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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 4 October 2019**

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 4 October 2019 ("the Subcommittee").

Background

Comprehensive Avoidance of Double Taxation Agreements/Arrangements

2. Double taxation refers to the imposition of comparable taxes by more than one tax jurisdiction in respect of the same source of income. The international community generally recognizes that double taxation hinders the exchange of goods and services as well as 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/Arrangements ("CDTAs") with Hong Kong's trading and investment partners to minimize double taxation.

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 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 do provide their residents with unilateral tax relief for the Hong Kong tax they paid on income derived

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

Article on exchange of information

4. A CDTA will normally include an exchange of information ("EoI") article which enables the two Contracting Parties to exchange information that is foreseeably relevant for carrying out the provisions of the CDTA concerned or to the administration or enforcement of the tax laws of the Contracting Parties. To enable Hong Kong to adopt the then prevailing international standard for EoI under CDTAs as promulgated by the Organisation for Economic Co-operation and Development ("OECD") in 2004, 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. Under the Amendment Ordinance, 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.

5. As at 30 September 2019, a total of 42 jurisdictions have entered into CDTAs with Hong Kong. According to the Administration, two¹ and 37 CDTAs are based on the pre-2004 and 2004 version of the OECD EoI Article respectively. The Administration has also indicated that the prevailing international standard is to adopt the 2012 version of the OECD EoI Article,² and the CDTAs signed with three jurisdictions (i.e. India, Finland and Estonia) are based on that version. It is envisaged that such an arrangement will apply to CDTAs to be signed by Hong Kong with other jurisdictions in future.

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

6. Under section 49(1A) of the Inland Revenue Ordinance (Cap. 112) ("IRO"), 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

¹ The two jurisdictions involved are Belgium and Thailand.

² A major feature of the 2012 version of the Organisation for Economic Co-operation and Development's Exchange of Information Article is to allow the use of exchanged information for limited non-tax related purposes.

double taxation and/or exchanging information in relation to any tax imposed by the laws of Hong Kong or the territory concerned.

The two Orders

7. The Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Kingdom of Cambodia) Order and the Specification of Arrangements (The Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Fifth Protocol) Order are made by CE in Council under section 49(1A) of IRO to give effect to the CDTA signed between Hong Kong and Cambodia ("the Cambodia CDTA") in June 2019, and to implement the Fifth Protocol ("the Mainland Fifth Protocol") to the CDTA signed between Hong Kong and the Mainland ("the Mainland CDTA") in July 2019³ respectively.

8. The Cambodia CDTA sets out the allocation of taxing rights between Hong Kong and Cambodia, and the relief on tax rates on different types of income. Profits from international shipping transport earned by enterprises of Hong Kong arising from Cambodia, which are currently subject to tax in Cambodia, will enjoy 50% tax reduction in Cambodia under the Cambodia CDTA. Hong Kong air carriers operating flights to Cambodia will only be taxed in Hong Kong at Hong Kong's corporation tax rate, which is lower than that of 20% in Cambodia. The withholding tax rates applicable to Hong Kong residents for income derived in Cambodia in the form of interest, royalties, dividends and fees for technical services will be lowered from the domestic rate of 14% to the cap of 10%.⁴

9. The Mainland Fifth Protocol adds a teachers and researchers article (i.e. Article 18A) to the Mainland CDTA with a view to promoting academic exchange and cooperation in research and development ("R&D") between Hong Kong and the Mainland. The Mainland Fifth Protocol also amends the

³ The Mainland and Hong Kong signed the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income ("the Mainland CDTA") and its First Protocol in August 2006. The Second Protocol, the Third Protocol and the Fourth Protocol to the Mainland CDTA were signed in 2008, 2010 and 2015 respectively. These Protocols form integral parts of the Mainland CDTA.

⁴ The withholding tax will be exempt if the interest is paid to the Hong Kong Special Administrative Region ("HKSAR") Government, the Hong Kong Monetary Authority, the Exchange Fund or a financial establishment appointed by the HKSAR Government and mutually agreed upon by the competent authorities of Hong Kong and Cambodia.

Mainland CDTA to provide additional safeguards against treaty abuse (including an explicit statement in the preamble that, amongst others, the Mainland CDTA is not intended to generate double non-taxation through tax evasion or avoidance) and artificial avoidance of the permanent establishment status. Such technical amendments seek to ensure that the Mainland CDTA follows the latest international tax standards promulgated by OECD to combat base erosion and profit shifting ("BEPS")⁵ by multinational enterprises.

