HONG KONG SOCIETY OF ACCOUNTANTS
(Incorporated by the Professional Accountants Ordinance, Cap. 50)

香港會計師公會

BY FAX AND BY POST
(2528 3345)

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Permanent Secretary for Financial Services and the Treasury
(Financial Services)
Financial Services Branch,
Financial Services and the Treasury Bureau,
18th Floor, Admiralty Centre Tower 1,
18 Harcourt Road,
Hong Kong.

Attn: Ms. Annie Kong

Dear Sir,

Hong Kong – Belgium Double Tax Agreement

I am writing in response to your letter dated 30 December 2003, requesting comments on the Belgium-Hong Kong Double Tax Agreement signed on 10 December 2003.

You may be aware that the Society wrote to the Commissioner of Inland Revenue (CIR) on 19 November 2003, suggesting that, in the course of negotiating double tax agreements (DTAs) with jurisdictions such as Belgium, the special circumstances of Hong Kong's territorial taxation system should be taken into account to the extent possible. A copy of the letter is attached for your information.

The Society appreciates the efforts of the Administration in negotiating and entering into a DTA with the Belgium Government ("the DTA"), which is based on the 1995 version of the OECD model convention, and which at the same time seeks to cater for the special circumstances of Hong Kong. This is the first such agreement concluded by Hong Kong with another jurisdiction and we take assurance from the CIR's reply to our letter of 19 November that it has always been the aim to conclude a DTA that will bring benefits to Hong Kong residents.

We believe that the 1995 version of the OECD model convention, which, amongst other things, provides for a reasonable degree of information exchange between revenue authorities in relation to the taxes covered by the convention, as reflected in Article 25 of the DTA, is appropriate for Hong Kong. As we pointed out in our response to the 2001 consultation on Exchange of Information for Tax Treaty Purposes, the protection offered by section 4 of the Inland Revenue Ordinance (IRO) has in the past benefited Hong Kong economically and the enforcement of such provisions is one facet of the rule of law in Hong Kong, which, taken as a whole, is fundamental to our future stability and prosperity.

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With regard to the specifics of the DTA, most of the points that we raise below are matters, which, in our view, require further clarification. The Society's main concern, therefore, is with areas of possible uncertainty in the agreement resulting from ambiguities or other interpretational issues. Amongst the suggestions that we would offer to improve clarity is that, when negotiating future DTAs, any modifications to the model convention should as far as possible be incorporated into the main body of the agreement, rather than being included in a Protocol.

Our comments on the specific matters contained in the DTA are set out below.

Article 4, paragraph 1/Protocol, paragraph 2

Article 4, paragraph 1, uses the term "resident in a Contracting Party", whereas paragraph 2 of the Protocol, which relates to Article 4, uses the term "resident of a Contracting Party". We would like to confirm whether or not anything is intended by this apparent inconsistency.

Article 4, paragraph 1, defines the term, "a resident in a Contracting Party" and states: "This term, however, does not include any person who is liable to tax in that Party in respect only of income from sources in that Party or capital situated therein". Referring to the first paragraph of Article 4, paragraph 2 of the Protocol states: "The last sentence of that paragraph does not preclude a person from being treated as a resident in a Contracting Party by reason of a territorial source principle in the taxation system of that Party." While the main body of the agreement, when read in conjunction with the Protocol, should be sufficient to cover Hong Kong "residents", we believe that this is one example where clarity could be improved and where it would be appropriate in the context of any future DTAs, to review the language of these two statements and to incorporate the qualification to Article 4 in the main body of the text.

The Society would like to obtain confirmation that the reduced tax rates under the DTA will apply to passive income received by a Hong Kong-incorporated company which has successfully achieved an offshore taxation claim, as described in Example 2 on page 2 of our letter to the CIR.

Article 7, paragraph 1

Under Article 7, paragraph 1, the profits of an enterprise of a Contracting Party will be taxable only in that Party unless the enterprise carries on business in the other Contracting Party through a permanent establishment situated therein.

