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Evgeny Guglyuvatyy

© School of Taxation and Business Law (Atax), Australian School of Business
The University of New South Wales

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An Australia-Hong Kong double tax agreement: Assessing the costs and benefits

Nolan Cormac Sharkey and Kathrin Bain¹

1. INTRODUCTION

With Hong Kong recently embarking on the rapid establishment of a significant double tax agreement (DTA) network, the possibility that it may conclude a DTA with Australia needs to be seriously considered by taxpayers, professionals and academics. Thus far it is notable that no announcement has been made about treaty negotiations, despite the fact that Hong Kong has concluded many DTAs with countries that are *prima-facie* similar to Australia in terms of taxation and economic development. Hong Kong and Australia have a very large business and social relationship and if it is suggested that DTAs are important to cross border trade, investment and employment, then a DTA should be considered between Australia and Hong Kong.

This article examines how a DTA would impact taxation in Australia and Hong Kong. In doing this it raises reasons why a DTA may bring significant benefits and it indicates where a DTA may not be thought to be desirable by either of the two jurisdictions. In balancing these findings against the background information on tax and DTA policy in both jurisdictions, as well as their economic relationship, it may be possible for commentators to speculate on why a DTA between Australia and Hong Kong may or may not come into existence.

The very significance of the relationship between the two jurisdictions means that a DTA will have a major impact in terms of both benefits and revenue losses. This significance may be why a DTA may not be thought to be desirable to Australia or Hong Kong when it is thought to be desirable between Hong Kong and other jurisdictions. In addition to this assistance with speculation on future developments, this article should make a major contribution to any contemplation that the Australian or Hong Kong authorities are having about the desirability of a DTA. It is also highly relevant in showing how a DTA would impact tax practice in both jurisdictions and will be invaluable if an announcement is made that treaty negotiations have commenced between Australia and Hong Kong. Finally, in its finding that much of the benefit that a DTA would bring to taxation in both jurisdictions is associated with the

¹ Dr Nolan Cormac Sharkey and Kathrin Bain are respectively, a Senior Lecturer and Lecturer in the School of Taxation and Business Law (Atax), Australian School of Business, University of New South Wales, Australia. While this is a joint article, part two is acknowledged as primarily the work of Ms Bain while part three is primarily the work of Dr Sharkey.

relative certainty in DTA principles of revenue jurisdiction in comparison to those employed in Australia and Hong Kong, this article suggests that there is scope for reform of jurisdictional nexus rules in Australia and Hong Kong regardless of DTA completion.

Part 2 of this article sets the context of the question of a DTA between Australia and Hong Kong by reviewing the treaty policy of both jurisdictions as well as their tax systems and the relationship between them. Part 3 provides a detailed analysis of the impact a DTA would have on the tax claims of both Hong Kong and Australia. It finds that this impact is significant and should be carefully considered by both jurisdictions as to benefits it could bring as well as the revenue loss it may create.

2. BACKGROUND

Australia's history of DTAs dates back 65 years, with the first DTA being signed with the United Kingdom in 1946. In contrast, Hong Kong did not enter into any DTAs until 1998, and until recently, there was little expansion in Hong Kong's DTA network. Since 2010, there has been rapid expansion of Hong Kong's DTA network. As yet, no negotiations have been scheduled between Hong Kong and Australia, despite an indication by Hong Kong that they would like to enter into such negotiations.² This part will first compare Australia's and Hong Kong's tax systems, DTA history and policies, as well as discuss the potential usefulness of an Australia-Hong Kong DTA.

2.1 Comparison of Australian and Hong Kong tax systems

One of the relevant considerations before entering into a DTA is the similarity of tax systems. Despite the fact that both the Australian and Hong Kong tax systems were based on United Kingdom tax legislation, there are significant differences between them. The key differences are discussed below.

Australia uses a combination of both residence and source based taxation. Broadly speaking, Australian residents are taxable on their worldwide income, and non-residents are taxable on Australian sourced income.³ In contrast, Hong Kong uses a purely source based taxation system, with tax only being imposed on income that arises in or is derived from Hong Kong.⁴

The tax bases of both countries are significantly different, with Australia having a much broader tax base. Although income is not comprehensively defined in Australian tax law, it is a wide concept, including both amounts of income (for example, salaries, business profits, income derived from property) and capital.⁵ The income tax rates vary based on the type and residency of taxpayer and, for individuals,

² Linda Tsang, 'Tax agreement between Hong Kong and Australia – negotiations', *IBFD* (online), 24 June 2011 <www.ibfd.org>

³ *Income Tax Assessment Act 1997* (Cth) ss 6-5, 6-10.

⁴ Ayesha MacPherson and Garry Laird, *Hong Kong Taxation Law and Practice* (The Chinese University Press, 2010) 13. See *Inland Revenue Ordinance 1947* (HK) ss 5 (property tax), 8 (salaries tax), 14 (profits tax).

⁵ *Income Tax Assessment Act 1997* (Cth) Pts 3-1, 3-3. Australia's 'capital gains tax' (CGT) took effect from 20 September 1985. Rather than being a separate tax, a taxpayer's 'net capital gain' for the year is included in taxable income and taxed at normal income tax rates.

level of income. Companies are currently subject to a flat tax rate of 30 percent.⁶ Individuals are subject to progressive taxation, with tax rates for the 2010-11 year ranging from zero percent to 45 percent for residents, and from 29 percent to 45 percent for non-residents.⁷

In terms of income, Hong Kong essentially taxes only business profits, salaries and rent from real property. Profits Tax is imposed at a flat rate (for the 2010-11 year) of either 16.5 percent (for corporations) or 15 percent (non-corporate taxpayers).⁸ Salaries Tax is a progressive tax, with rates for the 2010-11 year ranging from 2 percent to 17 percent. The total tax payable is not to exceed a rate of 15 percent. Property Tax imposed under Hong Kong's *Inland Revenue Ordinance* is a flat rate of tax (15 percent for the 2010-11 year) on the net assessable value of property.⁹ There is no capital gains tax in Hong Kong.¹⁰

Hong Kong does not tax dividends. Under s 26(a) of the *Inland Revenue Ordinance*, dividends from corporations that are subject to Profits Tax are specifically excluded from assessable profits. Although the wording of this exemption may imply that dividends paid by a corporation that has not been subject to Profits Tax will not be excluded under s 26(a), the Hong Kong Inland Revenue Department treats all dividends as non-assessable.¹¹ Interest derived from bank deposits, most Government Bonds and various debt instruments are also excluded from Hong Kong taxation.¹²

Australia's treatment of dividends is rather unique and worthy of discussion. Under the classical system of taxation, company profits are taxed at the company level. When the profits are distributed to shareholders in the form of dividends, the dividends are also taxed. This effectively results in economic double taxation – with the same amount of income being taxed twice, albeit in the hands of different taxpayers. In 1987, Australia introduced what is known as an imputation system¹³ in an attempt to eliminate the effect of double taxation. Under this system, tax paid by a company can be attributed ('imputed') to shareholders. When a company pays a dividend out of profits on which tax has already been paid, they can attach a 'franking credit' to the dividend (a dividend with a franking credit attached is a 'franked dividend'). The franking credit reflects the tax that has been paid by the company. If a dividend is paid from profits which have not been subject to tax at the company level (or the company decides not to attach franking credits to the dividend), it is known as an unfranked dividend. When a resident shareholder receives a franked dividend, they are required to include both the dividend received and the franking credit in assessable income. However, this franking credit then becomes a tax offset, which reduces the

⁶ *Income Tax Rates Act 1986* (Cth) s 12(1), Sch 7 Pt 1.

⁷ *Income Tax Rates Act 1986* (Cth), s 23(2). Most Australian resident individuals are also subject to an additional 1.5 percent tax (the Medicare Levy) to help fund Australia's public healthcare scheme. See *Medicare Levy Act 1986* (Cth).

⁸ *Inland Revenue Ordinance 1947* (HK) Schs 2, 8.

⁹ *Inland Revenue Ordinance 1947* (HK) s 5, Sch 2.

¹⁰ *Inland Revenue Ordinance 1947* (HK) s 14. See also MacPherson and Laird, above n 4, 275-276.

¹¹ MacPherson and Laird, above n 4, 277.

¹² *Inland Revenue Ordinance 1947* (HK) s 26A.

¹³ *Income Tax Assessment Act 1997* (Cth) Pt 3-6.

shareholder's tax liability. When the taxpayer is a resident individual, any excess franking credits are refunded.¹⁴

When a dividend is paid to a non-resident, withholding tax would normally be imposed, at either the rate specified in the relevant DTA or 30 percent in the absence of a DTA.¹⁵ However, franked dividends are exempt from withholding tax under s 128B(3)(ga)¹⁶ (despite the fact that Australia may have taxing rights to the dividends under DTAs). Non-resident shareholders are not entitled to use franking credits to reduce their tax liability, but the franking credit essentially operates as the final tax on the dividend.

Withholding tax is also payable on interest and royalties payable to non-residents at the rate of 10 percent¹⁷ and 30 percent¹⁸ respectively, unless a DTA imposes a lower rate.

