PART III – BUSINESS IN HONG KONG:
KEY FEATURES OF THE TAX FACTOR

Chapter 1 An Overview of International Taxation Trends and Practices

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Jurisdictions which have a respectable network of treaties are usually considered as serious players in the tax world. Most countries will only conclude treaties with countries which do not have a reputation as a tax haven, where taxes are collected in a fair and equitable way, where the rule of law is predominant and where taxpayers have access to remedies and are protected otherwise as well. Often non-tax-factors, like the observation of human rights, are taken into account as well. Therefore jurisdictions which are equipped with many tax treaties, concluded with other respectable countries, can demonstrate that their system meets the minimum standards the international tax community expects them to meet. This "signalling effect" must not be underestimated: head of taxes in corporations might face internal difficulties with their executive board or supervisory board members if they propose transactions where jurisdictions are involved which do not have this kind of international recognition. Tax administrations are often very critical when they have to assess such transactions. The existence of a tax treaty network might help a lot. The present Introduction further explains the significance of tax treaties which is the legal and policy instrument on which the present volume focuses, and then takes a closer look at the specific practice of Hong Kong SAR and China. These two players' tax rules and policies can only be properly assessed if assessed in the broader global context which has undergone important mutations in the last years. Part I provides an overview of the changing global landscape of tax law and policy. Part II provides the reader with a tale of two stories which allow differentiating and comparing Hong Kong with China. Finally, part III presents an overview of the key features of the tax factor in Hong Kong.

1. The Significance of tax treaties in general and from Hong Kong's perspective in particular

Hong Kong SAR has managed to conclude a significant numbers of tax treaties in an incredible short time. Hong Kong SAR's tax treaty network is quite remarkable. Many important countries belong to Hong Kong SAR's tax treaty partners. Tax treaties allocate taxation rights to the two contracting states. Tax treaty provisions make sure that income and property may only be taxed once. The object and purpose of tax treaties is to avoid double taxation. For a jurisdiction like Hong Kong SAR it is not obvious to have such a tax treaty network or to have treaties at all: since Hong Kong SAR has a territorial system of taxation foreign income is not taxed in the hands of Hong Kong SAR residence. They should not suffer under double taxation.

However, foreign investors may be exposed to double taxation. They might be taxed in Hong Kong SAR with their Hong Kong SAR sourced income and in their residence state as well.

However, providing relief from double taxation is not the only reason why tax treaties are concluded. Under tax treaties usually both countries sacrifice part of their revenue, in order to make cross border investment possible. If double taxation is avoided by unilateral means, it is usually only one country which loses revenues from taxes. Therefore countries might have an interest to conclude a treaty. They want to share the revenue sacrifice with another country. However, from the perspective of a taxpayer it does not matter that much if he gets relief from double taxation through a treaty or through unilateral measures: Many countries grant a credit for a foreign tax or sometimes even exempt foreign income even in the absence of a treaty. So providing relief from double taxation cannot be the only and are maybe not even the most important reason why treaties are concluded.

For taxpayers it is sometimes attractive that tax treaties often go beyond the mere avoidance of double taxation. They can lead to non-taxation as well and therefore create tax planning opportunities. It is obvious that this can be the consequence of the application of the exemption method. Although Hong Kong SAR treaties usually provide for the credit method, there are still tax treaty provision which might lead to double non taxation. The application of Art 15 par 3 OECD MC or of Art 20 OECD MC could have such effects.

Although relief from double taxation can be provided by unilateral means as well, it still makes a difference if certain relief mechanisms are enshrined in a tax treaty: most countries have a limited number of tax treaty negotiators, therefore tax treaties are changed very rarely. Tax treaties provide more legal certainty: Whereas domestic tax rules are often changed every year or in many countries even more often, investors can expect that they will be able to rely on the treaty framework for a much longer period. Tax Treaties are considered to be stable and long term investment requires certainty. Although the existence of a tax treaty and the stability of its framework are still be decisive for many investors, this factor has become less relevant over the years. In the old days it took approximately 20-30 years until a country has adjusted the majority of its tax treaties to changes in the OECD Model Convention, nowadays these changes are implemented much quicker. It took many countries just a couple of years or even less to include the new standards on exchange of information in their treaties. International pressure was high to act quickly.

Under the BEPS project it has also been suggested to implement all the expected changes of the OECD Model Convention through an international conference which should start right after agreement on the substantive rules has been reached. Stability suffers also because many countries have started

to terminate their treaties if they could not agree with their tax treaty partners on a revision. Twenty years ago this was a no go and treaty negotiators considered the termination of a treaty almost as hostile as declaring war. The attitude has changed over the years. Countries have even terminated treaties for rather minor reasons, like the lack of consensus to allocate the taxation right for pensions differently. This goes hand in hand with less reluctance by most countries to override treaty provisions by domestic law. When the US overrode some of their treaties by introducing CFC rules, tax experts were almost shocked. Now treaty override is widely accepted. This all leads to the fact that investors cannot expect a tax treaty to create such a stable framework as it was in the past, but it still relevant.

Treaties go beyond the mere avoidance of double taxation. They contain non-discrimination clauses as well which are usually relevant in the source state. Therefore some countries are interested that their residents are protected against discrimination when they invest abroad. Their residents must not be discriminated on grounds of nationality or for other explicitly mentioned reasons in the source state. The source state must not treat permanent establishments of enterprises of the other state unfavourable compared to its own residents.

Moreover, tax treaties contain exchange of information clauses as well. They provide a legal framework for the tax authorities of the contracting states for cooperation. The cooperation might go far beyond the questions which arise in the context of treaty application. Under such a framework tax evasion is much more difficult. Besides, tax administrations learn to work with each other and establish a relationship of trust and deeper understanding. This can create an environment which could be beneficial for law obeying taxpayers as well.

Fraud and evasion can be effectively fought under these treaties which provide not only exchange of information but mutual assistance in the collection of taxes. Countries have effective means to enforce their tax provisions under such a legal framework.

Mutual agreement procedures can also build up trust and better understanding. If countries coordinate their taxation rights via a treaty, instead of just coordinating their tax systems informally, they equip themselves with effective conflict settling tool. If treaties contain arbitration clauses as well, the tax administrations can make use of a face-saving-method to settle their disputes. Experience shows that such clauses have a preventive effect as well, and incentivises competent authorities to reach an agreement in a conflict, before the case goes to arbitration and they lose control.

Recently, there are also more side effects of treaties under domestic law: Many EU Member states allow deductions for certain payments to foreigners or are willing to treat foreign income as beneficial as domestic

China. Another influence has been the extension of FATCA: a number of countries in the region have or are about to sign such agreements with the US.

Throughout this debate, there has been a concern on the part of many governments in the region on how to protect the confidentiality of taxpayer information in this more open, transparent environment. We have also seen a network of tax information exchange agreements develop within the region: this network has helped improve the capacity of tax administrations to achieve an effective exchange of information with their treaty partners.

One side effect of these developments has been that countries which traditionally had a limited network of bilateral double taxation treaties have now been able to extend their treaty arrangements. Up to 2000, Hong Kong for example, had a very limited network of treaties (less than 6), whereas today it has more than 25 treaties, including many with its major trading partners. Such an expansion would not have been possible without an endorsement of the new exchange of information standards. And this extended treaty network has certainly made Hong Kong more attractive as a trading centre.

China has been very much at the forefront of concluding tax treaties in the region. It initially focused on developing its treaty network with OECD countries but has recently put more emphasis on extending treaties with developing countries. Today, it has more than 100 tax treaties based upon a mixture of the OECD and UN model. What is noticeable in recent treaties, is the way in which withholding taxes and dividends have been reduced, the tendency to allocate more taxation rights to the resident's country, the introduction of a GAAR type provision and provisions which enable the taxation of gains from the offshore transfer of property. We have also seen the introduction of the concept of beneficial ownership, although it remains unclear how in practice this will be applied. These changes have been accompanied by a more aggressive attitude on the part of the SAT towards achieving good tax compliance on the part of MNEs. At the same time, China has been expanding its networks of TIEAs with particular emphasis on achieving TIEAs with offshore jurisdictions which have traditionally acted as a conduit for investment into China (e.g. Samoa, Bermuda). One of the outcomes of these changes has been a significant increase in the tax revenues from foreign multinationals. Some estimates suggest that this may have increased by 50% since 2005.

