

Tax Analysis

Hong Kong Tax

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Hong Kong signs first tax information exchange agreement

On 25 March 2014, Hong Kong signed its first-ever tax information exchange agreement (TIEA) with another tax jurisdiction, the US. A TIEA, unlike a double tax agreement (DTA), is an agreement whose sole purpose is to provide for the exchange of information for the purposes of tax collection and enforcement of the relevant tax laws. A DTA, on the other hand, addresses both the elimination of double taxation and the prevention of fiscal evasion through the exchange of information between the contracting parties.

The TIEA, which entered into effect on 20 June 2014, allows an exchange of information between Hong Kong and the US upon request, including information that must be reported by financial institutions in Hong Kong to the US under the Foreign Account Tax Compliance Act (FATCA). The TIEA is a significant step toward the conclusion of an Intergovernmental Agreement (IGA) between Hong Kong and the US that would help financial institutions in Hong Kong comply with FATCA.

Background

Before the Hong Kong Inland Revenue Ordinance (IRO) was amended in July 2013, it was not possible for Hong Kong to enter into a TIEA with another jurisdiction because the IRO permitted Hong Kong to enter only into DTAs, not TIEAs. To align itself with the OECD's global initiative on the exchange of tax information to enhance cross-border tax transparency, Hong Kong amended the IRO to provide a legal framework for it to enter into TIEAs.¹

As noted above, Hong Kong also has been in negotiations with the US to conclude an IGA to implement FATCA. FATCA is intended to prevent US taxpayers who hold financial assets in non-US financial institutions from avoiding their US tax obligations. FATCA requires foreign financial institutions (FFIs) to report information about offshore accounts and investments held by US taxpayers to the US Internal Revenue Service (IRS) annually. There are two IGA models through which FFIs may provide the required information: Model 1 allows FFIs in other jurisdictions to report information on US account holders directly to their national tax authorities, which, in turn, will report the information to the IRS; Model 2 enables FFIs to report information directly to the IRS.

¹ The initiative resulted from a peer review among the members (including Hong Kong) of the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum), which is the continuation of a forum created by the OECD in the early 2000s to study the tax compliance risks posed by tax havens.

Hong Kong intends to enter into a Model 2 IGA with the US and, on 9 May 2014, the US government announced that a Model 2 IGA had been negotiated "in substance". The TIEA is widely seen as a necessary precursor to the Model 2 IGA with the US.

Features of the TIEA

The Hong Kong-US TIEA, like the exchange of information article found in Hong Kong's DTAs, contains the following features:

- Exchange of information upon "request": Information will be exchanged only upon a specific request from one of the parties. The TIEA does not provide for the automatic or spontaneous exchange of information.
- Foreseeable relevance "for tax purposes": A contracting party must demonstrate to the other contracting party that the information requested is relevant for tax purposes. For example, the US must show that the information requested under FATCA is foreseeably relevant for carrying out the administration or enforcement of US domestic laws concerning taxes covered by the TIEA, such as federal taxes on income; federal taxes related to employment and self-employment; federal estate and gift taxes; and federal excise taxes. In other words, the US could request information relating to US federal taxes from Hong Kong, regardless of whether such information is relevant for Hong Kong tax purposes. On the other side, Hong Kong can request information from the US related to Hong Kong profits tax, salaries tax and property tax. However, neither party can use the information obtained from the other party for nontax purposes; "fishing expeditions" are not allowed.
- Possession and control: The parties may request information that is "possessed" or "controlled"² by a person in the other jurisdiction. For instance, a multinational group may outsource information processing to a third-party data center in Hong Kong. Although the data center may not legally "possess" (but might be considered to physically possess) or own the information, it may be deemed to control the information, at least during the period of time for processing. Under the TIEA, the US could request information on the multinational group from the data center if the information is relevant for US tax purposes.
- Information-gathering process: Upon a request from a party, the tax authorities in the other jurisdiction will provide information that is readily available; otherwise, the tax authorities will request the information from the relevant persons. In the context of FATCA implementation, for example, the US may request certain information from the IRD, such as the US tax identification number or the date of birth of the taxpayer in Hong Kong, if the US account holders of FFIs do not consent to the FFIs providing the details to the IRS. The IRD will have to obtain any requested information it does not already possess from the relevant persons and supply the information directly to the IRS within a specific period of time; if the information cannot be provided within that time period, the IRD should inform the US, as well as the FFIs involved, that there will be a delay. The IRD should then exchange the information as soon as possible.
- Notification to persons affected: Before disclosing any information in response to a request from the US, the IRD generally must notify the affected person; however, there are certain exceptions (for example, where the notification could undermine the chance of success of an investigation because the affected person may have the opportunity to destroy the relevant records relating to the transaction in question). If the affected person requests a copy of the information, that information must be provided within a reasonable time. If the person wishes to amend any of the information to be disclosed, he/she must notify the IRD in writing within 21 days, based on the following grounds:
 - The information, or part of the information, does not relate to the person; or
 - The information, or part of the information, is factually incorrect.

In the case of a request by the US to Hong Kong, if the IRD refuses to amend the information, the affected person may request the Financial Secretary to review the IRD's decision within 14 days.