In the situation where the provision of credit is carried out in Hong Kong by a resident of Belgium and this activity amounts to the carrying on of a business in Hong Kong, the interest in the hands of the Belgian recipient would be chargeable to tax in Hong Kong under the IRO. Yet, since the Belgian resident does not maintain a permanent establishment in Hong Kong, he is not liable to tax in Hong Kong under the DTA (albeit chargeable to tax under the IRO). It is not entirely clear, therefore, whether the anti-avoidance provisions in section 16(2)(c) of the IRO would still apply in such circumstances.

Article 9, paragraph 1

The "associated enterprises" provisions apply where, for example, an enterprise of a Contracting Party "participates directly or indirectly in the management, control or capital" of an enterprise of the other Contracting Party, and conditions are made or imposed between the two

enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises. We believe that it would be helpful for more guidance to be provided by spelling out more specifically the nature and extent of the participation in the management, control or capital of an enterprise that could lead to this Article being applied by a Contracting Party.

The basis on which to attribute profits to one or other enterprise under this Article, and the grounds for doing so, are not clear, which could lead to uncertainty. Is it envisaged that the grounds for "re-allocating" profits between two enterprises would include, for example, challenges to transfer pricing arrangements or enforcement of anti-avoidance provisions? For Hong Kong tax purposes, section 20(2) of the IRO, which has seldom been invoked, provides for non-resident persons to be deemed to be assessable and chargeable with tax in certain circumstances. The Society would like clarification on the relationship between the "associated enterprises" provisions in the DTA and section 20(2) of the IRO, and whether and how they might be used in conjunction with one another.

Article 9, paragraph 2

Where a Contracting Party makes a determination regarding the deeming of profits under the provisions of Article 9, paragraph 1, the other Contracting Party should, under Article 9, paragraph 2, make a corresponding adjustment to the amount of the tax that has been charged therein. We should like to clarify the following:

- The exact basis for the adjustment. On the face of it, the provision seems to make it a requirement to make some form of adjustment, while leaving it to the discretion of the Contracting Party concerned to determine the basis and the amount.

- Whether the exchange of information between the competent authorities of the Contracting Parties could lead to further investigation and/or penalties?

Article 12, paragraph 2

Under Article 12, paragraph 2, if the beneficial owner of the royalties is a resident in the other Contracting Party, the tax rate to which the royalties arising in a Contracting Party will be subject in the Contracting Party will not exceed 5%.

We would like to know, in respect of the case where, say, 100% of the royalties received by a Belgian recipient for the use of intellectual property in Hong Kong are deemed to be its assessable profits arising in or derived from Hong Kong under section 21A and section 15(1)(a) or (b) of the IRO:

- Whether, in the circumstances, the effective withholding tax rate will be 17.5%, under the provisions of the IRO, or 5% under Article 12 of the DTA?

- If the provisions in the DTA prevail, whether or not the anti-avoidance provisions in section 21A of the IRO will apply in the circumstances? It would appear that the Inland Revenue Department may not be able to invoke Article 27 of the DTA to apply section 21A of the IRO, as levying a withholding tax of 17.5% would appear to "give rise to taxation contrary to the Agreement".

Article 14, paragraph 2

Article 14, paragraph 2 sets out the conditions under which remuneration derived by a resident in a Contracting Party in respect of an employment exercised in the other Contracting Party will be taxable only in the first-mentioned Party. We should like to seek clarification with respect to the tax consequences of the scenarios set out below.

Scenario 1

A Hong Kong resident, who is under a non-Hong Kong employment with e.g., a Swiss employer, renders services during a year in both Hong Kong and Belgium. His periods of services in Hong Kong and Belgium during the year are 265 days and 100 days respectively. He is entitled to a time-apportionment claim in Hong Kong. His remuneration is not paid by a Belgian employer nor borne by a permanent establishment in Belgium.