The process of transformation is continuing with countries as diverse as China and Indonesia now accepting the concept of automatic exchange of information: something which would have been unthinkable even two years ago. Nevertheless, it remains to be seen how far this concept can be effectively implemented in the Asian-Pacific environment.

As can be seen from the chapters in this volume, the existence of a treaty network has helped improve the ability of countries in the region to provide a stable and predictable tax environment, which in turn has encouraged FDI into the region.

The spread of exchange of information provisions between countries in the region, particularly with Singapore and some of the offshore financial centres such as Vanuatu and Samoa, has also helped governments to protect their tax base by being able to more effectively counter offshore non-compliance.

Undoubtedly the main influence that is going to shape the international tax arrangements in the region over the next decade will be the base erosion and profit shifting initiative ("BEPS") of the G20/OECD. This project was launched in 2013 and the 15 Action points foreseen in the November 2013 report are due for completion by the end of 2015. There are 5 Asian Pacific countries which play an active role in the G20: Australia, China, Indonesia, Japan and Korea.

Up to the end of 2014, reports on seven of the Actions had been provided to the G20 summit, although many of these reports did not contain firm recommendations. Over the next 12 months, we can expect that the OECD will be completing these reports and providing recommendations on the outstanding 8 reports. It is unlikely however that this initiative will be terminated by the end of 2015 since the question of implementation will continue to occupy both the G20 and the OECD for a number of years.

All these actions are likely to have a major effect on many of the countries in the region which will have to deal with how to implement the new concepts coming out of the BEPS report in the context of their tax treaties and transfer pricing rules. It is helpful to briefly look at some of the major action points and to ask what impact they may have on the region:

Action 1: Tax Challenges of the Digital Economy

The debates in Paris have shown that it is almost impossible to distinguish between the digital and the non-digital economy. Therefore, it is not feasible to have special tax rules, particularly corporate tax rules, which apply to the digital sector. This is why the debate is very much shifting focus away from the corporate tax issues that arise with the digital economy towards consumption taxes and digital products and we can expect that in the final report, proposals will be made for how to apply consumption taxes to such products but also that there will be some redefinition of the PE concepts under tax treaties.

the White Paper in assuming that any residual results from intangibles and allocating the residual to where the intangibles were developed.[12] This is a view that favours US revenue interests because more intangibles are developed in the US than elsewhere, but not surprisingly it has not been accepted by other OECD members. Nor is it congruent with the facts, since residuals can result from other reasons such as cost savings from synergies or advantages of scale, and they usually inhere in the relationship among the group members and cannot be allocated to any one of them.

OECD's preferred method of applying the profit split method is to analyse the functions, assets and risks of each member of the affiliated group. However, in the context of residuals this method also proves to be illusory. A functional analysis can only be applied to those functions that can be assigned to the group members, such as production or distribution, but it does not help with residuals that result from the relationship among the group members. Assets can include intangibles, which are usually the most valuable assets of a modern MNE, but intangibles also get their value from the relationship among the group members, as illustrated by the B and L case. This makes it very difficult for them to be allocated either to where they were developed or where they are exploited. The Glaxo case in which the IRS and HMRC disagreed about whether the profit from selling Zantac, a drug developed in the UK, into the US market resulted from the intangibles embodied in the drug itself or those used in Glaxo's marketing resulted in massive double taxation.[13]

Risk is the trickiest concept of all. Recent case studies by the US Joint Committee on Taxation reveal a model in which the entrepreneurial risk for a product is assigned to an affiliate in a low tax jurisdiction and the manufacturing and distribution of the product in high tax jurisdictions are done on a contract manufacturing and commissionaire basis.[14] But it is not clear what the allocation of entrepreneurial risk means among related parties. If a product fails because of technological change or defects in manufacturing or environmental hazards, the risk is effectively borne by the entire MNE, or more accurately by its management who risk being fired and by its shareholders who see the stock price plummet.

Under UT, these issues can be solved by using the formula to allocate the residual by the profit split method. The specific formula used can be negotiated, and is the topic of Durst's.[15] But in our opinion it is clear that

[12] I.R.S. Notice 88-123, 1988-2 C.B. 458 (a US Treasury study of transfer pricing methodology that resulted in the -development of the Comparable Profits Method and Profit Split).

[13] GlaxoSmithKlineHoldings (Americas) Inc. and Subsidiaries v Commissioner [2004] No. 5750-04.

[14] Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (2010), JCX 37-10.

[15] Michael Durst, A Formulary System for Dividing Income Among Taxing Jurisdictions, 22 Tax Management Transfer Pricing Report 2 (2013).

whatever formula is decided upon should be applied under UT to the entire profit of the integrated MNE and not divided into separate activities, and that this would be perfectly congruent with Article 7.

¶3-300 UT and Developing Countries

What can a developing country do to implement UT? In the absence of a treaty or in the event the treaty contains Article 7(4) language, the biggest obstacle to UT implementation may be access to information.

The recent redraft of the *UN Transfer Pricing Manual* recommends that among the documentation which a tax administration should request for a transfer pricing audit should be the "Group global consolidated basis profit and loss statement and ratio of taxpayer's sales towards group global sales for five years".[16] This provides a good basis for application of UT. The development of a global template for country-by-country reports by MNEs, mandated by the G20 and being developed as part of OECD's BEPS project, would also facilitate such an approach. The rejection of UT in the *OECD Transfer Pricing Guidelines* is based on its definition of formulary apportionment as "applying a formula fixed in advance". This leaves considerable scope for adoption of UT approaches with ad hoc formulas, which are not based on a fixed formula.

Specifically, as discussed in Michael Durst's work,[17] allocation according to operating expenses would be clearer and easier to administer, and most importantly would fit within the current rules of international tax. We have argued that in the context of the profit split method, the residual profit cannot be allocated on the basis of comparables and therefore can be allocated based on operating expenses without deviating from the ALS. This would entail first assigning to each country an estimated market return on the tax deductible expenses incurred by the multinational group in that country.

Developing countries should therefore be encouraged to draft their transfer pricing laws to include powers to adjust the accounts of any foreign-owned local company or branch, if the Revenue Authority considers that its accounts do not fairly reflect the profits earned locally, to bring the taxable profits into line with those which such a business would be expected to earn, having regard to: (a) similar businesses either in that country or elsewhere; and/or (b) the relationship of the local business to the worldwide activities of the corporate group of which it is a part. This would involve analysis and comparison of provisions in the tax laws of appropriate

[16] UN, *Practical Manual on Transfer Pricing for Developing Countries* (2013), para. 8.6.9.12.

[17] Durst, Formulary System, supra.

CONTRACTING STATES	DATE	ADOPTED VERSION OF ARTICLE 7: 7-4 LANGUAGE	TENTATIVE CONCLUSION
Venezuela	29 May 1991	Art. 31 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Oman	5 Oct. 2009	Art. 30 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Pakistan	24 Mar. 1982	Art. 29 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Panama	6 Oct. 2010	Art. 28 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Poland	20 Sep. 1979	Art. 30 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Portugal	20 Sep. 1999	Art. 32 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Qatar	24 Apr. 2008	Art. 30 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.

CONTRACTING STATES	DATE	ADOPTED VERSION OF ARTICLE 7: 7-4 LANGUAGE	TENTATIVE CONCLUSION
Taiwan	27 Feb. 2001	Art. 27 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Romania	5 Mar. 1998	Art. 29 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Saudi Arabia	13 Oct. 2008	Art. 29 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Slovenia	30 Jun. 2004	Art. 29 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Sri Lanka	17 Nov. 1982	Art. 30 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
United Arab Emirates	8 May 2007	Art. 28 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.
Uganda	31 Aug., 2004	Art. 31 "nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary"	Implementation of a formulary apportionment method would be valid under the treaty thus not requiring treaty renegotiation.

are opened, capital is expected to flow from A to B as investors reap the benefits of lower taxes there, which make the after-tax rate of return higher. As capital flows out of A and into B, its relative supply in the former drops and in the latter rises, causing, respectively, an increase and a decline in after-tax rates of return to capital in the two jurisdictions relative to the rates in effect immediately prior to the opening of borders. The flow continues until after-tax rates equalise, at which point the return to savings is the same in A and B. Savings neutrality, under this view, is preserved.

