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Paper for the House Committee

Report of the Subcommittee on Two Orders Made under Section 49(1A) of the Inland Revenue Ordinance and Gazetted on 14 September 2018

Purpose

This paper reports on the deliberations of the Subcommittee on Two Orders Made under Section 49(1A) of the Inland Revenue Ordinance and Gazetted on 14 September 2018 ("the Subcommittee").

Background

Comprehensive Avoidance of Double Taxation Agreements

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 undermines 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 to minimize double taxation.

3. Hong Kong adopts the territorial 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 may occur where a foreign jurisdiction taxes its own residents' income derived from Hong Kong. Although many jurisdictions provide their residents with unilateral tax relief for the Hong Kong tax they paid on income derived

therefrom, CDTA will enhance the certainty in respect of the elimination of double taxation. Besides, the tax relief provided under a CDTA may exceed the level provided unilaterally by the tax jurisdiction concerned.

Article on exchange of information

4. A CDTA would normally include an article that provides for the exchange of information ("EoI") necessary for carrying out the agreement between the two Contracting Parties. To enable Hong Kong to adopt the international standard for EoI under CDTAs, i.e. the Organization for Economic Cooperation and Development ("OECD") 2004 version of EoI Article, the Administration introduced the Inland Revenue (Amendment) (No. 3) Bill 2009 into the Legislative Council ("LegCo") on 8 July 2009. The Bill was passed on 6 January 2010 and enacted as the Inland Revenue (Amendment) Ordinance 2010 (Ord. No. 1 of 2010). Under Ord. No. 1 of 2010, the Inland Revenue Department ("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.

Orders made under section 49(1A) of the Inland Revenue Ordinance (Cap. 112)

5. Under section 49(1A) of the Inland Revenue Ordinance (Cap. 112), the Chief Executive ("CE") in Council may, by order, declare that the arrangements specified in the order have been made with the government of any territory outside Hong Kong for the purposes of affording relief from double taxation and/or exchanging information in relation to any tax imposed by the laws of Hong Kong or the territory concerned.

6. According to the Administration, since the enactment of Ord. No. 1 of 2010, CE in Council has made a total of 36 orders (not including L.N. 155 of 2018 and L.N. 156 of 2018 (collectively referred to as the "two Orders")) under section 49(1A) of Cap. 112 to give effect to CDTAs signed or upgraded based on the OECD 2004 version of EoI Article.

The two Orders

7. The two Orders are made by CE in Council under section 49(1A) of Cap. 112 to give effect to the CDTAs respectively signed by the Hong Kong Special Administrative Region ("HKSAR") with the Republic of India on 19 March 2018 ("India Agreement"), and by HKSAR with the Republic of Finland on 24 May 2018 ("Finland Agreement").

8. The two Orders were gazetted on 14 September 2018 and tabled at the Council meeting of 10 October 2018 for negative vetting. The two Orders are to come into operation on 30 November 2018.

The Subcommittee

9. At the House Committee meeting on 5 October 2018, 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 Kenneth LEUNG, the Subcommittee has held three meetings with the Administration to examine the two Orders.

10. To allow sufficient time for the Subcommittee to complete the scrutiny of the two Orders and compile a report to the House Committee, the Chairman moved a motion at the Council meeting of 31 October 2018 to extend the scrutiny period of the two Orders to the Council meeting of 28 November 2018. The motion was passed at the Council meeting of 31 October 2018.

Deliberations of the Subcommittee

Exchange of information arrangements under the India Agreement and the Finland Agreement

Use of exchanged information for non-tax related purposes

11. The Subcommittee notes that the respective EoI Article under the India Agreement (Article 26(2)) and Finland Agreement (Article 25(2)) provides, among other things, that information received by a Contracting Party under the relevant EoI arrangement may be used for other purposes ("non-tax related purposes") when such information may be used for such other purposes under the laws of the Contracting Parties and the competent authority *(which, in the case of HKSAR, means the Commissioner of Inland Revenue ("CIR") or his authorized representative)*[1] of the supplying party authorizes such uses. According to the Administration, the India Agreement and the Finland Agreement are the first two CDTAs signed by Hong Kong which will allow the use of the exchanged information for limited non-tax related purposes.