In light of these differences, it is not surprising that Australia has a higher proportion of tax revenue (compared to gross domestic product) than Hong Kong. In Australia, total tax revenue as a proportion of GDP was approximately 26 percent in the 2009-10 financial year.¹⁹ Although this is lower than the 2010 OECD average of 34 percent,²⁰ it is still significantly higher than Hong Kong, where in 2010 tax revenue as a proportion of GDP was only 13 percent.²¹

2.2 Australia's DTA network

2.2.1 History of Australia's DTAs

Australia is currently a party to 44 comprehensive DTAs (of which 26 are with OECD member countries) and an additional three that only relate to the taxation of individuals. Australia's DTAs are incorporated into domestic law through the *International Tax Agreements Act 1953* (Cth). With the exception of general anti-avoidance provisions, in the event of an inconsistency between a DTA and Australia's Income Tax Assessment Acts, the DTA will prevail.²²

Australia entered its first DTA with the UK in 1946 (coming into force in 1947). At the time the DTA was entered into, Australia was a self-governing Dominion of the British Commonwealth. The UK was the main source of foreign investment in Australia as well as Australia's main trading partner. Concern over the impact that double taxation would have on UK investment in Australia after World War II, as well

¹⁴ Excess franking credits for company shareholders are converted to carry forward tax losses: *Income Tax Assessment Act 1997* (Cth) s 36-55.

¹⁵ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(a).

¹⁶ *Income Tax Assessment Act 1936* (Cth).

¹⁷ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(b).

¹⁸ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(c).

¹⁹ Australian Bureau of Statistics, *Taxation Revenue as a Proportion of Gross Domestic Product (GDP)* (11 April 2011) Taxation Revenue Australia 2009-10

< <http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5506.0Main%20Features52009-10?opendocument&tabname=Summary&prodno=5506.0&issue=2009-10&num=&view=>>.

²⁰ OECD, *Tax Revenues Stabilise in OECD Countries in 2010* (29 November 2011) OECD <http://www.oecd.org/document/18/0,3746,en_21571361_44315115_49102162_1_1_1_1,00.html>.

²¹ The Heritage Foundation, *2011 Index of Economic Freedom – Hong Kong* (2011) <<http://www.heritage.org/index/Country/HongKong>>.

²² *International Tax Agreements Act 1953* (Cth) s 4.

as the UK signing its first DTA with the United States (US) in 1945, led to a formal offer by the Secretary of State for the Dominions to each of the Dominions to enter into a DTA similar to that negotiated with the United States.²³ Taylor noted that “the negotiation of the treaty with Australia proved to be the most difficult of all the treaty negotiations that the United Kingdom had with the Dominions at this time”,²⁴ largely due to the differences between the Australian and UK tax systems. Post 1946, Australia’s DTA network was slow to develop. When Australia became a member of the OECD some 25 years later (in 1971), only an additional five DTAs had been entered into: the US (1953), Canada (1957), New Zealand (1960), Singapore (1969) and Japan (1969).

The US first offered to enter into a DTA with Australia in 1947, but Australian concerns over the potential loss of revenue, and a belief that benefits under the DTA would flow to the US Treasury rather than US investors, meant that a DTA was not signed until 1953. From Australia’s point of view, entry into the DTA was partly motivated by a desire to maintain good relations with the US following World War II, as well as the potential to obtain a loan from the US government.²⁵ As a result of the negotiation of the Australia-US DTA, enquiries were made by Canada as to whether Australia would enter into DTA negotiations. Although Australia was once again concerned with the potential loss of revenue, it was thought that a DTA would improve relations with Canada and help encourage Canadian investment. Additionally, political considerations were also in play, that is, there was concern how it would look politically if Australia refused to negotiate a treaty with Canada considering one had already been entered into with the US.²⁶

Australia’s close proximity to New Zealand has meant that the two countries have always had a strong economic and trade relationship. It may therefore be of surprise that a DTA was not concluded between the two countries until 1960. Although discussions regarding double taxation between the two countries began in 1947, a satisfactory agreement was unable to be concluded at that time due to differences in tax systems.²⁷

Prior to Australia entering the OECD in 1971, two further agreements were entered into with Singapore and Japan (both signed in 1969). Although at the time regarded as a ‘developing country’, Australia had had a strong connection with Singapore for many years. For example, the establishment of an Australian representative office in Singapore in 1941 represented one of Australia’s first foreign posts.²⁸ Australia’s DTA with Japan was signed approximately one month after the signing of the Australia-Singapore DTA, although negotiations had commenced with Japan prior to negotiations with Singapore. Japan represented an important country in terms of

²³ John Taylor, ‘The History of Double Tax Conventions – Australia’ (Paper presented at The History of Double Taxation Conventions Conference, Rust Austria, 3-5 July 2008) 3-4 <<http://www2.wu-wien.ac.at/taxlaw/events/Conferencepapers/Rust2008/NRRust2008AustraliaTaylor.pdf>>.

²⁴ Ibid 4.

²⁵ Ibid 10-11.

²⁶ Ibid 14.

²⁷ Ibid 16. See also New Zealand, *Report Of The Taxation Committee* (Wellington, 1951) 97.

²⁸ Gareth Evans, ‘Australia’s Relations with Singapore’ (Speech delivered at the Singapore Australian Business Council and Foreign Correspondents’ Club, Singapore, 27 October 1988). <http://www.gevans.org/speeches/old/1988/271288_fm_australias_singapore.pdf>

Australian trade, and there was concern that failure to sign a DTA would be viewed by Japan as a discriminatory action.²⁹

It is apparent that Australia joining the OECD in July 1971 had an effect on the countries with which Australia negotiated DTAs. In the fifteen years following Australia joining the OECD, 16 DTAs were entered into, 12 of which were with existing OECD members: Germany (1972), France (1976), Netherlands (1976), Belgium (1977), the Philippines (1979), Switzerland (1980), Denmark (1981), Sweden (1981), Italy (1982), Korea (1982), Malaysia (1980), Norway (1982), Ireland (1983), Malta (1984), Finland (1984) and Austria (1986).

In the latter half of the 1980s and the 1990s, Australia's focus shifted to signing DTAs with its Asia-Pacific neighbours. Between 1988 and 1996, 10 DTAs were signed with Asia-Pacific countries: China (1988), Papua New Guinea (1989), Sri Lanka (1989), Thailand (1989), Fiji (1990), India (1991), Kiribati (1991), Indonesia (1992), Vietnam (1992) and Taipei (1996). Also in the 1990s, Australia entered into DTAs with emerging economies in Eastern Europe: Hungary (1990), Poland (1991), Spain (1992), the Czech Republic (1995), Slovakia (1999), Romania (2000) and Russia (2000). It has been suggested by Taylor that it is likely that Australia had not entered into DTAs with these European countries earlier due to political and economic factors that existed whilst the countries were under a communist regime.³⁰ Political factors also influenced Australia's refusal to enter into DTA negotiations with South Africa while the apartheid policy existed,³¹ although an Australia-South Africa DTA was signed in 1999. In the same year, a DTA was also signed with Argentina.

From 2001 onwards, there has been little expansion of Australia's DTA network, with a focus instead of revising existing DTAs. Since 2001, only three new comprehensive DTAs have been entered into: Mexico (2002), Chile (2010) and Turkey (2010). Three additional DTAs that only relate to the taxation of individuals were also been signed during this period: the British Virgin Islands (2008), the Isle of Man (2008) and Jersey (2009).

Australia's early DTA history demonstrates that a number of factors are relevant when examining countries with which Australia should start DTA negotiations. One of the first factors to consider is the extent of double taxation that is occurring between the two countries, with a DTA unlikely to be considered important unless double taxation is occurring on a large scale. If the extent of double taxation is considered an impediment to cross-border relations, consideration needs to be given to how a DTA will help prevent this, and what will be the associated impact on taxation revenue. This will be the focus of Part 3 of this article. Outside the tax spectrum, political considerations also come into play.

2.2.2 Australia's DTA policy

There are a number of model DTAs in existence, with the two most well known being the OECD Model Tax Convention on Income and Capital (OECD Model) and the United Nations Model Double Tax Convention between Developed and Developing

²⁹ Taylor, above n 23, 32.

³⁰ Taylor, above n 23, 40.

³¹ Taylor, above n 23, 30.

Countries (UN Model). It is well accepted that the OECD Model, which grants greater taxing rights to the country of residence, is better suited for developed (capital exporting) countries.³² In response to this, the UN Model was developed as a more suitable model for developing (capital importing) countries – with a greater emphasis on source based taxation.

Australia generally follows the OECD Model with some modifications. This is not surprising considering that all but six of Australia's DTAs were entered into after Australia joined the OECD in 1971. Of those six DTAs that were entered into prior to 1971, all but one have been subsequently replaced by new DTAs. The original Singapore DTA is still in force, but it has been amended by protocol. Further, the majority of Australia's DTAs are with OECD members. However, it was noted in both the 1999 Review of Business Taxation³³ and the 2003 Review of International Taxation Arrangements that Australia's DTAs placed a greater emphasis on source based taxation than the OECD Model.³⁴ Examples of this include Australia's DTAs including a broad definition of permanent establishment (PE) and relatively high withholding tax rates.³⁵ In terms of royalties, the OECD Model does not grant any taxing rights to the country of source.³⁶ Australia has expressed a reservation to this article, and follows the UN Model³⁷ in the sense that in all Australian DTAs, the source country is given taxing rights over royalties (although limited to the amount specified in the treaty).