The standard analysis disregards the fact that if capital begins to flow from A to B, then, under territorial taxation, A's tax revenues will drop, and, over time, the level of tax-financed amenities in A will drop as well. The drop in amenities will lower the pre-tax and after-tax rates of return to investment in A apart from any effect caused by changes in the relative supplies of factors of production there. That is, the drop in amenities will lower the value of A-sited assets in real terms. (Note that if A raises its rates to compensate for the reduction in tax revenue, the incentive to move capital from A to B becomes greater, undermining the effectiveness of the revenue-raising measure.) B's tax revenues will rise with parallel but opposite effects on productivity.

It therefore is not clear what significance there is to the resulting neutrality in savings decisions. The asserted efficiency property of savings neutrality is that it prevents taxes from differentially influencing investors' decisions to allocate more or less than they would to savings in the absence of double taxes.[18] The result qualifies as efficient on the standard assumption that non-double-tax-affected decisions maximise productivity, because they are not based on (doubly) tax-distorted prices. Implicit in this formulation is that all tax effects on market prices represent distortions, or, put otherwise, that taxes purchase no part of the return to investment. The conclusion does not hold, however, if real, (pre-tax) market prices depend on inputs that are supplied with taxes. Stated in the converse, if tax amenities contribute to productivity, then real market prices are not given by pre-tax prices, but by those prices plus some portion of assessed taxes, which means that the payment of taxes contributes to the value, not just the price, of the good purchased.

Returning to the discussion example, once it is acknowledged that taxes purchase part of the return to savings, it is not possible to maintain that the identity of after-tax returns to savings in A and B is efficient if tax revenues or burdens on infrastructure have been redirected from one jurisdiction to another along the way. The efficiency produced by ensuring that investment decisions do not differ on substitution grounds from what

[18] Altshuler, supra note 15, p257. In the discussion that follows, references to tax distortions should be understood to mean distortions arising from double juridical taxation, as what is sought is generally the removal of distorting effects resulting from the extra layer of tax, not the removal of the distortion effects resulting from all taxes.

they would be in pre-tax terms holds only when it is possible to assume that tax benefits will be separately supplied at the level necessary to support the pre-tax rate of return. The redirection of tax revenues and burdens on infrastructure from one jurisdiction to another in the open economy setting violates the assumption. In order to assess the efficiency properties in that setting, one can no longer assume (if one ever could) that the non-tax-affected world provides a benchmark of efficiency because, as demonstrated above, its efficiency properties depend upon a fixed demand for tax benefits.

Thus, consider what happens over time as capital flows and tax revenues adjust in the example. The real return to savings will be enhanced in B, the low-tax jurisdiction, as increased tax revenues improve the private-sector pre-tax rate of return there, causing increased investment. This development produces the seemingly odd result that tax-induced behaviour causes an increase in productivity, not a reduction. Capital that remains in A becomes less productive, which means that a given physical quantity of capital drops in value compared to the value it had in the pre-trade world. The resident of A nominally gets the same return on A-sited investment as the resident of B does on B-sited investment, but the resident of A has less to invest in real terms. The opposite effect in B, however, should be larger if B started with a lower level of tax amenities and lower productivity.[19]

On balance, it is not clear whether savings decisions in the resulting post-trade equilibrium are superior to the decisions that would be made if savings neutrality did not hold. To see this, assume the same facts, except that A and B satisfy all revenue requirements via lump-sum taxation. When borders are opened, capital will flow from B to A because of the superior return there. If that were the sole effect, optimum savings decisions would result when rates equalised. But the inflow of capital to A will impose an additional burden on A's infrastructure, causing the revenue target to fall short of what is needed to maintain its higher productivity. The opposite effect will occur in B. If revenue targets are not adjusted, then in real terms asset prices in A will drop and in B will increase. After-tax rates of return, however, will be identical in both jurisdictions. If some tax revenue were allocated from B to A (or if some capital were reallocated from A back to B), greater overall productivity would result, meaning that the world of lump-sum taxes is not optimal. The analysis implies that the non-tax-affected world is inferior to the tax-affected world.

Such an allocation in fact is what occurs under territorial taxation. When capital moves from A to B in the original example, tax revenue is redirected from A to B. Productivity in B is increased, resulting in a tax-affected world that is superior to the non-tax-affected world given that B began with fewer tax amenities than A.

[19] *See infra* Part 3.

developed jurisdictions are likely to be similar, forgone tax revenue (on outbound investment) should approximately equal new tax revenue on inbound investment.[51]

For a developing country, the situation is dramatically different. Developing countries will have trouble attracting capital, since productivity rates tend to be much lower. Lower productivity rates lead foreign investors to discount investment opportunities offering returns that are supra-marginal with reference to returns host-country investors could obtain on the same investment. In a system of universal territorial taxation, developing countries theoretically have two ways to deal with the resulting disincentive to inbound investment. They can increase taxes in order to develop infrastructure and improve the pre-tax rate of return, or they can cut taxes to reduce the after-tax cost of investment more directly. Table 2 demonstrates why, if no other considerations were in play, the former method ought to be vastly preferable. Over the range of average tax rates running from 10 to 30%, a 1% increase in average tax rates (measured as a fraction of GDP) is associated with approximately a 0.75% increase, on average, in after-tax return.

The difficulty with raising rates to improve infrastructure, of course, is that other considerations are in play. Higher rates do not directly translate to higher productivity but promote it when governments make effective use of tax revenues to build infrastructure – a time-consuming process.[52] Where net capital exporters adopt territorial systems, developing countries may not have the luxury of attracting capital by improving infrastructure with the aid of higher rates, because the prospect of improved investment returns materialising far in the future will not generally be attractive to investors whose time horizons typically are much shorter. By contrast, lower tax rates offer investors the opportunity for an immediately improved rate of return. The result is a prisoner's dilemma among underdeveloped countries: the option of competing on tax rates means that developing countries cannot compete on tax amenities, because investors will move their capital to obtain the more favourable after-tax return that is immediately available. From the perspective of an individual developing country that seeks to attract foreign capital, tax competition becomes the only rational strategy, but it leaves developing countries as a group worse off than if all could cooperate to

[51] *See, e.g.*, Edwared D. Kleinbard, *The Lessons of Stateless Income*, Tax Law Review (2011), Vo.65, 99, pp156-157. (noting that taxes should have a minimal impact on choices between domestic and cross-border investment where rates are comparable and opportunities for earnings stripping and other tax avoidance strategies are unavailable); Shaviro, *supra* note 4, pp391–392 (noting that reciprocal territorial and reciprocal worldwide taxation involving two countries "comes out exactly the same in the aggregate if the income amounts and applicable tax rates are identical".).

[52] *See* Alfaro, Kalemli-Ozcan and Volosovych, supra note 30, pp353-354, for a statement of the point as it relates to institutional quality (noting that the explanatory variables of institutional quality "are slowly changing over time".).

increase rates.[53] Instead of improved infrastructure leading to greater capital investment (and still more improved infrastructure as taxes per capita rise), the result is stagnating levels of development in countries that lacked adequate infrastructure to begin with, as under-financed tax amenities continue to go under-financed – another widely observed phenomenon.[54]

The overall picture that emerges is not pretty. On one hand, developed countries as a group can expect to experience enhanced growth compared with the closed-economy world they leave behind as borders become more open and group members reap gains from trade. On the other hand, developing countries that participate in the sweepstakes to attract foreign capital are likely to be mostly unsuccessful and to remain relatively infrastructure-poor to the extent they rely on foreign direct investment to fund growth. And, because seeking foreign capital means keeping tax rates low or lowering them compared with the rates they adopted in the system of closed economies, they do in fact increase reliance on foreign investment to fund growth. The result is that these countries all become less able to fund infrastructure from native economic activity and, consequently, more dependent on the vagaries of worldwide patterns of investment and trade to fund tax amenities.