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[1] See Article 3(1)(c) of the India Agreement and Article 3(1)(d) of the Finland Agreement.

12. The Subcommittee notes the Administration's advice that Hong Kong will only supply information to the CDTA partner upon a specific and bona-fide request for tax-related purposes in accordance with the EoI Article of the relevant CDTA. In other words, it is a pre-requisite that EoI must first be conducted for tax purposes in accordance with the relevant CDTA. The competent authority will reject any request for information based on purely non-tax related grounds. If the receiving party of tax information exchanged under a relevant CDTA subsequently intends to use such information for non-tax related purposes, OECD's requirement stipulates that this is permissible only where such use is allowed under the laws of both Contracting Parties and the competent authority of the supplying party authorizes such use.

13. On the scope of non-tax related purposes for which the exchanged information may be used, the Subcommittee notes the Administration's explanation that in the case and under the laws of Hong Kong, tax information may only be used for limited non-tax related purposes, such as the recovery of proceeds from drug trafficking, organized and serious crimes and terrorist acts under section 25A of the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405), section 25A of the Organized and Serious Crimes Ordinance (Cap. 455) and section 12 of the United Nations (Anti-Terrorism Measures) Ordinance (Cap. 575) respectively (collectively known as "specified non-tax related purposes").[2] Hence, the requesting party may only use the tax information exchanged under CDTAs for these limited non-tax related purposes if they also have similar laws permitting the use of tax information for the same purposes. They cannot use the exchanged tax information for other purposes even if permitted under their laws because to do so will go beyond the permitted use under the laws of Hong Kong.

14. Notwithstanding the above safeguards, since there are pre-existing arrangements for mutual legal assistance ("MLA") already made by HKSAR with India and Finland respectively under the Mutual Legal Assistance in

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[2] These provisions concern disclosure requirements under the said Ordinances. In gist, according to these provisions, where a person knows or suspects ("first person") that any property represents any person's proceeds of drug trafficking or an indictable offence, or is terrorist property, then the first person shall disclose that knowledge or suspicion to an authorized officer as defined under the relevant Ordinance. These officers include, as the case requires, a police officer and a member of the Customs and Excise Service.

Criminal Matters Ordinance (Cap. 525),[3] Mr James TO has expressed serious concerns over and staunch opposition to permitting the use of the information exchanged through CDTAs by the requesting party for non-tax related purposes instead of resorting to the pre-existing regime under MLA. He considers that this will be tantamount to undermining the statutory protection for the subject persons concerned under Cap. 525. Mr WONG Ting-kwong has likewise queried the appropriateness of opening up another pathway under CDTAs given the existence of the pre-existing regime under MLA.

15. The Administration has explained that the EoI arrangement under CDTAs has been an integral part of the CDTAs signed by HKSAR. While the use of the exchanged information for non-tax related purposes was previously an optional provision in the EoI Article in the Model Tax Convention on Income and on Capital ("Model Tax Convention") promulgated by OECD and Hong Kong has not received any requests for such use before, it has become an integral provision in the 2012 version of the EoI Article in the Model Tax Convention. As such, the international community would expect such provision to be incorporated into the new CDTAs in line with the prevailing international requirement. CDTAs to be signed by Hong Kong with other jurisdictions in future are also expected to include the same provision. In fact, a similar arrangement on the use of the exchanged tax information for non-tax related purposes has also been incorporated in the United Nations Model Double Taxation Convention.

Interface with pre-existing arrangements for exchange of information

16. Given that EoI requests under CDTAs and the requests for the use of the exchanged information for non-tax related purposes are handled by IRD, while MLA requests to Hong Kong are handled by the Department of Justice ("DoJ") in accordance with Cap. 525, members are concerned about the interface of the two different regimes and the operational details.