The Ralph Review highlighted the greater emphasis on source based taxation in Australia's DTAs was due to its traditional position as a net capital importer. In the early 1980s (when Australia's tax treaty network first started significantly expanding), Australian investment abroad was between 10 and 20 percent of the level of foreign investment in Australia.³⁸ However, in the 10 year period from 2001 to 2010, Australia's foreign investment abroad has consistently been approximately 60 percent of the amount of foreign investment in Australia.³⁹ The Review of International Taxation Arrangements expressed concerns that an emphasis on source taxation in DTAs would have a detrimental impact on Australian companies investing offshore.⁴⁰ In the more recent International Comparison of Australia's Taxes (released in 2006), it was stated that a key focus of Australia's international tax arrangements was to ensure that cross-border investment was encouraged.⁴¹

³² Bart Kusters, 'The United Nations Model Tax Convention and its Recent Developments' (2004) January/February *Asia-Pacific Tax Bulletin* 4, 4.

³³ Colloquially known as the Ralph Review or Ralph Report.

³⁴ Review of Business Taxation, *A Tax System Redesigned – More Certain, Equitable and Durable* (Commonwealth of Australia, Canberra, 1999) Recommendation 22.24.

³⁵ The Board of Taxation, *International Taxation – A Report to the Treasurer* (Commonwealth of Australia, Canberra, 2003) 89.

³⁶ OECD, *Model Tax Convention on Income and Capital*, Article 12.

³⁷ UN, *Model Double Tax Convention between Developed and Developing Countries*, Article 12.

³⁸ Review of Business Taxation, above n 34, Recommendation 22.24.

³⁹ Sourced from the Australian Bureau of Statistics, *International Investment Position, Australia: Supplementary Statistics, Calendar year 2009* (9 June 2011) Australian Bureau of Statistics <<http://abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5352.0Calendar%20year%202009?OpenDocument>>.

⁴⁰ The Board of Taxation, above n 35, 90.

⁴¹ Dick Warburton and Peter Hendy, *International Comparison of Australia's Taxes* (Commonwealth of Australia, Canberra, 2006) 302.

Australia does not have a clearly published DTA negotiation policy, with the Review of International Tax Arrangements stating:

*Like many other contracts entered into by governments, DTAs are negotiated largely in secret. To some extent, this is changing: in Australia in recent years the negotiation process has been partly opened to consultation, through the ATO's Tax Treaties Advisory Panel and direct dealing with specific taxpayers on particular issues. But the balance is still very much on the side of secrecy.*⁴²

In January 2008, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the government was seeking public comment and submissions on Australia's future DTA negotiation program and policy. The announcement included a summary of the main features of Australia's recent tax treaty practice, including the fact that although Australia broadly follows the OECD Model, it would be modified to ensure that Australia retained taxing rights over natural resources. In terms of withholding tax rates, these would generally be limited to five percent for inter-corporate non-portfolio dividends, 15 percent for other dividends, 10 percent for interest and five percent for royalties.⁴³

As part of the process of seeking public input, the government was particularly interested in submissions indicating countries that Australia should seek to negotiate or update a DTA. In this regard, the Review of International Tax Arrangements had indicated that updating DTAs with Australia's major trading partners was more important than entering into new DTAs with countries with which Australia has only low levels of trade or investment.⁴⁴ The current levels of trade and investment between Australia and Hong Kong will thus be examined in Section 2.4 of this article.

2.3 Hong Kong DTA network

Due to Hong Kong's source-based taxation system, double taxation is less of an issue than in a country such as Australia that utilises concepts of both residency and source. However, the Hong Kong Inland Revenue Department has stated:

Notwithstanding this, the Hong Kong Special Administrative Region Government (HKSARG) recognises that there are merits in concluding DTAs with our trading partners. A DTA provides certainty to investors on the taxing rights of the contracting parties; helps investors to better assess their potential tax liabilities on economic activities; and provides an added incentive for overseas companies to do business in Hong Kong, and likewise, for Hong Kong companies to do business overseas. Therefore, it has been the policy of the HKSARG to establish a DTA network that would minimise exposure of Hong Kong residents and residents of the DTA partner to double taxation. We have

⁴² The Board of Taxation, above n 35, 90.

⁴³ Chris Bowen (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), 'Australia's Tax Treaty Negotiation Policy' (Press Release, No. 004, 25 January 2008) <<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/004.htm&pageID=003&min=ceb>>.

⁴⁴ The Board of Taxation, above n 35, 91.

*actively engaged our trading partners in negotiating a comprehensive DTA (covering various types of income) with us.*⁴⁵

Hong Kong entered into its first DTA with China in 1998.⁴⁶ Following this first treaty, Hong Kong's DTA network was very slow to develop. No further DTAs were signed until December 2003, when a DTA was signed with Belgium. From that point until 2009, only three new DTAs were signed: Thailand (2005), Luxembourg (2007) and Vietnam (2008).

The main reason for the slow development of a DTA network was the inability of Hong Kong to meet the OECD Model Exchange of Information article due to their domestic tax legislation. Hong Kong's early DTAs contained a phrase under the Exchange of Information Article that read: "Information received shall not be disclosed to any third jurisdiction for any purpose without the consent of the Contracting Party originally furnishing the information". This was inconsistent with the OECD Model Convention,⁴⁷ and significantly restricted Hong Kong's ability to successfully negotiate DTAs.

Hong Kong's Financial Secretary announced in the February 2009 Budget Speech that legislation would be introduced to allow Hong Kong to negotiate DTAs that included the OECD Exchange of Information Article. Specifically, he stated:

*In recent years, our major trading partners have raised the requirements on the exchange of tax information under such agreements. Our existing legislation has not kept pace with this development. To further extend our network of such agreements, we consulted the industry in mid-2008 on liberalising the arrangements for the exchange of tax information. I believe that the business and professional community generally agrees that Hong Kong should align its arrangements for the exchange of tax information with international standards so that we can enter into such agreements with more economies. We plan to put forward relevant legislative proposals by the middle of this year.*⁴⁸

Amendments to the *Inland Revenue Ordinance* came into effect in March 2010 as a result of the *Inland Revenue (Amendment) (No. 3) Bill 2009*. The amendments allow Hong Kong's Inland Revenue Department to collect and provide information in any matter that may affect any liability, responsibility or obligation of any person under the laws of a country outside of Hong Kong concerning the tax of that outside country. The amendments also extend the power of the Commissioner of Inland Revenue to issue search warrants for the purposes of collecting such information, and make it an offence for a taxpayer to give false information in relation to tax matters outside of Hong Kong. (These amendments only apply to countries with which Hong Kong has

⁴⁵ Inland Revenue Department, *Policies: Double Taxation* (3 May 2011) Inland Revenue Department <<http://www.ird.gov.hk/eng/pol/dta.htm>>.

⁴⁶ It is well established that although Hong Kong is a Special Administrative Region of China, they operate two separate tax systems. See for example: *The Basic Law of Hong Kong Special Administrative Region of the People's Republic of China 1990* (HK), Australian Taxation Office *Taxation Ruling TR 97/19* 'Income tax: tax implications of resumption of Chinese sovereignty over Hong Kong'.

⁴⁷ OECD, *Model Tax Convention on Income and Capital*, Article 26.

⁴⁸ John Tsang, 'Budget Speech by the Financial Secretary' (Speech delivered to the Legislative Council, Hong Kong, 25 February 2009) <<http://www.info.gov.hk/gia/general/200902/25/P200902250108.htm>>.

entered into a DTA).⁴⁹ In order to protect taxpayer privacy, the *Inland Revenue (Disclosure of Information) Rules* came into effect at the same time as the amending legislation that sets out the IRD's practice for dealing with exchange of information requests, procedures to be followed, and safeguards available to taxpayers.

In regards to the amending legislation, the Commissioner of Inland Revenue, Chu Yam-Yuen, stated that "Hong Kong has entered a new phase in supporting the international effort to enhance tax transparency". The Commissioner further stated "Our target is to sign the new comprehensive agreement with all our trade partners. Our policy is not only to focus on exchange of information but we strive to negotiate the best deals for our taxpayers."⁵⁰

Since the legislation came into effect, Hong Kong's DTA network has expanded drastically. In 2010, DTAs were signed with 12 countries, all of which are now in force: Austria, Brunei, France, Hungary, Indonesia, Ireland, Japan, Kuwait, Liechtenstein, the Netherlands, New Zealand and the United Kingdom. A further five DTAs were signed in 2011, although as of December 2011 are not yet in force: Czech Republic, Malta, Portugal, Spain and Switzerland. In addition, Hong Kong is currently negotiating tax treaties with an additional 12 countries: Bangladesh, Canada, Finland, India, Italy, Jersey, Korea, Macao (Special Administrative Region), Malaysia, Mexico, Saudi Arabia, and the United Arab Emirates.

No negotiations are currently scheduled between Australia and Hong Kong. However, in a press release on 23 June 2011, the Hong Kong Government expressed interest in negotiating a DTA with Australia.⁵¹ As at December 2011, there has been no public response made by the Australian government.