Again, these predictions are largely borne out by the facts. As contrasted with growth in OECD countries, growth in developing countries tends to be sporadic, volatile and marked by periods of contraction.[55] Over the long run, it is only about half as large as growth in developed countries.[56] The lesson for developing economies in a world of tax competition would seem to be that it is better to stay out of the tax-driven competition to attract capital entirely and rely instead on domestic production and, perhaps, other sources of capital (such as foreign aid) to develop infrastructure.

b. Worldwide Systems

A universal worldwide system with a limited foreign tax credit differs from a territorial system most significantly in that tax rate competition over capital is largely eliminated. As economies become open, investors continue to have the choice to invest in low-tax or high-tax jurisdictions, but investors in capital exporting nations, who typically face high domestic rates, will

[53] The Stanford Encyclopaedia of Philosophy has an extended discussion of the prisoner's dilemma. Steven Kuhn, *Prisoner's Dilemma*, The Stanford Encyclopaedia of Philosophy, *available at*: http://plato.stanford.edu/entries/prisoner-dilemma. (last visited on 15 December 2014)

[54] *See, e.g.*, Eugene B. Gallagher, *Sociological Studies of Third World Health and Health Care: Introduction*, Journal of Health and Social Behavior (1989), Vo. 30, No.4, 345. ("[The 'Third World'] is a world characterised economic underdevelopment.")

[55] Lant Pritchett, *Understanding Patterns of Economic Growth: Searching for Hills Among Plateaus, Mountains, and Plains*, The World Bank Economic Review (2000), Vol. 14, Issue 2, 221, p222.

[56] Ibid, p225.

of, such company shall not be able to enjoy the benefits of the treaty[25] – from a practical standpoint, this specific rule has found sparse acceptance in the actual BITTs signed by the United States.[26] The proposed text for Article 4, paragraph 3, of the OECD Model Convention, would disallow benefits of the treaty, "except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States."[27] Therefore, if authorities disagree as to which State a particular corporate taxpayer shall be deemed a resident of, they may try and reach a consensus as to what the effects of their disagreement shall be under the treaty.

A couple of issues should be raised with this modification of Article 4, paragraph 3, if it is indeed implemented by the OECD. The first one is whether BITTs should open themselves even more to the scrutiny of competent administrative authorities, which – granted – may be more prepared than any legislative body to tweak tax implications of hybrids when a preemptive or responsive action in that regard is deemed necessary.[28] If the recommendations of Action 6 (designed to prevent the "Granting of Treaty Benefits in Inappropriate Circumstances") are adopted together with Action 2, authorities would have at their disposal two weapons against

[25] See United States Treasury Department, *United States Model Income Tax Convention of November 15, 2006* (2006), p08 (http://www.treasury.gov/press-center/press-releases/Documents/hp16801.pdf). This is an exception to the rule, also contained in paragraph 4, which states that a company otherwise regarded as a "dual-resident company" shall be resident of the Contracting State under the laws of which it has been created or organised.

[26] See the 1996 Convention with Austria (Article 4, paragraph 4) and the 2001 Convention with Denmark (Article 4, paragraph 3), which simply state that authorities of both Contracting States "shall endeavor to settle" cases of dual residence. See also the 1992 Convention with the Netherlands (Article 4, paragraph 4) and the 2006 Convention with Belgium (Article 4, paragraph 5), which provide that specific benefits shall be granted to dual resident companies even if tax authorities do not reach a mutual agreement as to the Contracting State of their residence for BITT purposes.

[27] See supra note 24, p05. The OECD has expressly stated in the Discussion Draft that the proposed text will not address all the hybrid mismatches related to dual-resident entities, either because a mismatch may derive from a discrepancy between domestic law and treaty provisions, or because a treaty may not exist between relevant countries in every case.

[28] Article 25 of the OECD Model Convention does not require competent authorities to necessarily abide by the request of taxpayers for the use of mutual agreement procedures (MAP), or to necessarily conclude an agreement (if a MAP is initiated) in the case of double taxation, which could arise if source and residence Contracting States respectively deny a deduction and include the corresponding payment in the ordinary income basis of the recipient, as a result of what they perceive to be a hybrid arrangement. See OECD, *2014 OECD Model Tax Convention on Income and on Capital*, OECD Publishing (2014), pp38-39. General MAP practice in and out of the OECD has taught taxpayers that, for starters, standstill situations are not often left unresolved by the existence of a MAP provision in the relevant BITT. See *Teletech Canada, Inc. v. Minister of National Revenue* 2013 FC 572. In addition, the application of MAP for civil law countries is seldom an exclusively administrative matter – taxpayers in these jurisdictions are free to seek judicial remedies (and are often more inclined to do so than their peers in common law countries) in the event diplomatic solutions do not appease them. See Igor Mauler Santiago, *Direito Tributário Internacional: Métodos de Solução dos Conflitos*, Quartier Latin (Brazil) (2006), pp213-214.

aggressive tax planning strategies involving hybrid entities; either they would fall at the first hurdle, which would be the new Article 4, paragraph 3, or they would be caught by the GAAR contained in the new Article 10, paragraph 6, of the OECD Model Convention.[29] The second issue raised by the proposed change is whether authorities would be willing (and if so, how willing) to reach an agreement as to the effects of their inability to decide on residence matters. Would a hybrid entity not be blessed by an agreement between competent authorities be considered a disqualified resident of a specific Contracting State? Of both of them? Of neither, perhaps? And if so, how would that result be coordinated with relevant BITT provisions? One could argue that the absence of a clear agreement between competent authorities would leave multinationals in a significantly disadvantageous position in comparison to companies operating in "responsive BITT jurisdictions" (in other words, BITT countries which are able to agree on residence matters with local authorities) or wholly domestic companies.

The other set of proposals brought by the second Discussion Draft has to do with transparent entities, and once again we find that the OECD is taking a page out of the playbook of the United States, the founding fathers of the check-the-box rules.[30] The proposed text for Article 1, paragraph 2, of the OECD Model Convention, which is intended to prevent the utilisation of transparent entities for the purpose of enjoying BITT benefits, seems clearly inspired by Article 1, paragraph 6, of the US Model.[31] The proposed text is accompanied by a saving clause which may be rendered unnecessary if a proposal from Action 6 is adopted.[32]

[29] The proposed Article 10 would include in the text of the OECD Model Convention an array of provisions related to the "Entitlement to Benefits" under the treaty, largely inspired by the Limitation on Benefits (LOB) provisions of the U.S. Model. See supra note 23, pp31-34. An important difference between the two lies on the proposed Article 10, paragraph 6, which would arm the OECD Model with an LOB GAAR. See OECD, *Public Discussion Draft – BEPS Action 6: Prevent the Granting of Treaty Benefits in Inappropriate Circumstances*, OECD Publishing (2014), p10 (http://www.oecd.org/ctp/treat ies/treaty-abuse-discussion-draft-march-2014.pdf). Last viewed on 05 January 2015.

[30] "Under regulations issued in 1996, entities organised under laws analogous to the corporation laws of the US states are classified as corporations for US tax purposes, and all other entities organised under foreign law may elect to be classified as either corporations or partnerships (or, for single-owner entities, as disregarded entities). The regulations, commonly known as the check-the-box regulations, facilitate so-called hybrid entities, entities that are corporations under foreign tax laws but are partnerships or disregarded entities for US tax purposes (or vice versa)." See Boris I. Bittker and Lawrence Lokken, *Fundamentals of International Taxation – US Taxation of Foreign Income and Foreign Taxpayers*, Thomson Reuters (2012/2013), pp65-56.

[31] Though the US Model provision refers to "income, profit or gain" and the OECD proposal for Article 1, paragraph 2, contains only the word "income", the proposed paragraph 26.9 of the Commentary to the OECD Model Convention clarifies that the meaning of the word "income", as used in Article 1, paragraph 2, includes, for example, "profits of an enterprise and capital gains." See OECD, *Public Discussion Draft – BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues)*, OECD Publishing (2014), p08.