10. The two Orders were gazetted on 4 October 2019 and tabled at the Council meeting of 16 October 2019 for negative vetting. The two Orders are to come into operation on 6 December 2019.

The Subcommittee

11. At the House Committee meeting on 11 October 2019, 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 one meeting with the Administration to discuss the two Orders.

12. To allow sufficient time for the Subcommittee to scrutinize the two Orders, the Chairman has given notice to move a resolution to extend the scrutiny period of the two Orders to the Council meeting of 4 December 2019. However, the resolution could not be dealt with by the time the Council meeting of 13 November 2019 was adjourned. As such, the period for amending the Orders expired at the Council meeting of 13 November 2019.

Deliberations of the Subcommittee

Inland Revenue (Double Taxation Relief and Prevention of Fiscal Evasion with respect to Taxes on Income) (Kingdom of Cambodia) Order

Article 23 of the Cambodia CDTA – Methods for elimination of double taxation

13. Article 23 of the Cambodia CDTA provides relief for double taxation where the same income earned by a resident of Hong Kong or Cambodia is taxable by both Hong Kong and Cambodia. The Subcommittee notes the

⁵ Base erosion and profit shifting refers to tax avoidance strategies of multinational enterprises in exploiting the gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity.

concern raised in the submissions from a member of the public that paragraph 3 of Article 23 may have contravened the Cambodia Democracy Act of 2019 passed by the House of Representatives of the United States in July 2019 ("the US Cambodia Democracy Act"). According to the submissions, the Government of Cambodia has taken several measures to restrict its media environment, especially through politicized tax investigations. Assets of persons who support the Government of Cambodia may be frozen not later than 180 days after the US Cambodia Democracy Act becomes law. The submissions have also pointed out that the 10 year economic development project as referred to in paragraph 3 of Article 23 is not a standard provision and should not form part of a standard tax agreement. The Subcommittee has sought the Administration's response to the concern, in particular whether Article 23 of the Cambodia CDTA would breach the US Cambodia Democracy Act.

14. The Administration has explained that Article 23 of the Cambodia CDTA states how double taxation in Hong Kong and Cambodia is eliminated. Paragraphs 1 and 2 of the Article are applicable to Cambodian residents and Hong Kong residents respectively. Any Cambodian tax paid by Hong Kong residents in respect of income derived from sources in Cambodia will be allowed as a credit against the Hong Kong tax payable on the same income, subject to the provisions of the tax laws of Hong Kong. Also, Hong Kong tax paid by Cambodian residents will be allowed as a deduction from Cambodian tax in respect of the same income.

15. As regards paragraph 3 of Article 23, the Administration has clarified that it contains a tax sparing provision, which applies to residents of both sides, allowing residents of one side to obtain a foreign tax credit for the taxes that have been "spared" (i.e. taxes that have not been actually paid) under the tax incentive programme of the other side. A sunset clause is included in paragraph 3 of the Article to limit the application of the tax sparing provision to 10 years starting from the entry into force of the Cambodia CDTA, subject to further extension by mutual agreement of the competent authorities of Hong Kong and Cambodia. Paragraph 3 of the Article is a general provision and does not refer to any particular economic development project.

16. The Administration has also pointed out that pursuant to paragraphs 2 and 3 of Article 23, if a Hong Kong resident invests in Cambodia and derives income therefrom, the amount of tax which Cambodia could have imposed on that income in accordance with its general legislation shall be allowed as a credit against Hong Kong tax payable in respect of that income, even if Cambodia has waived all or part of tax under its specific legislation for promoting its economic development. The tax sparing provision has no connection with the US Cambodia Democracy Act. The Cambodia CDTA only applies to persons who

are tax residents of Hong Kong or Cambodia. It does not apply to US tax residents, nor cover territories under US jurisdiction. It is not envisaged that the Cambodia CDTA would contravene the US Cambodia Democracy Act.