From Hong Kong's perspective, the expanded DTA network is expected to increase their competitiveness against other Asian countries such as Singapore (which as of 1 December 2011, was a party to 68 in force comprehensive DTAs, with an additional 10 signed but not yet ratified).⁵² However, differences in tax regimes (such as difficulties in defining 'resident') would pose challenges. It will be demonstrated in Part 3 of this article that the impact of an Australia-Hong Kong DTA will be significantly different for both countries, due in large part to the differences in existing tax systems.

2.4 Australian-Hong Kong relationship

Australia's current DTA focus is on updating current DTAs with major trading partners before focusing on entering into DTAs with minor trading partners. Hong Kong has expressed a desire to enter into DTAs with all trading partners. Thus, before moving to the technical analysis in Part 3 which examines the impact that an Australia-Hong Kong DTA would have on each country's tax system (and associated

⁴⁹ *Inland Revenue Ordinance 1947* (HK) ss 51(4AA), 51B(1AA), 80(2D).

⁵⁰ Hong Kong Economic and Trade Office in Washington D.C., *Hong Kong Enters New Phase of Tax Policy* (April 2010) Hong Kong Circle: Hong Kong Economic and Trade Office in Washington D.C. Newsletter

<http://www.hketowashington.gov.hk/dc/circle/circle10/Mar-Apr_2010/Articles/article04.htm>.

⁵¹ Tsang, above n 2.

⁵² See Inland Revenue Authority of Singapore, *Tax Treaties* (15 December 2011) <<http://iras.gov.sg/irasHome/page.aspx?id=812>>.

impact on tax revenue), it is relevant to examine the current levels of trade between Australia and Hong Kong.

In a 2008 speech entitled “The Australia Hong Kong Connection”, Stephen Smith (the then Australian Minister for Foreign Affairs and Trade) highlighted the relationship between the two countries, stating: “Australia and Hong Kong have long shared a special relationship in Asia, underpinned by strong people-to-people links and a highly complementary trading and investment partnership. As one of the world’s freest economies, Hong Kong plays a significant role in this region’s, and Australia’s, prosperity”.⁵³ At the time the speech was given, Hong Kong represented Australia’s second largest expatriate community.⁵⁴ Further, in the same year (2008), Hong Kong was Australia’s fourth largest source of foreign investment.⁵⁵ In terms of trade, Hong Kong was Australia’s 20th largest trading partner, 15th largest export market and 27th largest source of imports.⁵⁶

More recent figures are available from Hong Kong’s perspective. In 2010, Australia was Hong Kong’s 17th largest trading partner, 13th largest domestic export market, 11th largest re-export market, and the 21st largest source of imports. In terms of bilateral investment, in 2009 Australia was the 16th largest source of inward direct investment into Hong Kong, and the 10th major destination of outward direct investment from Hong Kong.⁵⁷ More detailed figures regarding the amount of trade and investment between Hong Kong and Australia (from Hong Kong’s perspective) is shown in the table below.

Table 1: Hong Kong’s trade and investment with Australia⁵⁸

Type of trade / investment	Amount (\$HK million)	Year
Domestic Exports (HK into AU)	1,148	2010
Re-exports (HK into AU)	36,926	2010
Total Exports (HK into AU)	38,074	2010
Total Imports (AU into HK)	16,064	2010
Total Trade	54,138	2010
Inward Direct Investment (AU into HK)	19,100	2009
Outward Direct Investment (HK into AU)	34,100	2009

⁵³ Stephen Smith (Australian Minister for Foreign Affairs and Trade), ‘The Australia Hong Kong Connection’ (Speech delivered at the Australian Chamber of Commerce, Hong Kong and Macau, 6 May 2008) <http://www.foreignminister.gov.au/speeches/2008/080506_austcham_hong_kong.html>.

⁵⁴ Ibid.

⁵⁵ Department of Parliamentary Services, *Foreign Investment in Australia: Recent Developments* (1 April 2011) Parliament of Australia <<http://www.aph.gov.au/library/pubs/bn/eco/AustForeignInvestment.pdf>>.

⁵⁶ Hong Kong Regional Cooperation Division, Trade and Industry Department, *Hong Kong Australia Trade Relations* (April 2011) Hong Kong Economic and Trade Office Sydney <<http://www.hketosydney.gov.hk/hkaustraderel.php>>.

⁵⁷ Ibid.

⁵⁸ Sourced from Hong Kong Regional Cooperation Division, Trade and Industry Department, above n 56.

By way of comparison, it is noted that Hong Kong and New Zealand signed a tax treaty in December 2010, which entered into force in November 2011. On the one hand, the existence of a Hong Kong-New Zealand DTA may be considered irrelevant from Australia's point of view. On the other hand, the discussion of Australia's DTA history in Section 2.2.1 indicates that the DTA networks of close neighbouring countries may be considered relevant when deciding whether to enter into DTA negotiations. In this vein, Australia has consistently maintained a wider DTA network than New Zealand. Taking into account the Hong Kong-New Zealand DTA, New Zealand currently has 37 comprehensive tax treaties (compared to Australia's 44). In addition, of New Zealand's 37 treaties, all bar two are with countries that also have a DTA with Australia – the exceptions being DTAs with the United Arab Emirates (signed in 2003 and entered into force in 2004), and now Hong Kong.⁵⁹

When the Hong Kong-New Zealand came into force in November 2011, the New Zealand Minister of Revenue, Peter Dunne, stated: "It will further strengthen New Zealand's significant international cross-border trade and investment partnerships for the benefit of businesses, investors and taxpayers in both countries". It was also noted that New Zealand and Hong Kong have a significant trade and investment relationship, with Hong Kong being New Zealand's 12th largest export market and sixth largest source of foreign investment.⁶⁰

From Hong Kong's perspective, Australia is a more significant investment and trading partner than New Zealand. In terms of bilateral investment, by the end of 2009, New Zealand was the 28th largest source of foreign direct investment into Hong Kong (whereas Australia was the 16th largest source, as noted above). New Zealand was not a major destination of outward direct investment from Hong Kong.⁶¹ In terms of trade, a comparison of Hong Kong's trade with Australia and New Zealand for 2010 is detailed in Table 2 below.

Table 2: Hong Kong's Trade - Australia and New Zealand comparison⁶²

	AU (HK\$ million)	Size of market	NZ (HK\$ million)	Size of market
Domestic Exports	1,148	13 th largest	115	27 th largest
Re-exports	36,926	11 th largest	3,093	41 st largest
Total Exports	38,074		3,830	
Total Imports	16,064	21 st largest	3,574	26 th largest
Total Trade	54,138	17 th largest	6,527	40 th largest

⁵⁹ Inland Revenue New Zealand, *Tax Treaties* (December 2011) Inland Revenue New Zealand Policy Advice Division <<http://taxpolicy.ird.govt.nz/tax-treaties>>.

⁶⁰ Inland Revenue New Zealand, *NZ-Hong Kong DTA in Force* (10 November 2011) Inland Revenue New Zealand Policy Advice Division <<http://taxpolicy.ird.govt.nz/news/2011-11-10-nz-hong-kong-dta-force>>.

⁶¹ Hong Kong Regional Cooperation Division, Trade and Industry Department, *Hong Kong New Zealand Trade Relations* (March 2011) Hong Kong Economic and Trade Office Sydney <<http://www.hketosydney.gov.hk/hknztraderel.php>>.

⁶² Sourced from Hong Kong Regional Cooperation Division, Trade and Industry Department, above n 56 and n 61.

The significance of trading relationship that currently exists between Australia and Hong Kong lends support to the argument that Australia should consider entering into DTA negotiations. As cross-border trade and investment increases, so too does the potential for double taxation. However, the strength of the existing relationship is just one factor that is relevant in determining whether a DTA should be entered into between Australia and Hong Kong. Also of relevance is the impact a DTA would have on each country's tax system and associated effect on taxation revenue, the focus of Part 3 of this article.

3. IMPACT OF A DTA ON AUSTRALIAN AND HONG KONG TAX OUTCOMES

Part 3 provides an analysis of how the signing of a DTA by Australia and Hong Kong would impact tax outcomes in both jurisdictions. As discussed in Part 2, there may be various reasons why two jurisdictions would conclude a DTA that go beyond altering technical tax outcomes. A treaty may simply be viewed as symbolic of the two jurisdictions willingness to bind themselves in respect of their taxing jurisdictions and therefore show that they have a good cooperative relationship. There may also be taxation related reasons that don't actually impact the manner in which the taxes operate. These would include using the DTA to allow cooperation between revenue and other government authorities. However, ultimately DTAs are meant to prevent double taxation and share revenue jurisdiction between two countries. It would be expected that a DTA would only be needed when it actually makes a material difference to taxation outcomes. The question that arises is what difference to tax outcomes would a DTA between Hong Kong and Australia make? If these are negligible, a DTA may not be considered necessary. On the other hand, if the differences are material, then Australia and Hong Kong would need to consider such differences and whether they are desirable or undesirable in how they impact both taxpayers and the revenue claims of the countries themselves.