17. The Subcommittee has enquired, in the case where the tax information received by India or Finland under the relevant CDTA is or concerns a criminal matter covered by Cap. 525 and the party concerned requests to use the exchanged information for the specified non-tax related purposes, (a) whether

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[3] MLA in criminal matters is a form of international legal cooperation allowing governments to render assistance to each other in the investigation and prosecution of criminal offences as well as the restraint and confiscation of proceeds of crimes. MLA arrangements of HKSAR with India and Finland have been implemented respectively by the Mutual Legal Assistance in Criminal Matters (India) Order (Cap. 525AD) that came into force on 11 June 2011, and the Mutual Legal Assistance in Criminal Matters (Finland) Order (Cap. 525Y) that came into force on 19 February 2012.

the requesting party will be required to seek such information by making a request under Cap. 525 if no such request has been made; and (b) the guiding principles (including any legal and policy considerations) for determining whether such a request would be handled under the EoI arrangement provided in the relevant CDTA or in accordance with the relevant MLA arrangement under Cap. 525. Further, if it is decided that such request would be handled under the EoI arrangement provided in the relevant CDTA, whether any safeguarding provision similar to that provided under Cap. 525 will be available to the subject person concerned. The Subcommittee has also enquired about the relevant procedures for providing the requested information to the requesting party under a CDTA, the Inland Revenue (Disclosure of Information) Rules (Cap. 112BI) ("Disclosure Rules") and the Departmental Interpretation and Practice Notes ("DIPN") No. 47.

18. According to the Administration, the EoI arrangement under CDTAs and the MLA arrangement under the MLA Agreements are two separate regimes independent of each other. While Hong Kong has made MLA arrangements with India and Finland as provided in the Mutual Legal Assistance in Criminal Matters (India) Order (Cap. 525AD) and the Mutual Legal Assistance in Criminal Matters (Finland) Order (Cap. 525Y), the MLA arrangements concerned do not prevent Hong Kong from providing assistance pursuant to other agreements, arrangements or practices (including CDTAs) to India and Finland. The Administration has stressed that Hong Kong has all along taken a prudent approach towards the exchange of tax information under CDTAs. First and foremost, the competent authority (i.e. CIR or his authorized authorities where Hong Kong is concerned) will not entertain any request for information made on purely non-tax related grounds. The EoI Articles of the India and Finland Agreements also clearly stipulate that information will be exchanged only upon requests and the information sought should be foreseeably relevant to the application of the CDTA provisions or the administration and enforcement of domestic tax laws of the Contracting Parties. To this end, the requesting party is required to provide, in each EoI request, the relevant particulars as set out in the Schedule to the Disclosure Rules, such as the purpose of the disclosure request and the tax type concerned, etc. Based on the information provided, IRD will examine whether the information requested is foreseeably relevant and whether the request is made in compliance with the requirements under the Disclosure Rules. If the conditions are not fulfilled, IRD will not accede to the EoI request.

19. The Administration has reiterated that IRD attaches great importance to preventing any abuse of the use of the information exchanged under CDTAs for non-tax related purposes. It has stressed that on every occasion where the requesting party intends to use the tax information exchanged under a relevant CDTA for non-tax related purposes, the competent authority of the requesting

party should seek prior authorization from IRD, which will then consult the relevant law enforcement agencies and DoJ in Hong Kong whether it is appropriate to accede to the request. This procedure conforms to the relevant practice of IRD as set out in its DIPN No. 47. IRD will reject such requests if the relevant law enforcement agencies or DoJ objects to the disclosure.

20. Further, IRD will give consent to the competent authority of the requesting party concerned only if such use of information is permitted by the current exemption provided under section 58 of the Personal Data (Privacy) Ordinance (Cap. 486) in relation to crimes under the laws of a place outside Hong Kong with which Hong Kong has legal or law enforcement cooperation. Also, if Hong Kong considers that the requesting party does not comply with its duties regarding the confidentiality of the information exchanged under the relevant EoI Article, Hong Kong may suspend assistance under the EoI Article of the relevant CDTA until such time as proper assurance is given by the requesting party that those duties will be honoured. In extreme cases, Hong Kong can terminate the relevant CDTA and bring the case to OECD.