17. The Subcommittee has enquired about the reasons for incorporating a tax sparing provision in the Cambodia CDTA and the possible impacts on Hong Kong. The Administration has responded that the provision has been included in the CDTA at the request of Cambodia. The Administration has further pointed out that it is not unusual to include a tax sparing provision in a CDTA between a developed economy and a developing economy where the latter may grant tax incentives to attract foreign investment. It has been noted that some of the CDTAs signed by Cambodia also contain a similar tax sparing provision. Similar tax sparing provisions also exist in Hong Kong's CDTAs with Brunei, Malaysia, Thailand and Vietnam. In general, a tax sparing provision included in a CDTA signed by Hong Kong is paired with a 10-year sunset clause to provide a time limit on the application of the provision. Given that Hong Kong adopted the territorial basis of taxation, income derived by a Hong Kong resident from its economic activities carried out in Cambodia is in general not taxable in Hong Kong. Therefore, the tax sparing provision would rarely have practical application in Hong Kong and the impact of such provision on Hong Kong would be minimal.

Consultation on the Cambodia CDTA

18. Some members of the Subcommittee have enquired about the consultation conducted by the Administration on the Cambodia CDTA, including whether the Administration has engaged the Joint Liaison Committee on Taxation ("JLCT") and relevant stakeholders such as the American Chamber of Commerce in Hong Kong ("AmCham") regarding the view that paragraph 3 of Article 23 of the CDTA may contravene the US Cambodia Democracy Act.

19. The Administration has advised that while no specific consultation on the Cambodia CDTA and its provisions had been conducted, the business community and professional bodies have all along supported the Government's policy to conclude more CDTAs with the trading and investment partners of Hong Kong so as to minimize double taxation and facilitate cross-border businesses. Hong Kong Trade Development Council, Hong Kong General Chamber of Commerce, Federation of Hong Kong Industries, Hong Kong Small and Medium Enterprises Association, Hong Kong Institute of Certified Public Accountants, Taxation Institute of Hong Kong and Hong Kong Association of Banks, had in particular asked the Government to conclude a CDTA with Cambodia during the Administration's previous engagements with them. At the Subcommittee's request, the Administration has drawn the attention of JLCT and AmCham to the Cambodia CDTA and the US Cambodia Democracy Act, and

has not received any comments from them. Moreover, the Administration has informed the Subcommittee that two "Big Four" accounting firms had issued tax updates on the signing of the Cambodia CDTA, highlighting the key provisions thereof.⁶

Article 26 of the Cambodia CDTA – Exchange of information

20. The Subcommittee notes that while the EoI arrangements provided in Article 26 of the Cambodia CDTA are largely based on the OECD 2004 version of the EoI Article, the Article does not contain the sample provision which provides that the EoI Article "does not create obligations as regards automatic or spontaneous exchanges of information between the Contracting Parties".

21. The Administration has explained that OECD has promulgated in recent years new international standards on tax cooperation. Hong Kong has correspondingly implemented a number of initiatives to comply with these requirements including automatic exchange of financial account information in tax matters ("AEOI") and combating BEPS, the latter of which involves automatic exchange of country-by-country reports and spontaneous EoI on tax rulings. With these new developments, the EoI article of CDTAs that Hong Kong signed in recent years no longer contains provisions which preclude automatic or spontaneous EoI. For example, the EoI article of CDTAs signed with Belarus, Saudi Arabia, India and Finland in 2017 and 2018 have duly reflected this change.

22. The Administration has added that Cambodia has so far not set any date for implementing AEOI nor committed to OECD on the implementation of the BEPS package. Hence, while the EoI Article of the Cambodia CDTA would not preclude the possibility of automatic or spontaneous EoI having regard to the Commentary on the Model Tax Convention on Income and on Capital promulgated by OECD, there will be no automatic or spontaneous EoI between Hong Kong and Cambodia at this stage.

23. As regards paragraph 2 of the Protocol to the Cambodia CDTA which provides that the Cambodian competent authority may disclose information in

⁶ Deloitte Touche Tohmatsu – <https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/tax/hk-tax-news/deloitte-cn-tax-hktn-issue96-en-190628.pdf> and Ernst & Young – [https://www.ey.com/Publication/vwLUAssets/Hong_Kong_and_Cambodia_sign_income_tax_treaty/\\$FILE/2019G_003373-19Gbl_Hong_Kong_and_Cambodia_sign_income_tax_treaty.pdf](https://www.ey.com/Publication/vwLUAssets/Hong_Kong_and_Cambodia_sign_income_tax_treaty/$FILE/2019G_003373-19Gbl_Hong_Kong_and_Cambodia_sign_income_tax_treaty.pdf)

accordance with its confidentiality provisions and Article 26 of the Cambodia CDTA to the Legislature of Cambodia (National Assembly and Senate) and government bodies of Cambodia with a supervisory function over tax administration and enforcement, the Administration has confirmed that such government bodies are confined to the Office of the Council of Ministers, Ministry of Economy and Finance, Ministry of Interior, Ministry of National Assembly-Senate Relations and Inspection, and National Audit Authority as provided in paragraph 2 of the Protocol.