[32] It would be the proposed text for Article 1st, paragraph 3: "This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits

Additionally, countries endeavour to encourage well-established domestic companies to expand their business into other markets because national companies abroad bring long-term capital gains, help build economic and political ties with other nations, and may ensure access to natural resources that the home country lacks.[2] Concluding international agreements with relevant partners is one of the regulatory policy tools that work towards fostering foreign expansion of national companies.[3] The existence of an international investment agreement ("IIA") may signal to international investors a favourable investment environment, and provide them with guarantees that their investments will benefit from adequate regulatory conditions in their business operations.[4]

The main purpose of IIAs is to ensure a stable and predictable environment for investment, through providing investor protection (including relative and absolute standards, as discussed below) and giving access to investor and state arbitration in a case of a breach of a treaty obligation.[5] As a result, IIAs interest all members of the international

Economy, in Thomas Cottier and Panagiotis Delimatsis (eds) The Prospects of International Trade Regulation – From Fragmentation to Coherence, Cambridge University Press (2011), pp417-451.

2 For an overview, see Andreas .F. Lowenfeld, *International Economic Law*, Oxford University Press (2002), pp391-414.

3 See Daniel R. Sieck, *Confronting the Obsolescing Bargain: Transacting Around Political Risk in Developing and Transitioning Economies Through Renewable Energy Foreign Direct Investment*, SUFFOLK TRANSNATIONAL LAW REVIEW (2010), Vol. 33, 1, p319.

4 For further information on the impact of these treaties on foreign direct investment (FDI) flows, see Julien Chaisse and Christian Bellak, *Do Bilateral Investment Treaties Promote Foreign Direct Investment? Preliminary Reflections on a New Methodology*. TRANSNATIONAL CORPORATIONS REVIEW (2011) Vol. 3, 4, pp3-11. See also Julien Chaisse and Christian Bellak, *Navigating the Expanding Universe of Investment Treaties—Creation and Use of Critical Index*. JOURNAL OF INTERNATIONAL ECONOMIC LAW (2015) Vol. 18, 1, pp79-115. Also Jeswald W. Salacuse and Nicholas P. Sullivan, *Do BITs Really Work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain*, HARV. INT'L L. J. (2005), Vol. 46, 2, 67-69, p76. The United States Trade Representative's office recognised the goals of the United States Bilateral Investment Treaties Program to be the protection of United States investment abroad, the encouragement and adoption in foreign countries of policies that treat private investment fairly; and supporting the development of international law standards that are consistent with the stated goals. See also Jeffrey Lang, *Keynote Address*, *CORNELL INT'L L. J.* (1998), Vol. 31, 1, p457.

5 Along with an increase in number of IIAs, the last decade has also witnessed an exponential surge in investment disputes between foreign investors and host country governments. Arbitral panels are charged with the task of applying the rules of IIAs in specific cases, an often complex process given the broad and sometimes ambiguous terms of these arrangements. See, generally, Kenneth J. Vandevelde, *A Brief History of International Investment Agreements*, U.C. DAVIS J. INT'L L. & POL'Y (2005), Vol. 12, 1, pp173-175 (noting that foreign investors are increasingly resorting to the mechanism of international arbitration for resolving their disputes with the government of a host country). On the emerging issue of sovereign debt restructure by international Tribunals, see Julien Chaisse, *The Impact of International Investment Agreements on the Greek Default*, in Chin Leng Lim and Bryan Mercurio (eds) International Economic Law after the Global Crisis – A Tale of Fragmented Discipline, Cambridge University Press (2015), pp535-572.

community.[6] Capital-exporting countries use these rules to seek investment opportunities abroad and to protect their investments in foreign jurisdictions.[7] Capital-importing economies use these rules to promote inward investment by ensuring that foreign investors have a stable business environment in conformity with high international standards.[8]

Germany and Pakistan signed the very first bilateral investment treaty ("BIT") in 1959; since then BITs have been one of the most popular and widespread forms of IIAs.[9] Since IIAs play a significant role in the economic development of all countries, they have considerably expanded in number and type, creating their own specific and dynamic branch of international economic law.[10] The core of foreign investment is based on BITs[11] and, increasingly, on preferential trade agreements ("PTAs").[12] Currently, more

6 See Julien Chaisse, *Exploring the Confines of International Investment and Domestic Health Protections: General exceptions clause as a forced perspective*, AM. J.L. & MED (2013), Vol. 39, 2/3, p332.

7 See Rudolf Dolzer and Christoph Schreuer, *Principles of International Investment Law* (2008) p22 ("[T]he purpose of investment treaties is to address the typical risks of a long-term investment project, and thereby to provide for stability and predictability in the sense of an investment-friendly climate.").

8 *Ibid.* at 22.

9 Stephen M. Schwebel, *The Influence of Bilateral Investment Treaties on Customary International Law*, Am. Soc. Int'l L. Proc. (2004), Vol. 98, 2, p27.

10 Since NAFTA's entry into force there has been an explosion in the number of IIAs that involve many countries. IIAs have existed primarily between developed and developing countries to protect the formers' investors. See *Andreas .F. Lowenfeld, International Economic Law*, p554–564 (discussing the restrictions on government action regarding foreign investment included in bilateral investment treaties). However, in the last decade, there has been a growing number of IIAs concluded between developing countries, characterizing the evolution of emerging economies and the ascendancy of sovereign wealth funds. See Julien. Chaisse, Debashis Chakraborty, and Jaydeep Mukherjee, *Emerging Sovereign Wealth Funds in the Making: Assessing the Economic Feasibility and Regulatory Strategies*, Journal of World Trade (2011), Vol. 45, 4, pp837-876.

11 A BIT is a treaty between two states that ensures that investors of a state-party receive certain standards of treatment when investing in the territory of the other state-party. Jose E. Alvarez, *Empire, Contemporary Foreign Investment Law: An "Empire of Law" or the "Law of Empire"?*, Ala. L. Rev. (2009), Vol. 60, 1, p957-959. The purpose of the BIT is to encourage FDI between the two state-parties, which hopefully leads to economic growth for both state-parties.

12 In this paper, we use the term BITs in reference to international instruments specifically devoted to the promotion and protection of foreign investment. PTAs are meant to denote all bilateral, regional, or plurilateral arrangements that seek the preferential liberalization of investment flows, along with trade in goods and in services. PTAs also often provide rules on other areas, such as intellectual property, competition, and movement of natural persons. Both BITs and PTAs with investment disciplines are encompassed under the broader terms of IIAs. Not all PTAs deal with the protection of direct investments (as such, and not as services); direct investment matters are often included in a separate chapter of the PTA. The North American Free Trade Agreement (NAFTA) is a prime example of a PTA. Chapter XI of NAFTA is devoted to the promotion and protection of foreign investments. These separate investment chapters in PTAs are comparable, on average, to self-standing BITs. They can include both rules on investment liberalization (non-discrimination

justified, but the temporary enforcement measures taken before even the local appeals or court proceedings have played out, were so damaging to the operations of the company that they were hardly of any consequence. After all, the company will not survive the temporary measures anyway. That situation, the tribunal found, does violate the BIT because it amounts to an expropriation.

In terms of substance, one can observe that four key substantive provisions have been important to conclude in a breach of the relevant treaty, namely, the expropriation clause, the FET clause, the full protection and security standard, and the NT provision. Each of these four provisions will be further analysed.

¶6-300 Key Breaches: Emergence of a Parallel Economic Regime for Tax

Investment agreements enshrine a series of obligations on the parties aimed at ensuring a stable and favourable business environment for foreign investors. These obligations pertain to the treatment that foreign investors and their investments are to be afforded in the host country by the domestic authorities, as well as ensuring that foreign investors have the ability to perform certain key operations related to their investment. The "treatment" granted to investors encompasses all types of laws, regulations and practices from public entities that apply to or affect the foreign investors or their investments.[32] All public entities are bound by the international obligations, including the federal and sub-federal governments, where applicable, local authorities, regulatory bodies, and entities that exercise delegated public powers. Measures adopted by private actors can also – although rather exceptionally – fall under the scope of international agreements when such private measures can ultimately be attributed to a governmental entity. The set of obligations is rather consistent amongst the great number of IIAs. The core provisions found in an investment agreement typically include a most favoured-nation ("MFN") treatment obligation, the granting of NT, an obligation to provide FET as well as protection and security to foreign investors, and an obligation to allow international transfers of funds. These diverse provisions are important to reassure foreign investors that they will be able to reap the benefits of their investment. In the context of tax disputes, the expropriation clause and the fair and equitable treatment have proven the most important.