- Denial of a request: An information exchange request may be denied in certain circumstances. These include situations where the information would disclose a trade, business, industrial, commercial or professional secret or trade process; where the information is covered by a legal professional privilege; or where disclosure of the information would be contrary to public policy (e.g. the information relates to a state secret).

² The IRO was amended in 2013 to expand the power of the IRD to obtain information from taxpayers that "control" as well as "possess" the information, to conform to the OECD model TIEA.

- Confidentiality: The confidentiality provisions of the TIEA take precedence over any domestic rules that may permit disclosure to a third party other than the tax authorities. For example, under the TIEA, information obtained by the IRS from the IRD may be used by the IRS only for US tax purposes. However, the protocol to the TIEA allows the information obtained by the IRS to be further disclosed to certain US entities that serve tax-related purposes, i.e. the Treasury Inspector General for Tax Administration and the congressional Government Accountability Office, which are responsible for auditing the IRS, and the Office of the Treasury Assistant Secretary for Tax Policy and the tax-writing committees in Congress, whose duties require inquiries into tax administration for planning tax law enactments and implementation and proposing tax law changes. Disclosure to a third jurisdiction is not allowed.
- Retroactive effect: Information that existed or was generated before the effective date of the TIEA may be exchanged if the information is foreseeably relevant for taxes imposed in periods that start after the TIEA came into effect (on 20 June 2014); otherwise, the TIEA does not have retroactive effect.
- No "tax examination abroad" provision: The TIEA generally follows the OECD model TIEA, except that the TIEA does not contain a "tax examination abroad" article. Under such an article, Country A can allow the officials of Country B to enter the jurisdiction to interview individuals and examine records or be present at tax examinations in Country A, with the written consent of the persons concerned in Country A. Since the TIEA does not contain this article, IRS officials cannot come to Hong Kong to interview individuals and examine records, and vice versa.
- Mutual Agreement Procedure (MAP): The TIEA contains a MAP article to resolve difficulties or questions arising from the implementation or interpretation of the TIEA. However, the article leaves it open for both parties to adopt and implement procedures to facilitate the implementation of the TIEA. This is different from the MAP mechanism in Hong Kong's DTAs that allows a taxpayer a specified period of time to petition to either tax authority if his/her tax affairs are not handled in accordance with the DTAs. The TIEA provision may lead to disputes, e.g. where an item of information is considered by a taxpayer to be a trade secret or legally privileged information, but the tax authorities do not agree. It should be noted that the grounds upon which a taxpayer may ask the tax authorities to amend the information to be exchanged (as mentioned above) do not include such a "difference in opinion."

Future trends

"Automatic" exchange of information seems to be becoming the next global standard, as evidenced by a statement of the G20 leaders (including China) on 6 September 2013:

"Calling on all other jurisdictions to join us by the earliest possible date, we are committed to automatic exchange of information as the new global standard, which must ensure confidentiality and the proper use of information exchanged, and we fully support the OECD work with G20 countries aimed at presenting such a single global standard for automatic exchange by February 2014 and to finalizing technical modalities of effective automatic exchange by mid-2014."

The G20 already has requested the Global Forum (of which Hong Kong is a member) to establish a mechanism to monitor and review the implementation of the new global standard on the automatic exchange of information, and has stressed the importance of developing countries being able to benefit from a more transparent international tax system.³ Going forward information will be exchanged automatically through the operation of DTAs, TIEAs or the multilateral convention on mutual administrative assistance in tax matters. Under the OECD model, the standard under the "automatic exchange" mechanism is known as the "Common Reporting Standard (CRS),"⁴ which operates similarly to FATCA, as follows:

- Reportable accounts are defined to include accounts held by individuals and entities (covering trusts and foundations), with a requirement to look through passive entities to report on the individuals that ultimately control these entities.
- The financial information to be reported for reportable accounts includes all types of investment income (covering dividends, interest, income from certain insurance contracts and other similar types of income), as well as account balances and sales proceeds from financial assets.
- The financial institutions that are required to report under the CRS include banks and custodians, as well as other financial institutions, such as brokers, certain collective investment vehicles and certain insurance companies.
- Due diligence procedures will be followed by financial institutions to identify reportable accounts.

³ Pascal Saint-Amans, the Director of the OECD, spoke about this topic in a seminar organized by the IRD in Hong Kong on 10 July 2014.

⁴ The Standard for Automatic Exchange of Financial Account Information in Tax Matters, introduced by OECD on 13 February 2014, was endorsed by G20 finance ministers on 23 February 2014. The full version of this global standard with detailed Model Competent Authority Agreement & CRS and the Commentaries thereon was released by the OECD on 21 July 2014.

Conclusion

In light of the new CRS standard, it is important to note that cross-border tax avoidance schemes involving financial accounts likely will become more transparent to the relevant tax authorities. Accordingly, TIEAs (and similar agreements), like the new TIEA between Hong Kong and the US, will become powerful tools at the disposal of the tax authorities in combating tax avoidance schemes. Contemporaneous documentation that supports the substance and business purpose of a tax planning arrangement has become even more important in this new environment.

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