21. DoJ has also supplemented its view that the EoI arrangements under the relevant CDTAs and the MLA arrangements with the relevant jurisdictions as implemented by Cap. 525 are two separate regimes independent of each other. Provision of assistance pursuant to Cap. 525 is subject to the restrictions laid down in section 3(3) of Cap. 525, which stipulates that the provisions of Cap. 525 shall not operate to prejudice the generality of section 4 of Cap. 112. Section 4 of Cap. 112 is about preserving secrecy of tax information kept by IRD. By operation of section 3(3) of Cap. 525, as read with section 4 of Cap. 112, Cap. 525 cannot be invoked to obtain tax information direct from IRD. Accordingly, if India or Finland makes a request for legal assistance pursuant to the relevant MLA arrangement for obtaining tax information kept in the custody of IRD, the request will be declined in light of section 3(3) of Cap. 525.[4]

22. In respect of the handling of requests from India and Finland for the use of the information exchanged under the relevant CDTAs for non-tax related purposes, DoJ has advised that to assist IRD from the legal perspective, DoJ provides opinion on whether the information can be used for any non-tax related purposes under the laws of Hong Kong. IRD may be reminded that under the laws of Hong Kong, tax information may only be used for the limited non-tax related purposes, covering those specified non-tax related purposes. Since the use of the information for non-tax related purposes

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[4] See paragraph 4 of LC Paper No. CB(1)163/18-19(02).

should be allowed under the laws of both contracting parties, a CDTA partner may only use the tax information for such limited non-tax related purposes if the CDTA partner also has similar laws permitting the use of the information for such limited purposes. DoJ has reiterated that the CDTA partner cannot use the information for a non-tax related purpose even if permitted under its laws if such a purpose is not permitted under the laws of Hong Kong. Further, IRD may also be reminded to have due regard to the requirements under Cap. 486 as mentioned in paragraph 20 above.[5]

23. While taking note of the Administration's explanations, Mr James TO has remained seriously concerned over the EoI arrangements under the two Orders that allow the use of the tax information exchanged for non-tax related purposes. He considers that based on DoJ's above view that Cap. 525 cannot be invoked to obtain tax information direct from IRD and accordingly an MLA request for obtaining tax information kept in the custody of IRD will be declined. It follows that an MLA counterpart (if not being a party to an EoI arrangement provided in Cap. 112) of Hong Kong may be unable to obtain any tax information so kept through the relevant MLA arrangement, even if such information is requested for any specified non-tax related purposes under the relevant ordinances. Mr TO urged the Administration to consider making amendments to the relevant ordinances (including Cap. 405, Cap. 455, Cap. 575 and Cap. 525) to provide for the means of handling requests for tax information in such cases, such as through MLA. The Administration has noted Mr TO's views, and has undertaken to relay his views to the relevant policy bureaux.

24. Mr James TO has indicated that he will give notices to move motions at the Council meeting of 28 November 2018 to repeal the two Orders.

Safeguards for protecting the interests of taxpayers of Hong Kong

25. The Subcommittee has examined whether there are sufficient safeguards to protect the interests of taxpayers of Hong Kong who are the subject of the disclosure requests under CDTAs.

26. The Subcommittee notes the Administration's explanation that in handling an approved EoI request, IRD will normally notify the person who is the subject of the request of (a) the nature of the information requested by a CDTA partner and (b) his right to request, within 14 days after the date of notification, a copy of the information that IRD is prepared to disclose to the

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[5] See paragraphs 6 and 7 of LC Paper No. CB(1)163/18-19(02).