On the face of it, it may be expected that given Hong Kong's limited source based tax jurisdiction, the signing of a DTA would make little difference to tax outcomes. In Australia as well, the tax claim against non-residents is generally consistent with that allowed under DTA principles. However, detailed analysis of how the tax laws of the two jurisdictions operate and how DTAs operate to shape tax laws often reveals unexpected outcomes. Therefore it is necessary to conduct a thorough and detailed analysis of the tax claims that both Australia and Hong Kong make under domestic laws and the manner in which DTAs operate. The following analysis does this by considering the major categories of income dealt with by DTAs in turn as well as the critical areas of residence. As DTAs all differ, the nature of any future DTA between Australia and Hong Kong is anticipated by the developing practice of Hong Kong and Australia. Reference has been made to recent DTAs of both jurisdictions as well as international models. As will be demonstrated, a DTA between Australia and Hong Kong would have a significant impact on both jurisdictions. As such, both countries should carefully consider the benefits it may bring against the potential loss of revenue.

3.1 Residency

3.1.1 Residence of individuals

Prior to Australia's introduction of a temporary resident regime in 2006, a DTA between Australia and Hong Kong would have made a very significant impact on the

Australian taxation of Hong Kong people who came to Australia for relatively short periods of time. This is because Australia's multiple tests of residency for tax purposes and the way they have been administered are very wide and verge on the aggressive. For example, based on TR 98/17,⁶³ a person who spends very little time in Australia may be regarded as a resident for tax purposes if they are working in Australia. Given the very significant numbers of people from Hong Kong who come to Australia for a variety of work, study and leisure activities, this approach would certainly have been a concern in that they may have been drawn into Australia's worldwide tax jurisdiction upon becoming residents. For example, a Hong Kong professional with significant offshore wealth may have been deeply concerned that by taking a short term work position in Australia, they may have ended up with a large tax liability on their worldwide income. Also, the common law concepts used to determine tax residency in Australia are inherently flexible and can be difficult to anticipate with precision. This uncertainty itself would be a concern for such a visitor from Hong Kong.

A DTA would resolve this uncertainty by providing a tie-breaker test that would allocate most of these short term residents to Hong Kong (assuming they are Hong Kong residents generally). This is because when such a person is found to be an Australian resident and thereby a dual resident, the tie breaker would focus on their permanent home, centre of vital interests, habitual abode, and right of abode or nationality (in order) to determine which jurisdiction they would be allocated to for DTA purposes.⁶⁴ Given their established connections to Hong Kong, this would likely see them classified as residents of Hong Kong for DTA purposes and prevent Australia's taxation of their income that doesn't have the necessary connection to Australia.⁶⁵

The introduction of the temporary residence regime has reduced the impact a DTA would have in this area in that this regime generally ensures that a resident who is a temporary resident is not taxed on their foreign source income that is not part of their Australian employment income.⁶⁶ A temporary resident is generally tax resident who does not hold a permanent visa or citizenship and does not have an Australian spouse.⁶⁷ This ensures that many expatriate workers from Hong Kong would now not be taxed on their offshore income despite being tax residents of Australia. The DTA would still be of benefit to those who earn part of their employment income offshore in relation to their Australian employment, as temporary residents would still be taxed on such income. In contrast, under a DTA, such income would be excluded for Hong Kong residents as it is not derived from services rendered in Australia. This can be seen in the analysis in Section 3.2.1 on employment income below.

Finally, it should be noted that the uncertainty inherent in Australia's residency tests remains a major concern for many Hong Kong people despite the temporary residence regime. For these people, the certainty that a DTA would create and the reduction in Australian tax that a DTA would create (as outlined above) would be very beneficial.

⁶³ Australian Taxation Office *Taxation Ruling TR 98/17* 'Income tax: residency status of individuals entering Australia'.

⁶⁴ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(2). This treaty will be used as a general model for comments made in this analysis given its recent nature and inclusion of Hong Kong.

⁶⁵ The impact of Australian taxation on various categories of income is discussed below under the relevant headings.

⁶⁶ *Income Tax Assessment Act 1997* (Cth), s 768-910.

⁶⁷ *Income Tax Assessment Act 1997* (Cth), s 995-1.

The reason that Australia's residence rules are such a difficult area in relation to Hong Kong people is that the patterns of residence that Hong Kong people have in relation to Australia are complex and unanticipated by traditional concepts of residence. As noted above, many people from Hong Kong come and go from Australia regularly. In addition, many live their lives between the two jurisdictions with assets, work and family spread between the jurisdictions. An example of this is the well documented astronaut migration phenomenon⁶⁸ whereby one member of a couple works in Hong Kong most of the time but has a dependent spouse and children in Australia. Given the complex matrix of factors that can lead to residence of Australia, the residency status of such persons is inherently uncertain.⁶⁹ In addition many of them would have a permanent visa or would have a spouse with a permanent visa making temporary residence inapplicable to them. For this significant group of persons, a DTA would make a major improvement to their taxation status in Australia by providing certainty and also by reducing their tax liabilities.

A DTA would also have a major impact in relation to Australian people spending significant periods of time in Hong Kong. Under Australian law, an Australian is likely to remain domiciled in Australia and for this reason can only escape Australian tax residence if they can demonstrate that they have established a permanent home outside of Australia.⁷⁰ This is unlikely to be the case unless they have made a commitment to live in Hong Kong for a long period of time.⁷¹ Administratively this would usually require at least two years away from Australia and based in Hong Kong.⁷² Even if this period of time away is reached, Australian law may find that they remain a resident of Australia on a different basis such as regular return visits to Australia⁷³ and the existence of close family members in Australia.⁷⁴ For these reasons, the very significant group of expatriate Australians working in Hong Kong (as was demonstrated in Section 2.4) may have difficulty in escaping Australian tax residence. Again, even if they think they may have, they will not be able to be certain due to the uncertainty in the residence tests. Previously many workers may not have been concerned with this continued Australian tax residence due to the foreign service exemption that was available under s 23AG.⁷⁵ However, since this exemption was significantly restricted with effect from 1 July 2009,⁷⁶ this issue is likely to be of significant concern.

A DTA would make a major change to the taxation of these people. Hong Kong's DTAs to date are interesting in that they create a concept of residence of Hong Kong despite the fact that Hong Kong does not generally adopt residency as a concept relevant to its taxation laws. The tests that have been used for this purpose are familiar

⁶⁸ Yuying Tsong and Yuli Lui, 'Parachute Kids and Astronaut Families' in Nita Tewari and Alvin Alvarez (eds), *Asian American Psychology: Current Perspectives* (Psychology Press, 2008) 365-380.

⁶⁹ See for example: TR 98/17, above n 63, as well as cases cited below for an indication of the wide range of factors that may result in residence.

⁷⁰ *Income Tax Assessment Act 1936* (Cth), s 6(1) definition of 'resident'.

⁷¹ See for example: *FCT v Applegate* (1979) 9 ATR 899.

⁷² See for example: Australian Taxation Office, *Taxation Ruling IT 2650* 'Income tax: residency – permanent place of abode outside Australia'.

⁷³ See for example: *AAT Case 13,559* (1998) 41 ATR 1156.

⁷⁴ See for example: *Re Joachim and FCT* [2002] AATA 610; 50 ATR 1072.

⁷⁵ *Income Tax Assessment Act 1936* (Cth).

⁷⁶ The exemption now only applies to income earned as an aid or charitable worker or as a specified government employee (e.g. defence force personnel).

from many other tax jurisdictions. A resident of Hong Kong for DTA purposes can be a person who ordinarily resides in Hong Kong, who spends more than half a year in Hong Kong or more than 300 days in two years.⁷⁷ It is clear that it would be far easier for expatriate workers to meet these Hong Kong residency tests than it would be to escape Australian residence rules. They would therefore become dual residents and under the tie breaker rules discussed above, may be allocated to Hong Kong. While not all persons would end up with this outcome, there will be far more certainty in the Australian tax treatment of Australian workers in Hong Kong. In addition, of concern to Australia would be the certain loss of tax revenue due to losing a significant number of tax residents if a DTA was concluded with Hong Kong.

3.1.2 Corporate residence

As with individuals, the introduction of a Hong Kong DTA results in the introduction of a corporate residence concept for Hong Kong tax purposes that is not generally relevant to Hong Kong taxation but is essential for the operation of a DTA. To date, this test has been the common international standards of place of incorporation and/or management and control.⁷⁸ Thus, a company that is either incorporated in Hong Kong or is managed and controlled in Hong Kong will be a resident of Hong Kong for tax purposes. Australia adopts similar tests⁷⁹ and the key impact of a DTA in this area will therefore be its impact on dual resident companies. The tie-breaker that is likely to be adopted for dual residents is the OECD standard of place of effective management.⁸⁰

The major impact of a DTA between Hong Kong and Australia in this area will therefore be that certain companies that are currently regarded as tax residents of Australia will not be regarded as residents for DTA purposes with the consequent loss to Australia of significant taxing rights. This would primarily occur when a company incorporated in Australia has its management and control in Hong Kong by virtue of its directors being there. If such companies earned significant non-Australian source income, the DTA would prevent all Australian taxation of these amounts. A proportion of these companies may become controlled foreign companies (CFCs) for Australian tax purposes by virtue of the Australian control of their shares.⁸¹ This would allow Australia to retain some taxation rights through the CFC measures. However these are reduced from that which would be claimed from a resident.

