.

4. 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 has incorporated in all its CDTAs signed an EoI article that is on par with the prevailing international standard as far as practicable.

The Two Orders

5. The Two Orders are made by the Chief Executive in Council under sections 49 and 49(1A) of the Inland Revenue Ordinance (Cap. 112) to give effect to the following CDTAs:

- (a) L.N. 119 - Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Republic of Korea) Order – to implement the CDTA which was made between the Government of the Hong Kong Special Administrative Region of the People's Republic of China ("HKSAR Government") and the Government of the Republic of Korea and signed on 8 July 2014 ("the Korean Agreement"); and
- (b) L.N. 120 - Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Socialist Republic of Vietnam) (Amendment) Order 2014 – to implement the Second Protocol to the CDTA which was made between the HKSAR Government and the Government of the Socialist Republic of Vietnam ("Vietnamese Government") on the subject and signed on 13 January 2014 ("the Vietnamese Second Protocol").

The Two Orders will come into operation on 12 December 2014.

The Subcommittee

6. At the House Committee meeting held on 24 October 2014, members agreed to form a subcommittee to study the Two Orders. The membership list of the Subcommittee is in the **Appendix**. Under the chairmanship of Hon James TO Kun-sun, the Subcommittee has held two meetings, including one with the Administration, to scrutinize the Two Orders.

7. To allow more time for the Subcommittee to study the Two Orders, the Subcommittee agreed that the Chairman shall move a motion before the expiry of the 28 days' scrutiny period (i.e. the Council meeting of 19 November 2014) to extend the scrutiny period of the Two Orders to 10 December 2014.

However, the date of the Council meeting of 19 November 2014 has been changed to 20 November 2014. In accordance with section 34(2) of the Interpretation and General Clauses Ordinance (Cap. 1), the period for amending the Two Orders expired on 19 November 2014, and hence the Subcommittee Chairman cannot move the proposed motion to extend the scrutiny period of the Two Orders.

Deliberations of the Subcommittee

8. The Subcommittee supports the Two Orders. The major deliberations of the Subcommittee are set out in the ensuing paragraphs.

Benefits of the Korean Agreement

9. The Subcommittee has examined the benefits of the Korean Agreement to Hong Kong residents. The Administration has explained that the Korean Agreement has set out clearly the allocation of taxing rights between the HKSAR and the Republic of Korea and the relief on tax rates on different types of income. The benefits of the Korean Agreement to Hong Kong residents/companies include double taxation relief on profits of Hong Kong companies doing business through a permanent establishment in Korea; exemption from Korean tax on income derived by Hong Kong residents, which is not paid by (or on behalf of) and borne by a Korean entity, from employment exercised in Korea for aggregate periods not exceeding 183 days in any relevant 12-month period; exemption from Korean tax on profits earned by Hong Kong airlines from operating flights to Korea and on profits earned by Hong Kong residents from international shipping transport that arise in Korea; as well as reduced Korean withholding tax on interest, royalties, or dividends received by Hong Kong residents that arise in Korea. In particular on Korean withholding tax, the Subcommittee notes that for interest income, the current rates are 14% for bonds and 20% for others; for royalties and dividends, the current rate is 20%. Under the Korean Agreement, the withholding tax rates on interest and royalties will be capped at 10%. As for dividends, it will be capped at 10% if the beneficial owner is a company which holds directly at least 25% of the capital of the company paying the dividends, and capped at 15% in all other cases.

10. Regarding the eligibility of interest and dividends earned by Hong Kong residents from unit trust funds operated in Hong Kong but constituted in Korea for double taxation relief under the Korean Agreement, the Administration has explained that the definitions of "person" and "resident of a Contracting Party" (paragraph 1(f) of Article 3 and paragraph 1(a) of Article 4) in the Agreement cover a trust constituted outside Hong Kong with its central management and control in Hong Kong. Hence, an investment fund set up in the form of a trust

with its central management and control in Hong Kong but constituted in Korea will still be regarded as a Hong Kong tax resident and thus be entitled to the relevant tax relief under the Korean Agreement. In respect of application for the tax relief, the Administration has pointed out that Hong Kong residents can request the Inland Revenue Department ("IRD") to issue a certificate of resident status for the purposes of claiming tax benefits under CDTAs.