¶6-310 The Protection of Investment against Expropriation

The protection of foreign investors has historically been the main goal of IIAs. Hence, the inclusion of disciplines against the nationalisation or expropriation of foreign investments constitutes a pivotal guarantee for

[32] See generally Heather L. Bray, *Note, ISCID and The Right to Water: An Ingredient in the Stone Soup*, ICSID REVIEW (2014), Vol. 29, 2, p474.

foreign investors (1). We then analyse the application of this provision in the context of water-services-related disputes (2).

¶6-311 The Regulation of Expropriation

There are significant discrepancies in the way the FET is defined in investment treaties and in different countries' practices; this is because some IIAs will cover both direct and indirect expropriation whereas some will not address indirect expropriation. The choice is important, because if a treaty covers indirect expropriation, it means that the IIA grants a protection to foreign investors who may be faced with serious alterations of the investment climate which they could not have reasonably anticipated. There is however no clear definition of indirect expropriation. Despite a number of decisions by international tribunals, the line between the concept of indirect expropriation and governmental regulatory measures not requiring compensation has not been clearly articulated and it depends on the specific facts and circumstances of the case.[33] In recent years, a new generation of US and Canadian investment agreements, including the investment chapters of FTAs, have introduced specific language[34] and established criteria to assist in determining whether an indirect expropriation requiring compensation has occurred. During the last decade, jurisprudence has demonstrated that the cases of indirect expropriation fall short of the actual physical taking of property but that they may result in the effective loss of management, use, or control, or a significant depreciation of the value of the assets of a foreign investor.[35]

Indirect expropriation can be further divided into regulatory takings, which are "those takings of property that fall within the police powers of a State, or otherwise arise from State measures like those pertaining to the regulation of the environment, health, morals, culture, or economy of a host country".[36] The issue of regulatory takings is a particular point of concern from the perspective of tobacco control, as well as other sensitive areas of public policy.[37]

[33] See Anne Van Aaken, *International investment law between commitment and flexibility: a contract theory analysis*, JOURNAL OF INTERNATIONAL ECONOMIC LAW (2009), Vol. 12, 1, pp510-512.

[34] See, for a discussion, Rachel D. Edsall, *Indirect expropriation under NAFTA and DR–CAFTA: potential inconsistencies in the treatment of state public*, BOSTON UNIVERSITY LAW REVIEW (2006), Vol. 86, 2, pp953-961.

[35] As stated by Gemplus Arbitral Tribunal, "an indirect expropriation occurs if the state deliberately deprives the investor of the ability to use its investment in any meaningful way". See *Gemplus, S.A., SLP, S.A. and Gemplus Industrial, S.A. de C.V. v. United Mexican States*, ICSID Case No. ARB(AF)/04/3 & ARB(AF)/04/4, Award, (16 June 2010), Part VIII, para. 23.

[36] United Nations Conference on Trade and Development, *Taking of Property*, 12, U.N. Doc. UNCTAD/ITE/IIT/15 (2000).

[37] See Julien Chaisse, *Exploring the Confines of International Investment and Domestic Health Protections – General exceptions clause as a forced perspective*, AMERICAN JOURNAL OF LAW & MEDICINE (2013), Vol. 39, 2/3, p332.

When the Basic Law was being drafted, the committee in charge of drafting the Economy part [Economy Special Subject Subgroup ("ESSS")] admitted that the balanced budget article (Article 107) and the low tax policy article (Article 108) were imported from the USA and were based on fiscal constitutionalism or the principle of constitutional restraint on government's power.[26] However, it was not explained why these rules were imported into the Basic Law or what necessitated incorporating these rules for Hong Kong. Whether these rules would be effective in Hong Kong conditions was never explained.[27] It is not an exaggeration to say that the power of government was restricted in terms of "low tax" policy for the purpose of keeping Hong Kong as the destination of foreign investments.

Given the precondition that the low tax policy be included in the Basic Law it was argued that balanced budget rule must be institutionalised due to the economic and political uncertainties before and after 1997.[28] It was considered that a conservative fiscal policy is more important than anything else. Though, as it was pointed out that the Hong Kong government has full autonomy in public finance. In order to prevent such autonomy from being abused, a balanced budget rule must be constitutionalised in the Basic Law.[29]

Technically, the incorporation of Article 107 in the Basic Law may not satisfy all the characteristics of a constitutional economics in particular, fiscal constitutionalism. However, it does reflect certain vital ingredients of balanced budget theory. Article 107 provides for guidelines for the HKSAR government. These are most in HKSAR government should: (a) follow the principle of keeping expenditure within the limits of revenues in drawing up its budget; (b) strive to achieve a fiscal balance; (c) avoid deficits; and (d) keep the budget commensurate with the growth rate of its gross domestic product.[30] All these limits on governmental power were aimed at maintaining Hong Kong as the favourable jurisdiction for investment and to capitalise on the proximity of Hong Kong with China.

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[26] See Shu-Hung Tang, *Fiscal Constitution and the Basic Law (Draft) of Hong Kong*, Working Paper Serial No. 89005, School of Business, Hong Kong Baptist College, (July 1989) p12.

[27] Lam Hong-che, *Constitutional Economics: Restraining Government's Abuse of Power*, Hong Kong Economic Journal Monthly, (4 November 1986) Vol. 10, p.51 as quoted in Shu-Hung Tang, *Fiscal Constitution and the Basic Law (Draft) of Hong Kong*, p.13. On the question of the relevance of these principles in HKSAR one scholar Mr. Lam wrote Constitutional Economics gives us many insightful revelations. The power to tax and the spending of the future government of the HKSAR should be clearly specified in the Basic Law – if it is respected by Beijing, even if the free lunch group "becomes a majority within the future democratised representative legislature", it may not be able to distribute "free lunches" because of insufficient revenues. The government of HKSAR has to live within the limits of its revenues. It is absolutely essential that the Basic Law takes away the HKSAR's authority to create budgetary deficits so as to avoid the risk of having to levy higher tax - an element which is so crucial to Hong Kong's economic prosperity.

[28] See Shu-Hung Tang, *Fiscal Constitution and the Basic Law (Draft) of Hong Kong*, pp13-14.

[29] See Shu-Hung Tang, *Fiscal Constitution and the Basic Law (Draft) of Hong Kong*, p14.

[30] The Basic Law, Article 107.

Article 108 or the low tax policy article also reflects the essence of fiscal constitutionalism in the Basic Law. It states that: the HKSAR shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.[31]

The ESSS argued that the two fiscal constitution articles could guarantee the fiscal stability of the HKSAR government: insulate the economy from interference of excessive welfare expenditure; and promote business confidence and stimulate investment.[32]

After long discussions on pros and cons of including the fiscal constitutional provisions, "low tax" and "balanced budget" provisions were finally adopted in the Basic Law. The discussion ended with comments that the inclusion of these provisions would have a significant bearing on the operation of the HKSAR government as well as on the entire community. They were praised by their supporters as a bill of economic liberties comparable to Bill of Rights and being one of a kind in the World.[33]

The cumulative effect of these provisions on HKSAR is that it has created a special tax requirement formula which has to be adhered to by government. The sovereign power to tax has been limited by enunciating the theory of constitutional economics in the Basic Law.[34] These rules of dictate that the HKSAR government while enacting any tax laws must take a "low tax policy" as a reference.[35] Being an SAR with a "high degree of autonomy", Hong Kong does have the power to practice independent tax system *but* within the four corners of the fiscal constitution.[36]

Therefore, investors coming to Hong Kong for investment have guarantees in the Basic Law that low tax policy will be in in place which is above and beyond the security provided through "legitimate expiation"

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[31] The Basic Law, Article 108.

[32] See Shu-Hung Tang, *Fiscal Constitution and the Basic Law (Draft) of Hong Kong*, p17.