For companies incorporated in Hong Kong, the DTA residence issues would have little impact. This is because Australia would only ever seek to tax them when they have at least their central management and control in Australia.⁸² If this is the case they will be likely to be allocated to Australia under the tie-breaker test as they would also be expected to have their place of effective management in Australia. There would therefore be little change to the Australian taxation of these companies.

Having discussed how a DTA would impact the residency status of Hong Kong and Australian individuals and companies, the analysis will now look at how different

⁷⁷ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(1)(a).

⁷⁸ *Ibid.*

⁷⁹ *Income Tax Assessment Act 1936* (Cth), s 6(1).

⁸⁰ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(3).

⁸¹ *Income Tax Assessment Act 1936* (Cth), Pt X.

⁸² The tests are more complex than this but will not be discussed here. See *Income Tax Assessment Act 1936* (Cth) s 6(1).

categories of income derived by such residents would be impacted by a DTA. The following will assume a clear residency status of taxpayers as either Hong Kong or Australian.

3.2 Active income

3.2.1 Employment income

As noted in Parts 2.4 and 3.2.1, there are significant numbers of Australians working in Hong Kong and Hong Kong people working in Australia, making the impact a DTA would have on employment income very relevant. A DTA based on the anticipated model would make notable changes in relation to Australian and Hong Kong residents who earn employment income that has a connection with the other jurisdiction. As will be seen with several other instances below, one of the key changes that a DTA would bring about is a significant increase in certainty in relation to taxing rights in both Australia and Hong Kong. This is primarily the result of the continued reliance of both jurisdictions on uncertain common law tests to determine their taxing rights rather than mechanical and predictable rules.

As noted in Section 2.1, Australia will generally only tax non-residents on their Australian sourced income.⁸³ Common law principles determine whether a non-resident's employment income has an Australian source.⁸⁴ Australian case law has developed a significant focus on the place where work is done as being the source of employment income,⁸⁵ which is consistent with DTAs that also focus on where work is performed as the key taxing nexus.⁸⁶ However, Australian law is not certain on this nexus with precedents establishing that the place that work is done is not always the source of employment income. In the facts of *FCT v Mitchum*⁸⁷ for example, there was a clear finding that the place where the work was done was not significant in determining the source of employment income. However, the case did not clearly articulate what the other relevant factors are. It is therefore submitted that DTAs provide a significant increase in certainty to non-resident employees whose work has some connection to Australia in that it ensures that the test is one that looks to where the work is performed as the sole relevant nexus.

In addition to providing certainty in relation to the source of employment income, a DTA will also impact Australian taxing rights in relation to work done in Australia by non-residents. It will do this by restricting Australia's taxing rights in relation to persons who do short term work in Australia. Under current Australian law, non-residents will be taxed on their Australian sourced employment income even if they worked in Australia for a very short time.⁸⁸ In contrast, it is a standard DTA feature that those who are in a foreign jurisdiction for less than half the income year are not taxed there.⁸⁹ This does not, however, apply to those that are employed by a resident of the foreign jurisdiction or in a PE in the foreign jurisdiction. Therefore, for persons working in Australia for shorter periods and employed offshore, a DTA will make a

⁸³ *Income Tax Assessment Act 1997* (Cth) s 6-5(3).

⁸⁴ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183.

⁸⁵ *FCT v French* (1957) 98 CLR 398.

⁸⁶ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(1).

⁸⁷ *FCT v Mitchum* (1965) 113 CLR 401.

⁸⁸ *Income Tax Assessment Act 1936* (Cth) s 6-5(3); *FCT v French* (1957) 98 CLR 398.

⁸⁹ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(2).

significant difference to their tax outcomes in Australia in that they will not be taxed at all in relation to this income. At present all such income is subject to Australian taxation.

As with Australia, a DTA prima-facie makes little difference to the taxation of employment income by Hong Kong as Hong Kong generally only taxes employment income sourced in Hong Kong.⁹⁰ However, a more detailed analysis demonstrates that a DTA significantly alters the concepts that Hong Kong employs in taxing employment income. It is also noted that like Australia, Hong Kong's use of potentially uncertain common law principles in determining source will also be more certain under a DTA.

Hong Kong law has developed a concept of source that focuses on where the employment is located rather than where the work is performed. This location of employment is determined on the basis of factors including the location of the employment contract as well as the location of the employer and place of payment. These may all be in a different place to the place where the work is performed⁹¹ by an employee and would usually be outside Hong Kong when workers are sent to Hong Kong by foreign employers. In addition, Hong Kong's tax claim is statutorily altered by the exclusion of those whose employment is sourced in Hong Kong on these principles but who actually render all their services outside Hong Kong. Those without Hong Kong employment who render services in Hong Kong for more than 60 days in a year are added to the tax base by statute.⁹²

From the above, it can be seen that the basis for taxing employment income allowed under a DTA is quite different from that claimed by Hong Kong. With a DTA, Hong Kong would only be able to tax Australian residents if they actually rendered services in Hong Kong regardless of their having employment located or sourced in Hong Kong as determined on some other basis by Hong Kong law.⁹³ This is a significant reduction in Hong Kong's taxing jurisdiction and should have a notable impact on those with Hong Kong based employment, in particular those who work throughout the region. In addition, for those without Hong Kong based employment who spend between 60 and 180 days in Hong Kong, the DTA will prevent Hong Kong from its tax claim when services are rendered in Hong Kong for more than 60 days (assuming the person is not employed by a Hong Kong based person or PE).⁹⁴

The impact that this reduction in Hong Kong's tax base has on Australian residents that earn employment income with a connection to Hong Kong may in many cases be negligible, and simply amount to a transfer of tax from Hong Kong to Australia. This is a direct result of Australia's taxation of residents on their worldwide income. Without a DTA, Hong Kong's higher tax claim would be likely to be treated as a foreign income tax offset in Australia given Australia's higher income tax rates. This is particularly the case since the removal in 2009 of the general exemption for foreign service income under s 23AG. If s 23AG had been retained as it originally stood, the

⁹⁰ *Inland Revenue Ordinance 1947* (HK) s 8(1).

⁹¹ *CIR v Goepfert* (1989) 1 HKRC.

⁹² *Inland Revenue Ordinance 1947* (HK) s 8(1). An exemption for work of less than 60 days is given in s 8(1B).

⁹³ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(1).

⁹⁴ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(2).

signing of the DTA would have been a major benefit to many Australians working in Hong Kong for period of greater than 90 days and less than 180 days in particular, as the income would have been exempt in Australia and Hong Kong. Finally, it must be noted that despite the fact that Australia's prima-facie income tax rates are higher than Hong Kong's, they are not always higher in their final application to an amount of income. This is because Australia's income tax allows losses from investments and other categories of income to reduce the tax otherwise payable on employment income. This feature and the allowance for a full tax deduction for interest paid on investments means that the phenomenon of negative gearing may reduce the actual tax rates applied to many Australians wage income to the extent that it may be comparable to the tax they would pay in Hong Kong.

Thus it can be seen that in relation to the income earned by employees, a DTA between Australia and Hong Kong would make a significant impact on taxation outcomes for both the taxpayers themselves and the countries. In the case of both jurisdictions, a DTA would increase certainty in relation to taxing jurisdictions when compared to the vagaries of the common law determinations of source. This, it is submitted, would be a very positive outcome in relation to taxation in both jurisdictions. In addition, in relation to Australian tax, short term workers from Hong Kong will be significantly advantaged by a DTA that prevents Australia taxing persons that are in Australia for less than 180 days in the year. Hong Kong would be unlikely to increase its tax take to collect the Australian tax given up. Similarly, short term Australian workers in Hong Kong and those with Hong Kong located employment (but who don't work there most of the time) would be less likely to be taxed in Hong Kong. However, in many of these cases, the tax given up by Hong Kong may simply be collected by Australia. Thus, the net impact on Australian revenue would have to take into consideration both increases and decreases in different circumstances. Hong Kong however would see only a decrease in revenue from the DTA's treatment of employees.

Finally it should be noted that a DTA may provide tax relief to particular categories of persons deriving personal service income such as academics, officials and entertainers. There is a possibility that in some of these cases, this treatment may provide an additional constraint on the jurisdiction's taxing rights. These will not be further explored in this article.

3.2.3 Business profits

As noted in Section 2.4, Australia and Hong Kong have a substantial business relationship making the taxation of business profits of key interest. With business profits, as with employment income, a DTA between Australia and Hong Kong would bring the significant benefit of creating a higher degree of certainty in relation to taxing jurisdictions. Again, this is a direct result of both countries current reliance on uncertain common law concepts of source when taxing non-residents on their business profits. In addition, a DTA is also likely to constrain the taxing jurisdiction of both countries. This is not surprising in the case of Australia but perhaps less expected in the case of Hong Kong given its already narrow tax base.