CDTA partner concerned ("relevant information"). Within 21 days after IRD has provided a copy of the relevant information, the subject person may request CIR to amend any part of the relevant information on the ground that certain information is factually incorrect or does not relate to him. CIR may decide whether to make any amendment or not. If the person is dissatisfied with CIR's decision, the person may, within 14 days after CIR's notice of decision, further invite the Financial Secretary to direct CIR to make the amendments so requested. If the person is aggrieved by any of the administrative decisions, he may apply to the court for judicial review. According to the Administration, this notification and review mechanism has worked well in the past and offered additional and comprehensive protection to the taxpayers in Hong Kong in the context of EoI.

Disclosure of exchanged information to oversight bodies under the India Agreement

27. The Subcommittee notes that, under paragraph 5(b) of the Protocol to the India Agreement, the competent authority of India may disclose information to Parliamentary Committees, Special Investigation Team constituted by Government, and any other oversight bodies mutually agreed upon in writing (collectively known as "specified bodies"). The Subcommittee is concerned whether such specified bodies are similarly required to abide by the personal data protection and confidentiality principles in respect of the information disclosed to them under the relevant EoI and disclosure arrangements.

28. The Administration has indicated that there are situations where the CDTA partners are required by their respective domestic laws to disclose the exchanged information to the oversight bodies of the tax authorities concerned. In the case of India, IRD has ensured that the specified bodies under paragraph 5(b) of the Protocol to the India Agreement are subject to the same safeguards that meet the international standards in respect of the protection of taxpayers' privacy and confidentiality of the exchanged information.

<u>Claiming of treaty benefits under the India Agreement and the Finland Agreement</u>

Approach to counter tax avoidance and proof of eligibility to benefits

29. The Subcommittee notes that in gate-keeping against tax avoidance, Hong Kong adopts the approach of principal purpose test ("PPT") by including relevant provisions in CDTAs to counter treaty shopping that aims at obtaining reliefs provided in the relevant CDTAs. Pursuant to the relevant provisions, an eligible Hong Kong resident may seek tax reduction or tax

relief from the competent authority of India or Finland pursuant to the India Agreement or the Finland Agreement respectively. In case of dispute, the Hong Kong resident may, for instance, resort to litigation filed in an Indian court of law or the mutual agreement procedure under the India Agreement for dispute resolution. Separately, upon application by a Hong Kong resident, IRD will issue a Certificate of Resident Status for his presentation to the CDTA partner to facilitate his claiming of treaty benefits under the relevant CDTA.

30. The Subcommittee notes that under Article 4(1) of the India Agreement and the Finland Agreement respectively, "resident of a Contracting Party" means, in the case of HKSAR and amongst other criteria, any individual who stays in HKSAR for more than 180 days during a year of assessment (i.e. "180-day rule"). In this regard, the Chairman has enquired whether the criterion is different from that adopted internationally for defining "resident" for tax assessment. The Administration has advised that while Hong Kong has generally adopted the 180-day rule for defining "resident" for tax assessment purposes, the 183-day rule (i.e. under which a resident of a place is an individual staying for more than 183 days during a year of assessment) has been adopted internationally recently especially for the employment provision.

Taxation arrangements for artistes and sportspersons under Article 18 of the India Agreement

31. The Subcommittee notes that Article 18 of the India Agreement sets out the taxation arrangement for artistes and sportspersons. According to the Administration, this Article is modeled on the relevant provision in the Model Tax Convention promulgated by OECD, which has been included with a view to promoting cultural exchange. The Subcommittee notes the relevant tax relief arrangement that pursuant to Article 18(3), literally, if an activity performed in a Contracting Party by entertainers or sportspersons is substantially supported by public funds of one or both of the Contracting Parties or of political subdivisions or local authorities thereof, the income derived from the activity performed should be taxable only in the Contracting Party of which the entertainer or sportsperson is a resident, but not in the other Contracting Party. In addition, per the general understanding in the international tax arena, this provision should apply where public funds should account for more than half of the total funding support.