Specification of Arrangements (The Mainland of China) (Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income) (Fifth Protocol) Order

Article 5 of the Mainland Fifth Protocol – new Article 18A of the Mainland CDTA on teachers and researchers

24. Article 5 of the Mainland Fifth Protocol adds a new Article 18A to the Mainland CDTA which provides tax relief to reduce the tax burden of eligible teachers and researchers who work across the boundary with a view to promoting academic exchange and cooperation in R&D between Hong Kong and the Mainland. The Subcommittee has enquired about the operation of the Article including the scope of "university", "college", "school", and "educational institution or scientific research institution recognized by the Government" to which the Article applies, and the criteria for these bodies to be recognized by the Government of the Mainland.

25. The Administration has advised that under Article 18A, if an individual employed by a recognized educational or scientific research institution of one side (residence side) visits the other side (work side) and stays there for the primary purpose of teaching or conducting research at a recognized educational or scientific research institution of the work side, his/her remuneration for such teaching or research to the extent that it is paid by or on behalf of his/her employer in the residence side shall be exempt from tax in the work side for a period not exceeding three years, provided that such remuneration is subject to tax in the residence side and (in relation to remuneration for research) the research is undertaken in the public interest. The Administration has set out the scope of the Article and details of the Mainland Fifth Protocol in a press release issued on 19 July 2019 which announced the signing of the Protocol. IRD will provide further guidance on the application of the Article.

26. As regards the definitions of the four terms referred to in paragraph 24 above, the Administration has responded that they are not provided in the Mainland CDTA. Pursuant to paragraph 3 of Article 3 (i.e. General Definitions

Article) of the Mainland CDTA, unless the context otherwise requires, undefined terms should have the meaning which they have under the laws of the side applying the Mainland CDTA, and any meaning under the applicable tax laws of that side prevails over a meaning given to the terms under other laws of that side.

27. The Administration has advised that in the case of the Mainland, reference has to be made to two circulars, i.e. Circular [2016] No. 91 and Circular [1999] No. 37 promulgated by the State Taxation Administration which set out the scope of institutions to which the Teachers and Researchers Article in CDTAs (including the new Article 18A of the Mainland CDTA) applies.⁷ In respect of Hong Kong, "university", "college", "school", "educational institution or scientific research institution recognized by the Government" refer to those recognized under IRO or other relevant legislation in Hong Kong, e.g. the Education Ordinance (Cap. 279) and various ordinances governing the universities, etc. Broadly speaking, research institutes in Hong Kong supported by the Innovation and Technology Fund, such as local universities, the Hong Kong Applied Science and Technology Research Institute, and the Hong Kong Productivity Council, would be considered as recognized scientific research institutions within the scope of the new Article 18A.

Recommendation

28. 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.

⁷ Pursuant to the State Taxation Administration ("STA") Circular [2016] No. 91, "university, college, school or educational institution recognized by the Government" means schools providing pre-primary, primary, secondary, higher and special education, including kindergartens, primary schools, primary schools for adults, junior high schools, vocational junior high schools, senior high schools, senior high schools for adults, specialised secondary schools, specialised secondary schools for adults, vocational high schools, technical schools, special education schools, schools for children of foreign personnel, colleges and universities, higher vocational (professional) colleges and adult education colleges. Pursuant to STA Circular [1999] No. 37, "scientific research institution recognised by the Government" means institutions that are under the administration of ministries/committees/institutes of the State Council, provinces, autonomous regions, municipalities as well as cities specially designated in the state plan; and are exclusively engaged in scientific research and development.

Advice sought

29. Members are requested to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
26 November 2019

**Subcommittee on
Two Orders Made under Section 49(1A) of the
Inland Revenue Ordinance and Gazetted on 4 October 2019**

Membership list

Chairman Hon Kenneth LEUNG

Members Hon James TO Kun-sun
 Hon Charles Peter MOK, JP
 Hon Christopher CHEUNG Wah-fung, SBS, JP
 Hon Elizabeth QUAT, BBS, JP
 Hon CHU Hoi-dick
 Hon Jeremy TAM Man-ho

(Total : 7 members)

Clerk Ms Connie SZETO

Legal Adviser Miss Rachel DAI