In Australia, the income tax claim made on non-residents when there is no DTA is the same as in the case of employment income - they are taxed on their Australian sourced income. The concept of a PE has little relevance to the non-DTA tax claim that Australia makes in respect of business profits. The source of business profits is

determined in accordance with common law precedents and is, by its nature, something that evolves over time and can be difficult to determine with certainty given the array of possible business activities.⁹⁵ Thus, precedent indicates that the place of contracting may be important in trade while the place of manufacture may be highly significant in cases of manufacturing.⁹⁶ However, there is always the possibility that in a particular case, a particular factor may be held to be highly significant to the generation of a particular business profit and the location of this factor may be used as a major indicator of source. Precedent also indicates that the source of business profits may be apportioned between different territories where different factors are located in different territories.⁹⁷

Given the above, it is not surprising that the source of a business profit in accordance with common law principles can be difficult to predict with certainty. Up until recently, Australia partially addressed these difficulties with deemed source rules contained in the *Income Tax Assessment Act 1936* (Cth).⁹⁸ However, these provisions were unexpectedly repealed as part of the Australian government's process of repealing redundant provisions from the 1936 Act. It is submitted that the only way that these could be held to be redundant was on the assumption that a DTA existed in relation to the relevant non-resident.

The signing of a DTA between Hong Kong and Australia would alter Australia's tax claim to effectively only allow it to tax business profits that are attributable to a PE that a Hong Kong resident has in Australia.⁹⁹ This, it is submitted, is a significantly more certain concept than "sourced in Australia". Determinations of profit attributable to a PE, while far from trouble-free, are more certain as they rely upon a built up international body of knowledge on how they should be determined based on international tax and accounting practice and methods. In this respect, a DTA creates a more predictable business taxation environment in Australia.

In addition, there is no doubt that the allowed claim under a DTA is less than that allowed without a DTA. It is certainly possible to have business profits sourced in Australia without having a PE. This is indeed what tax planners often attempt to create when considering business profits earned in Australia. For example, it may be possible to sell products in Australia without establishing a PE. There would be a significant chance that selling in Australia would create an Australian sourced business profit but without a PE, Australia will be unable to tax such profits. In addition, even when a PE is established in Australia, the profits attributable to it may be less than what would be sourced in Australia under common law principles.¹⁰⁰ Thus, Hong Kong residents engaged in business in Australia would stand to significantly benefit from the conclusion of a DTA between the two jurisdictions. It is unlikely that Hong Kong would collect any tax that Australia did not collect as a result of the conclusion of a DTA.

⁹⁵ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183.

⁹⁶ *D & W Murray Limited v Commissioner of Taxation* (WA) (1929) 42 CLR 332; *Commissioner of Taxation (NSW) v Kirk* [1900] AC 588.

⁹⁷ *Commissioner of Taxation (NSW) v Hillsdon Watts Ltd* [1937] HCA 13.

⁹⁸ *Income Tax Assessment Act 1936* (Cth), former ss 38 to 43.

⁹⁹ *Australia-Hong Kong Income and Capital Tax Treaty* (2010), Article 7.

¹⁰⁰ The converse is also possible and the deemed source rule, if applied, may actually increase the tax claim in certain instances.

Under its Profits Tax, Hong Kong will seek to tax a business profit when a trade, business or profession is carried on in Hong Kong and then to the extent that the profit arises in Hong Kong.¹⁰¹ The concept of a profit arising in Hong Kong is very similar to the concept of an Australian sourced business profit in Australia and courts in both jurisdictions have looked to similar precedents in deciding on these matters. Consideration of when a trade, business or profession is carried on in Hong Kong has focussed on whether a taxpayer has their central management and control in Hong Kong and the location of business assets and activities in Hong Kong.¹⁰² Simply having an office or soliciting orders in Hong Kong is not enough to meet the threshold. However, in *CIR v Bartica Investment Ltd*¹⁰³ the placing of bank deposits in Hong Kong, receiving interest in Hong Kong, keeping accounting and other records in Hong Kong, and having nominee directors meet in Hong Kong was enough to find the taxpayer was carrying on business in Hong Kong.

It can be seen that Hong Kong makes a narrower claim to the taxation of business profits than Australia in the sense that it not only requires the profit to arise in Hong Kong but also requires that the trade, business or profession is carried on in Hong Kong. The issue that then arises is whether a DTA would reduce Hong Kong's claim further. That is, does "profits attributable to a PE in Hong Kong" ever amount to less than "profits arising in Hong Kong from a trade, business or profession carried on in Hong Kong"? It is submitted that the answer to this will significantly depend on whether the factors that have been used in Hong Kong to determine that the trade, business or profession is carried on in Hong Kong will always amount to a PE in Hong Kong. The answer to this is no, as it is possible to conceptualise circumstances such as a variation on the *Bartica* scenario where a PE would not be found. Such situations would however be rare. The exclusions from the definition of PE in many DTAs would also increase these possibilities. Once a PE is found in HK, the second question that arises is whether the profits that would be attributable to it could be less than those that would arguably arise in Hong Kong from the trade, business or profession being carried on in Hong Kong. Again, this would seem to be a possibility that could arise in concept as long as the factor that links such business profit to Hong Kong is not part of the PE. Finally, it is noted that particular business profits are pushed out of the business profits article in DTAs and this may have the impact of reducing Hong Kong's tax base. For example, it may be argued that dealings in land are a business profit and the business profit may be linked to Hong Kong due to the flexible concept of source even if the land is outside of Hong Kong.¹⁰⁴ A DTA may push the land sale out of the business profits analysis and therefore prevent Hong Kong from taxing it.

It can therefore be seen that despite Hong Kong's narrow tax base, the signing of a DTA with Australia may still lead to a reduced tax claim in respect of business profits in Hong Kong. In the case of individual taxpayers, this reduction in Hong Kong tax is likely to be transferred to Australia through Australia's worldwide tax claim, its high tax rates and its use of foreign income tax offsets. In relation to companies however, Australia's granting of the s 23AH¹⁰⁵ foreign branch profits exemption will mean that the tax not collected by Hong Kong will be a genuine saving to taxpayers. Again, the

¹⁰¹ *Inland Revenue Ordinance 1947* (HK) s 14(1).

¹⁰² *Case A146* (1991) 1 HKRC.

¹⁰³ *CIR v Bartica Investment Ltd* (1996) 4 HKTC 129.

¹⁰⁴ *Kwong Mile Services Ltd v CIR* (2004) 7 HKCFAR 275.

¹⁰⁵ *Income Tax Assessment Act 1936* (Cth).

major benefit of the DTA is the predictability it creates in relation to tax claims over business profits in both jurisdictions. Thus, the merit of the conclusion of a DTA between Hong Kong and Australia will need to be evaluated through a balancing of the reduced tax claims with the desirable increase in certainty in tax claims.

3.3 Passive income

3.3.1 Interest income

The taxation of interest income in both jurisdictions would remain largely unchanged by the conclusion of a DTA but there are some notable points for consideration. Australia's tax claim on interest through its withholding tax regime is structurally very similar to that allowed by a DTA. In Australia, interest derived by non-residents is taxed at 10 percent (withholding on gross) unless it is connected to a PE in Australia.¹⁰⁶ If it is, then it is taxed by assessment. This is little different to what occurs under most DTAs except that there may be minor differences as to what constitutes a PE.¹⁰⁷ In these unusual circumstances the DTA may alter outcomes. One area in which a DTA may make a significant difference is when interest is sourced in Australia under common law principles but not subject to the withholding tax regime because it is not paid by an Australian or a non-resident's Australian establishment. While it is not often noted in Australian commentary, such interest still falls within the Australian tax base. This is because s 128D¹⁰⁸ only removes from the assessment regime interest that is dealt with by the withholding regime. An example of when this would occur is when a non-resident lends money to another non-resident (neither of which has an Australian PE) and the loan is concluded and funds provided in Australia. Such interest is likely to be sourced in Australia¹⁰⁹ but would not fall within the withholding tax regime. While these circumstances may appear to be odd, it should be noted that they may readily occur in private affairs when non-residents spend considerable time periods in Australia. In addition, it is possible that a person may have been a resident when the arrangement was made but has since become a non-resident. The DTA would prevent Australian taxation of these amounts of interest. Finally, given the uncertainty that surrounds the source of income in these circumstances, the DTA can again be seen to be creating certainty.

As noted in Section 2.1, bank interest is not taxed in Hong Kong. The only interest that may be taxed is that which forms part of a business profit. In these circumstances the factors discussed above in relation to business profits in Hong Kong should be considered. A DTA will only allow Hong Kong to tax interest when it is effectively connected to a PE in Hong Kong or paid by a Hong Kong resident. Will this always be the case in the limited circumstances that Hong Kong seeks to tax interest income? Based on the earlier analysis, arguably not. There is therefore again potential for a DTA to reduce Hong Kong's tax claim.

¹⁰⁶ *Income Tax Assessment Act 1936* (Cth) s 128B(2).

¹⁰⁷ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 11.

¹⁰⁸ *Income Tax Assessment Act 1936* (Cth).

¹⁰⁹ *Commissioner of Inland Revenue (NZ) v N V Philips Gloeilampenfabrieken* 10 ATD 435; *CIR v Lever Brothers & Unilever Ltd* (1946) 14 SATC 1.

3.3.2 Royalties

The analysis of how a DTA would impact the taxation of royalties by Australia and Hong Kong has some similarities to the analysis in respect of interest. In Australia, royalties paid to a non-resident are generally taxed through a final withholding tax.¹¹⁰ Unlike with interest, there is no exclusion from withholding when the royalty is derived through a PE. Also, the withholding tax rate is a very significant 30 percent of the gross royalty. The alteration of these two features would be the most significant impact that the signing of a DTA would have on taxation of royalties by Australia. A DTA would ensure that when dividends are derived by a Hong Kong resident through a PE in Australia, they will be subject to taxation by assessment rather than withholding.¹¹¹ This is a very significant change and would provide a notable incentive for Hong Kong residents to carry on royalty generating business in Australia as they would get the benefit of having business expenditure as a tax deduction against their royalty income. For royalties that are not connected to a PE, the DTA should reduce the withholding tax rate from 30 percent of the gross to 15 percent or lower on the gross. This again is a major reduction to the Australian tax claim over Hong Kong residents.