Purposes of the Vietnamese Second Protocol

11. The Subcommittee has enquired about the reason for signing the Vietnamese Second Protocol. The Administration has advised that Hong Kong and Vietnam signed a CDTA ("the Vietnamese Agreement") on 16 December 2008¹. According to the prevailing international standard, EoI should be conducted regardless of a domestic tax interest². Before 2010, Hong Kong could not adopt the prevailing international standard on EoI in CDTAs. The Inland Revenue (Amendment) Ordinance 2010 which came into effect in March 2010 liberalised the EoI arrangement under CDTAs by removing the domestic tax interest requirement for the purpose of EoI. Since then, it has been the Administration's policy to adopt the 2004 version of the Organization for Economic Cooperation and Development ("OECD") EoI Article in CDTAs so as to meet the international standard. As the Vietnamese Agreement was signed in 2008, the EoI Article of the Vietnamese Agreement adopted the old version of OECD EoI Article which contains domestic tax interest requirement and is not up to the prevailing international standard. The Vietnamese Second Protocol modifies the Vietnamese Agreement by removing the domestic tax interest requirement in the EoI Article, and enables the EoI arrangement under the Vietnamese Agreement to be compliant with the OECD standard on tax transparency.

EoI provisions in the Korean Agreement and the Vietnamese Second Protocol

12. The Subcommittee has examined whether the Korean Agreement and the Vietnamese Second Protocol have incorporated sufficient safeguards to protect taxpayers' privacy and confidentiality of information exchanged under the EoI arrangement. The Administration has pointed out that the Inland Revenue (Amendment) (No. 2) Ordinance 2013 which came into effect in July 2013, amongst others, has further enhanced the EoI arrangement under CDTAs in terms of tax types and limitation on disclosure. The Administration has

¹ The agreement was titled "Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income", and was given effect in Hong Kong by the Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Socialist Republic of Vietnam) Order (Cap. 112 sub. leg. BE).

² The concept of domestic tax interest describes a situation where a contracting party can only provide information to another contracting party if it has an interest in the requested information for its own purposes.

confirmed that the Korean Agreement (Article 24) and the Vietnamese Second Protocol (Article 1) have adopted highly prudent safeguard measures to protect taxpayers' privacy and confidentiality of any information exchanged which include the followings:

- (a) information will only be exchanged upon receipt of request 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 CDTA partners should be treated as confidential;
- (d) information will only be disclosed to the tax authorities and not for release to their oversight bodies unless there are legitimate reasons given by the CDTA partners;
- (e) information requested should not be disclosed to a third jurisdiction; and
- (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.

13. On members' enquiry about the handling of EoI requests under the Korean Agreement and the Vietnamese Second Protocol, the Administration has advised that there are established procedures for handling EoI requests under CDTAs. Before acceding to an EoI request from a contracting party, IRD will examine whether the request is foreseeably relevant to the carrying out of the CDTA or to the administration and enforcement of the contracting party's local tax laws, and consider carefully the supporting evidence and facts of proof provided by the contracting party. Moreover, when gathering information from the subject persons or relevant third parties who hold the relevant information or documents under the EoI request, IRD will consider their objections, if any, to the disclosure of the information to the contracting party.

Consultation with stakeholders in developing CDTAs

14. The Subcommittee has enquired about the consultation with stakeholders in developing the Korean Agreement and the need to update the provisions in the Vietnamese Agreement. The Administration has advised that

IRD gauges the views of the public and interested parties on CTDAs through various means, including announcing plans of CDTA negotiations with jurisdictions concerned in IRD's website, and engaging professional and advisory bodies on issues relating to CTDAs through the Joint Liaison Committee on Taxation which was a discussion platform comprising representatives from chambers of commerce, Hong Kong Institute of Certified Public Accountants and Taxation Institute of Hong Kong, etc. On CTDAs signed with other jurisdictions, the Administration has pointed out that IRD conducts regular reviews on existing CTDAs. Taking into account operational experience and views of the relevant stakeholders, contracting parties will discuss necessary amendments to the CTDAs. As regards the Vietnamese Agreement, the Administration has advised that it is not aware of views from the business community or the Vietnamese Government for reviewing provisions in the Vietnamese Agreement other than those relating to the EoI Article. In view of the enhanced business exchanges between Hong Kong and its trading and investment partners in recent years, the Subcommittee suggests that the Administration should take more proactive actions in engaging views of the business community and relevant stakeholders on the development of new CTDAs and review of existing CTDAs.

Advice sought

15. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
27 November 2014

**Subcommittee on the Two Orders Made under Sections 49 and 49(1A) of
the Inland Revenue Ordinance and Gazetted on 17 October 2014**

Membership list

Chairman Hon James TO Kun-sun

Members Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon Kenneth LEUNG

(Total : 3 members)

Clerk Ms Connie SZETO

Legal Adviser Miss Carrie WONG