It seems that in this case the Hong Kong resident would still be liable to tax in Belgium in respect of his remuneration attributable to his services there. This is so as the remuneration attributable to the service in Belgium is not taxable in Hong Kong under time-apportionment according to the laws in force in Hong Kong (and so condition (d) under Article 14, paragraph 2 of the DTA is not fulfilled).

Scenario 2

A Belgian resident, who is under a non-Hong Kong employment with e.g., a Swiss employer, renders services during a year in both Hong Kong and Belgium. His periods of service in Belgium and Hong Kong during the year are 265 days and 100 days respectively. His remuneration is not paid by a Hong Kong employer nor borne by a permanent establishment in Hong Kong.

In this case, the remuneration of the Belgian resident attributable to his services in Hong Kong would be exempt from tax in Hong Kong under the DTA. This is on the assumption that, being a Belgian resident, the remuneration attributable to the Hong Kong services would be taxable in Belgium according to the laws in force in Belgium (i.e., all four conditions under Article 14, paragraph 2 of the DTA are fulfilled).

If the above understanding of the tax consequences of the two scenarios is correct, it seems that while Hong Kong gives up its taxing right in situations like scenario 2, Belgium retains its taxing right in the reverse situations like scenario 1.

Firstly, we should like to seek clarification as to whether the above interpretation is correct. Secondly, we note that the OECD model convention and the arrangement for the avoidance of double taxation between the Hong Kong SAR and the Mainland do not contain provisions similar to condition (d) in Article 14, paragraph 2. We should be grateful to learn, therefore, the reasons for the inclusion of this condition in the DTA and to know whether it is intended that a similar condition will be included in future DTAs negotiated by the Government.

Article 23, paragraph 1

The non-discrimination provisions apply to Belgian nationals, and to persons with the right of abode, or which are incorporated or otherwise constituted, in Hong Kong. It is not clear whether the term "Belgian nationals" is intended to cover persons that are incorporated or otherwise constituted in Belgium. If not, we should like to know:

- Why Belgian companies are not included in the provisions?
- Whether consideration was given to making the non-discrimination provisions applicable more broadly to residents in the respective Contracting Parties?

Article 25, paragraph 2(c)

According to Article 25, paragraph 2(c), Article 25, paragraph 1 shall not be construed so as to require a Contracting Party to disclose information "contrary to public policy". We should be grateful for some indication as to the situations in which disclosure of information might be regarded as "contrary to public policy".

Other issues

Review of section 16(2) of the IRO

Where an overseas holding company lends to a Hong Kong subsidiary, either for the expansion of its existing business, or for the acquisition of a business or a company, no relief from "double taxation" would be available in respect of the interest cost. Article 7 of the DTA appears to preserve the position under the IRO (but see our comments above on Article 7).

In our Budget Proposals 2004/05 submitted to the Financial Secretary on 17 December 2003 (and also in previous budget submissions) we suggested, inter alia, that section 16(2) of the IRO should be amended to allow deductions for interest incurred or paid on money borrowed from overseas associates for the production of assessable profits. We believe that the current tax treatment in Hong Kong, which is to deny the deduction of this interest entirely, acts as a disincentive to the establishment of regional headquarters and offices and other (group) operations in Hong Kong. Under the circumstances, we suggest that consideration be given to reviewing section 16(2) with a view to excluding its application where a DTA is in force (given suitable restrictive criteria as a safeguard against possible abuses).

Scope of the DTA

As to our view on other aspects of the scope of the DTA and DTAs generally, we would refer you to the Society's letter to the CIR of 19 November 2003.

Should you have any questions on this submission, please do not hesitate to contact me at the Society by telephone (on 2287 7084) or email (peter@hksa.org.hk).

Yours faithfully,

PETER TISMAN
TECHNICAL DIRECTOR
(BUSINESS MEMBERS & SPECIALIST PRACTICES)

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Encl.

c.c. Mrs. Alice Lau, Commissioner of Inland Revenue