Finally, as was discussed with interest, a DTA would clarify Australia's residual taxing rights over royalties based on the source concepts. At present, there remains the possibility that royalties derived by Hong Kong residents but that are not paid by an Australian or a non-resident with a PE in Australia may remain taxable if the source of the royalty can be found to be in Australia. This is because as with interest, s 128D only excludes from assessment royalties that fall into the withholding tax regime. As the common law source of royalty income is not related to the location of the payer,¹¹² such situations may arise. However, the actual common law source rules are again very unclear. A DTA would prevent Australia from taxing any royalty of a Hong Kong resident that is not either paid by an Australian or effectively connected to an Australian PE. In doing this it will create significant certainty in relation to Australia's tax jurisdiction over royalties and also reduce Australia's jurisdiction. This would be a notable benefit to Hong Kong residents as it is unlikely that Hong Kong would impose taxation in Australia's place.

The final point above is something that Australia should consider carefully if it is going to conclude a DTA with Hong Kong and offer a low rate of withholding tax for royalties unconnected to Australian PEs. The reduced tax claim together with Hong Kong's narrow tax base means that a DTA with Hong Kong may create significant treaty shopping possibilities for residents of third countries who can structure their Australian involvement through Hong Kong. This would also mean that Australia would be likely to pay significant attention to anti-treaty shopping and limitation of benefits features in any DTA that it concludes with Hong Kong. It is submitted that Australia should carefully consider whether low rates of withholding tax on passive income under any Hong Kong DTA are desirable.

Hong Kong only makes a limited taxation claim in relation to royalties derived by persons. However, the following analysis indicates that, again, Hong Kong may still

¹¹⁰ *Income Tax Assessment Act 1936* (Cth) s 128B(2B).

¹¹¹ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 12(4).

¹¹² *FCT v United Aircraft Corporation* (1943) 68 CLR 525.

have to curtail its claims in relation to royalties derived by Australian residents if it concludes a DTA with Australia. Under s 15 of the *Inland Revenue Ordinance*, royalties as well as rents for moveable property are deemed to be business profits and sourced in Hong Kong if the property they relate to is used in Hong Kong. However, as outlined above, a DTA would restrict Hong Kong taxation of royalties derived by Australian residents to those paid by Hong Kong residents and those effectively connected to a PE in Hong Kong. This has significant potential to restrict Hong Kong's claim under s 15 in that the use of property in Hong Kong will not always be paid for by Hong Kong residents or be connected with a PE in Hong Kong. There are many possible circumstances where property such as intellectual property may be exploited in Hong Kong without these factors being present. A DTA will therefore restrict Hong Kong's taxation of royalty income. The taxation not collected by Hong Kong will likely be collected by Australia through the worldwide taxing of residents meaning that although taxpayers will have no difference in their total tax burden, Australia will benefit. Unlike with business profits above, royalties are unlikely to be exempt under s 23AH when earned by Australian resident companies as they are viewed as passive income and not entitled to the exemption.

3.3.3 Dividends

The taxation of dividends in Australia and Hong Kong will only be minimally impacted by the conclusion of a DTA. As discussed in Section 1.2, Hong Kong never taxes dividends and therefore there can be no restriction through a DTA. In Australia, dividends that are derived through a PE are taxed by assessment¹¹³ while those that are not are potentially subject to withholding tax. However, franked dividends¹¹⁴ and dividends paid out of conduit foreign income are not taxed under the withholding regime. Conduit foreign income is essentially income earned by Australian companies offshore. The remaining unfranked dividends are subject to a 30 percent withholding tax and it is these that will be impacted by the conclusion of a DTA, with a DTA likely to reduce this rate significantly. The highest rate that is likely to be contemplated is 15 percent while it is possible that a much lower rate or an exemption may be provided if Australia follows the practice of some recently concluded DTAs. A low rate will however raise the possibility of significant treaty shopping opportunities though Hong Kong and Australia would need to consider this very carefully in any treaty negotiation.

In relation to dividends derived through a PE, the DTA would make little difference as Australia now prescribes similar treatment under its domestic law by allowing for assessment of such dividends. There may be minor differences to current treatment in that the DTA definition of a PE is likely to differ from that currently used for Hong Kong residents. Finally, a DTA would prevent Australia's claim tax dividends paid by non-resident companies from profits sourced in Australia. This difficult to enforce claim is currently still made under s 44(1)b of the *Income Tax Assessment Act 1936* but a DTA would prevent any such taxation when Hong Kong residents derive dividends that are not paid by Australian companies. Thus it can be concluded that a DTA will provide some tax benefit to Hong Kong residents that derive dividends that

¹¹³ *Income Tax Assessment Act 1936* (Cth) s 128B(3E).

¹¹⁴ *Income Tax Assessment Act 1936* (Cth) s 128B(3)(ga).

are connected with Australia. Hong Kong would not collect the tax saved through Australia's reduced claim.

Income from real property and from the alienation of real property should be minimally impacted by the conclusion of a DTA between Australia and Hong Kong. A DTA is likely to allow the country where the real property is situated to retain full primary taxation rights over both rents and gains on disposal. As both Australia and Hong Kong are unlikely to exceed this jurisdiction under their domestic rules, this would not be a constraint. Australia generally only taxes gains made on Australian real property and rents from real property in Australia when these are derived by a non-resident. Under its Property Tax, Hong Kong only seeks to tax to rents on Hong Kong real property. It would be expected that gains on the disposal of real property that constitute a business profit would generally only be sourced in Hong Kong or Australia when the property is in the same jurisdiction. However, as noted above, there is the possibility that a business profit in relation to real property may be found to be sourced in one of these jurisdictions despite the fact that the land is not within the jurisdiction. Indeed the *Kwong Mile*¹¹⁵ case suggested such a possibility. In these circumstances a DTA would likely prevent such taxation by either Hong Kong or Australia. Again, the DTA can be seen to bring desirable certainty to inherently flexible common law source rules.

4. CONCLUSION

This article has discussed how a DTA would impact taxation in Australia and Hong Kong. Part 2 provided background and context, by comparing the key features of each country's tax system and then reviewing the DTA policy (including DTA history) of both countries. The strong trade and investment relationship between the two jurisdictions was established, increasingly the likelihood that a DTA would have a major impact in terms of both benefits and revenue losses. This impact was examined in depth in Part 3, which indicated that a DTA between Hong Kong and Australia would indeed have a significant impact bringing improvement in terms of certainty as well as a reduction in the tax base in many circumstances in both countries. This outcome may come as surprise in relation to Hong Kong given its generally narrow tax base. A major finding of the analysis is that both jurisdictions have a significant degree of uncertainty in their tax bases due to the retention of flexible common law concepts of source and, in Australia's case, residence. Notably, Australia retains these concepts in certain circumstances despite having replaced them in many circumstances with clearer regimes such as the withholding tax regime. This finding indicates that Australia and Hong Kong should consider the appropriateness of the retention of these tests in an increasingly global business and social environment that exacerbates the uncertainty in these concepts.

There is no doubt that the conclusion of a DTA would significantly reduce the tax claims of both Australia and Hong Kong. In Australia's case, the impact a DTA would have on the residence of taxpayers would need to be seriously contemplated due to the possibility of a very significant loss of revenue. A discussion of Australia's DTA history highlights the fact that the potential loss of revenue may be an impediment to entering into a DTA. Australia would also see its tax base reduced in relation to business profits and royalties. Hong Kong would have its tax base curtailed through a

¹¹⁵ 7 HKCFAR 275.

DTA as well. However, the tax that is no longer payable to Hong Kong may simply be collected by Australia under its worldwide tax base. Hong Kong should therefore consider the desirability of this outcome of a DTA. On the other hand, tax given up by Australia under a DTA would not be likely to be subsequently collected by Hong Kong due to its narrow tax base. Hong Kong residents under the DTA therefore stand to significantly benefit from it. This may be a concern for Australia in that it will create the possibility that persons from third countries will structure their Australian business through Hong Kong to take advantage of its benefits together with Hong Kong's minimal tax base. Australia should therefore pay careful attention to the inclusion of anti-treaty shopping and limitation of benefits clauses in any DTA that is contemplated with Hong Kong. It is submitted that Australia should determine the rates of withholding tax granted to royalties and dividends under any DTA very carefully to determine whether a low rate is in its interests.

Hong Kong has indicated a desire to enter into DTA negotiations with Australia. Due to the significant relationship between the two countries, Australia should genuinely consider entering into such negotiations. However, also of concern to Australia will be the potential loss of taxation revenue, which, as indicated in Part 3, is likely to be significant. This will affect Australia's willingness to enter into treaty negotiations with Hong Kong. The analysis in Part 3 has also indicated areas where a DTA would have most impact. If treaty negotiations do commence, it is these areas that warrant the most discussion and negotiation.