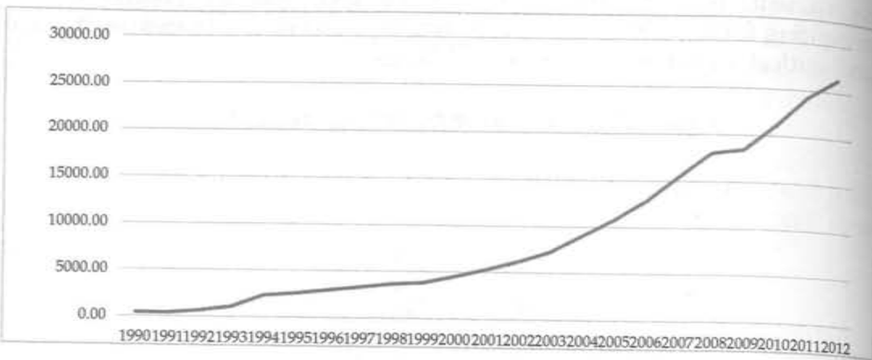
[33] See "Constitutional Economics and the Provisions on Economy in the Basic Law (Draft)", p.267.

[34] The idea behind inclusion of constitutional economics in the Basic Law has even gone beyond the idea propounded by Buchanan himself. See Yash Gahi, *Constitutional Law*, in Judith Sihombing (ed.), Annual Survey of the Law 1990-1991, Hong Kong Law Journal Limited (1992) p191.

[35] See the Basic Law, Article 108.

[36] The Basic Law, Article 2, and Chapter V. The economic provisions of the Basic Law serve four principal purposes: (a) separate the economic system of the HKSAR from the economic system of the PRC; (b) provide a framework for the operation of a capitalist market; (c) establish key elements of constitutional economics; and (d) maintain Hong Kong's status and role as an international trade and finance centre. See Yash Ghai, *Constitutional Law*, p192.

Figure 3: Trends of China VAT from year 1990 - 2012[92]



The Chinese VAT has the same basic features as the European VAT, with some minor differences. It is applicable to the sale of taxable goods and the provision of labour services in relation to the processing of goods, imports and of repair and replacement services within China. The term "Taxable goods" refers to tangible goods as well as certain utilities such as electricity, thermal power and gas excluding real estate properties (subject to real state taxes).

The current VAT is part of the indirect taxes family, and together with the business tax ("BT", mainly to services, excluding the ones taxed under the VAT) and consumption tax (applied to luxury goods in addition to VAT), represent the tax treatment applied to sales of goods and services in China.

Concerning to rates, generally, exports are zero-rated, except for certain categories of goods in which VAT would be due under domestic sales rules. Moreover, in exports, some related input VAT can be fully or partially refunded, depending on the categories of goods. The non-refundable portion would be absorbed as cost of export and consequently reflected in the final price.

The standard VAT rate is 17%[93] and a reduced rate of 13% may be applied to some products related to basic household necessities such as food, fuel, electricity, books, newspapers, magazines and agricultural products.

The rapid growth of China's economy and the development of the infrastructure of a modern economy should provide the opportunity for

[92] Graphic prepared by Natasha Rocha Maggessi with information from China statistical year book 2013, Government Finance, item 9-4. http://www.stats.gov.cn/tjsj/ndsj/2013/indexeh.htm (last viewed on 16 February 2015).

[93] "Order of the State Council of the People's Republic of China (No.538), promulgated in 11/10/08, Art. 2.

an evolution of its tax system, as seen in the significant reforms made in recent years[94]. Perhaps the most impacting change occurred in 2011, when China released the details of a pilot program for the reform of its turnover tax regime that will result in the merge of VAT and BT into a single tax. The pilot program debuted in 2012 in the city of Shanghai and only for some chosen industries with the promise of gradual extension to more cities and industries.

There were not many changes related to the deductions systematic, although there were some critical changes to the current VAT. It should be considered that the changes are not fully implemented in most Chinese cities, but the new rules represent the most updated understanding of some concepts by PRC authorities and what is expected to happen in the future for Chinese VAT.

The VAT Tax Reform, aims to merge BT-business tax (an essentially service tax) with VAT-value added tax (mostly for goods) and reduce even more the tax burden due to double taxation and cascade effect in some operations, enacting a number of benefits for multinational companies conducting business in China.

Although the rate of the VAT to services will be higher than the applicable current BT rate, selected service providers are allowed to offset outputs with inputs, so in the end, only the added value of the service will be taxed and not the full price of the service provided, achieving "production neutrality", a key advantage of modern VAT[95]. Therefore, the nominal tax rate may seem higher but the effective tax payable should be lower. In addition, trading business will also be able to claim input tax for services used as part of the production of the final products, which it was not possible under old BT rules.

It is clear that, China, with its "young" VAT tax system, has a long way to achieve a more transparent and reliable environment. Even with the recent changes, rules and basic definitions need to be well elaborated in accordance to modern practices and taxpayer specific needs. Due to the lack of legislation, some operations are taxed discretionary by tax departments enhancing tax avoidance and corruption levels.

As a start, there should be fewer different types of deduction rates and deduction procedures, especially for export rebates. The system could be simplified by implementing all legal deductions according to VAT stated in the seller's invoice, allowing only the profit margin to be taxed. Further, it

[94] Bert Brys et al., *Tax Policy and Tax Reform in the People's Republic of China*, p13. http://dx.doi.org/10.1787/5k40l4dlmnzw-en (last viewed on 16 December 2014).

[95] Bert Brys et al., *Tax Policy and Tax Reform in the People's Republic of China*, p13. http://dx.doi.org/10.1787/5k40l4dlmnzw-en (last viewed on 16 December 2014).

any action of the courts deciding against investors, rather it involves a denial of a right to go to court, to refuse to entertain a claim, undue delay in judgment or the administration of justice in a deficient way, and clear misapplication of law.[11] In *Glamis Gold*, a 2009 case involving the minimum standard of treatment in NAFTA, which is tied to CIL, the tribunal described the standard, as "...a violation of the customary international law minimum standard of treatment", as codified in Article 1105 of the NAFTA, requires an act that is sufficiently egregious and shocking – a gross denial of justice, manifest arbitrariness, blatant unfairness, a complete lack of due process, evident discrimination, or a manifest lack of reasons – so as to fall below the accepted international standards and constitute a breach of Article 1105.[12] Such a breach may be exhibited by a "gross denial of justice or manifest arbitrariness falling below acceptable international standards", or the creation by the state of objective expectations *in order to induce* investment and the subsequent repudiation of those expectations.

Every state has the right to expropriate, as long as it is for a public purpose (e.g. road or rail construction), not arbitrary or discriminatory (applicable both to foreign and domestic investors), in accordance with the due process of law (i.e. in accordance with basic standards of fair procedure, proper notice, allowed to have access to a process to challenge the expropriation) and accompanied by adequate compensation. These requirements are generally expressed either in CIL or national laws, and the only issues are what state actions constitute expropriation and what is the standard for compensation. There are two kinds of expropriation. The direct expropriation is relatively clear. It occurs when a state takes over an investor's property. However, the indirect expropriation is some sort of government action, other than which substantially affects an investor's ability to use its property, but there is no formal transfer of property to the state. It is less clear when an indirect expropriation has taken place.

¶8-130 Dispute Settlement in IIAS

There are two different kinds of dispute settlement procedures in IIAs: State-to-State Dispute Settlement, and Investor–State Dispute Settlement.

Most IIAs have established a process to address disputes between states, regarding the "interpretation or application" of the treaty. However, these procedures have rarely been used. The major issue is whether the

[11] Sometimes the denial of justice is quite evident, such as in the *Loewen* case where in civil judicial proceedings a US lawyer for the plaintiff made discriminatory remarks regarding the foreign defendant effectively making the dispute a racial issue. See Loewen Group, Inc. and Raymond L. Loewen v. United States of America, ICSID Case No. ARB(AF)/98/3, 26 Jun 2003. The court failed to prevent the lawyer from making these prejudicial arguments and very substantial punitive damages were awarded against the defendant investor as a result.