Drafting issues of the India Agreement and Finland Agreement

Entitlement to benefits

32. The Subcommittee notes that Article 21 (Entitlement of benefits) of the Finland Agreement stipulates the exception that "unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Agreement", whereas no such exception is stipulated in similar provisions (e.g. Articles 10(6), 11(8), 12(7), 13(7) and 14(7)) of the India Agreement. The Subcommittee also notes that these provisions are essentially anti-abuse provisions based on the principal purpose of transactions or arrangements (i.e. PPT). Insofar as the anti-abuse provisions under the India Agreement and Finland Agreement are concerned, the legal adviser to the Subcommittee invited the Administration to confirm that, based on the Administration's response relating to the exception as stated in paragraphs 13 and 14 of LC Paper No. CB(1) 43/18-19(03), these provisions operate to the same effect despite the difference.

33. In respect of the above, the Administration reiterated its response in LC Paper No. CB(1) 43/18-19(03) that the Finland Agreement adopts the approach of adding a general anti-abuse rule based on PPT as a separate article of the CDTA, whereas the India Agreement adopts the approach of including the PPT provisions under the relevant individual articles and such articles have clearly stipulated the conditions for applying the PPT provisions in relation to the income concerned. As such, under the approach adopted for the India Agreement, it is not necessary to include the "exception" clause, which makes reference to other provisions of the CDTA. Notwithstanding the difference in the drafting approach of the PPT clause adopted for the India Agreement and Finland Agreement, the relevant articles in both agreements indeed serve to provide for the prevention of fiscal evasion and have no substantive difference in the operative effect.

Definition of "permanent establishment"

34. The Subcommittee notes that, while the OECD Council has approved the 2017 update to the Model Tax Convention which covers changes to Article 5 (Permanent establishment) and its Commentary,[6] the same changes

[6] According to the Administration, the changes to Article 5 of the Model Tax Convention was recommended in OECD's report on "Preventing the Artificial Avoidance of Permanent Establishment Status" released in October 2015 as part of the final base erosion and profit shifting package. In particular, the report recommends changes aimed at preventing the use of certain common tax avoidance strategies that have been used to circumvent the existing definition of permanent establishments.

have not yet been adopted in the respective Article 5 on permanent establishment under the India Agreement and Finland Agreement. Hence, the Chairman has asked whether OECD has required the Contracting Parties of a CDTA to spontaneously update the definition of "permanent establishment" in the relevant Article of the CDTA following the corresponding update of the Model Tax Convention.

35. The Administration has advised that updating of the relevant definition is not mandatory. While Hong Kong plans to give effect to the Multilateral Convention to Implement Tax Treaty Related Matters to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument") subject to the extension of its application to Hong Kong by the Central People's Government,[7] the Multilateral Instrument will not deal with the definition of "permanent establishment" in Hong Kong's pre-existing CDTAs, and any update should be mutually agreed with the relevant Contracting Parties.

Recommendation

36. The Subcommittee has completed scrutiny of the two Orders. The Subcommittee will not propose amendments to the two Orders. The Subcommittee also notes that the Administration will not propose amendments to the two Orders.

Advice sought

37. The Subcommittee Chairman gave a verbal report on the deliberations of the Subcommittee at the House Committee meeting on 16 November 2018. Members of the House Committee are invited to note this written report.

Council Business Division 1
Legislative Council Secretariat
20 November 2018

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[7] The Administration briefed the Panel on Financial Affairs in March 2018 that it had planned to give effect to the Multilateral Instrument by an order in the gazette to be made by CE in Council under section 49 of Cap. 112, and the order would be subject to negative vetting by LegCo.

Appendix

Subcommittee on Two Orders Made under Section 49(1A) of the Inland Revenue Ordinance and Gazetted on 14 September 2018

Membership list

Chairman	Hon Kenneth LEUNG
Members	Hon James TO Kun-sun Hon WONG Ting-kwong, GBS, JP Hon Charles Peter MOK, JP Hon Alvin YEUNG (Total：5 members)
Clerk	Ms Doris LO
Legal Adviser	Miss Evelyn LEE