[12] See Glamis Gold, Ltd. v. The United States of America, UNCITRAL, 8 Jun 2009.

scope of the procedures covers all provisions in IIAs or whether it excludes some of them. Most state-to-state procedures cover all IIA obligations but some contain exclusions. The current US Model BIT, for example, excludes the provisions regarding the maintenance of labour and environmental standards. Typically, state-to-state procedures require prior consultation between the states and then arbitration procedures in case there is no amicable solution after consultation. This state-to-state mechanism at least offers a platform to developing countries and less developed countries ("LDCs") to require a developed country to engage with them regarding issues of interpretation. Arbitration procedures have not been traditionally transparent. Proceedings, notifications, and decisions have often not been made public.

Investor-State Dispute Settlement ("ISA") is a particular feature of IIAs which differentiates them from all other type of treaties. Investors from one party state are permitted to seek financial compensation from the other party state through binding arbitration on the grounds that the other party state has failed to comply with its obligations under the treaty. It fulfils investors' needs in the following ways:

- it avoids exposure of the investor to the uncertainties of host state laws and regulations by creating a separate treaty-based set of rules to govern host state conduct;
- it gives investors an alternative to the host state judicial system to seek relief from host state actions;
- an investor can determine when there has been a breach of a treaty obligation and launch a claim; and
- it is unnecessary for an investor to rely on its home state espousing its claim – there may be various reasons why a state may not want to make a claim against another state in diplomatic relations.

Committing to investor-state dispute settlement could have advantages for a host state because:

- it sends a positive signal to investors that it is committed to offering a predictable and secure investment regime;
- it creates an incentive to develop domestic polices favourable for attracting new investment and maintaining on-going investment, including policies that are predictable, certain and transparent; and
- it locks in pro-investment, market-opening reform by making it difficult to change domestic policy.

¶8-200 PRC Investment Treaty Practice

China's interests lie on providing for substantive protection for its investors abroad as well as opening new investment opportunities, while formalize agreements on international tax issues between the Mainland of China and other countries. In the past 31 years since the conclusion of the first tax treaty with Japan in 1983, the Mainland of China has established an extensive tax treaty network that has reached out for 101 jurisdictions around the globe, including two Comprehensive Double Taxation Arrangements ("Tax Treaties") entered into with Hong Kong and Macau respectively. In addition, due to the nature of international traffic that is more susceptible to double taxation, the Mainland of China has concluded dozens of airline and shipping treaties. In recent years, the Mainland of China has signed 10 Tax Information Exchange Agreements ("TIEAs") with low/no tax jurisdictions like Bahamas, the British Virgin Islands, Bermuda, etc., and has become the 56th signatory to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters ("Multilateral Convention") in an effort to fight offshore tax evasion.[1]

Hong Kong has also realized that double taxation arises when two or more tax jurisdictions overlap, such that the same item of income or profit is subject to tax in each. Hong Kong adopts the territoriality basis of taxation, which means Hong Kong residents generally do not suffer from double taxation. Notwithstanding this, the Hong Kong Special Administrative Region Government recognises that there are merits in concluding comprehensive double taxation agreements/arrangements with trading partners. A tax treaty 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. A late starter though, Hong Kong has seen a remarkable growth in the number of tax related treaties and agreements concluded in the last decade, including 31 comprehensive tax treaties, 34 airline and shipping income agreements as well seven TIEAs[2].

¶9-200 Similarities in Treaty Policy between the Mainland of China and Hong Kong

The tax treaties concluded by the Mainland of China and Hong Kong with their trading partners are similar in the following aspects:

First, in following the basic structure of the Organization for Economic Co-operation and Development ("OECD") Model Tax Convention and the United Nations ("UN") Model Tax Convention: Almost all the treaties have 30 articles or so; describing the persons and taxes covered by the treaty; defining the general and the key terms like tax residency and permanent

[1] State Administration of Taxation (China), Tax Treaty (税收条约), available at http://www.chinatax.gov.cn/n810341/n810770/index.html (last visited on 1 April 2015).

[2] Inland Revenue Department (Hong Kong), Double Taxation Relief and Exchange of Information Arrangements, available at http://www.ird.gov.hk/eng/tax/dta1.htm (last visited on 21 November 2014).

establishment; allocating the taxing rights on income and capital between source and resident states; specifying the methods to eliminate double taxation; making special provisions to resolve treaty-related disputes and exchange tax information; with the final provisions concerning entry-into-force and termination of the treaty.

Second, in making reference mainly to the OECD Model Tax Convention while drawing on valuable elements of the UN Model Tax Convention so as to best adapt to their specific context. For example, despite the absence of the corresponding paragraph in Article 5 of the OECD Model Tax Convention, almost all the tax treaties[3] concluded by the Mainland of China and Hong Kong, besides the common types of permanent establishments ("PE") like building, construction, assembly or installation projects which last for a prescribed period of time and dependent agents who habitually exercise the authority to conclude contracts in the name of a foreign enterprise, embrace the paragraph of "service PE" in the UN Model Tax Convention, allowing the source state to tax profits derived from services performed therein, provided they last long enough to constitute a PE.

Third, in adopting the same principles in allocating taxing rights with regards to certain income as prescribed in the Model Tax Convention of the OECD or the UN. For example, almost all[4] the treaties recognise that the remuneration derived by a resident of a contracting state in respect of an employment exercised in the other contracting state shall be taxable only in the first-mentioned state if: a) the recipient is present in the other state for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; and b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and c) the remuneration is not borne by a permanent establishment which the employer has in the other State. Moreover, both the Mainland of China and Hong Kong allow for direct and indirect tax credits. The amount of credit, in both jurisdictions, is restricted to the amount of tax that would be payable as computed under the crediting jurisdiction's taxation laws and regulations. Tax sparing relief is unilaterally or bilaterally included in some treaties.

[3] State Administration of Taxation (China), Tax Treaty (税收条约), available at http://www.chinatax.gov.cn/n810341/n810770/index.html (last visited on 21 November 2014); Inland Revenue Department (Hong Kong), Double Taxation Relief and Exchange of Information Arrangements, available at http://www.ird.gov.hk/eng/tax/dta1.htm (last visited on 21 Nov, 2014).

[4] State Administration of Taxation (China), Tax Treaty (税收条约), available at http://www.chinatax.gov.cn/n810341/n810770/index.html (last visited on 21 November 2014); Inland Revenue Department (Hong Kong), Double Taxation Relief and Exchange of Information Arrangements, available at http://www.ird.gov.hk/eng/tax/dta1.htm (last visited 21 November 2014).

relevant treaty countries. The OECD Model Tax Convention has introduced the arbitration process as an extension of the MAP that serves to enhance the effectiveness of the procedure. Making reference to the OECD Model Tax Convention, Hong Kong has introduced the arbitration process in some tax treaties. For example, Hong Kong/Guernsey Treaty provides that "where a person has presented a case to the competent authority of a Contracting Party on the basis that the actions of one or both of the Contracting Parties have resulted for that person in taxation not in accordance with the provisions of the Agreement, and the competent authorities are unable to reach an agreement to resolve that case within two years from the presentation of the case to the competent authority of the other Contracting Party, any unresolved issues arising from the case shall be submitted to arbitration if both competent authorities and the taxpayer agree and the taxpayer agrees in writing to be bound by the decision of the arbitration board. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either Party. The decision of the arbitration board in a particular case shall be binding on both Parties with respect to that case".

The Mainland of China, however, has never included the arbitration process in any of its tax treaties due to legal barriers and seems not to be going to introduce it for the time being, despite the hot discussions by international tax community on BEPS Action Plan 14 which reiterates OECD's recommendation on arbitration as the final solution to unresolved MAP cases. The SAT of the Mainland of China has focused more on operational details of MAP by releasing Circular Guoshuifa [2005] 115 in 2005 and SAT Public Notice No.56 in 2013 in an effort to better serve resident taxpayers doing business overseas.

¶9-342 Exchange of Information ("EOI")

Tax treaties concluded by the Mainland of China and Hong Kong with other jurisdictions are similar in the wording of the provision concerning exchange of information, but different in practice, which can be seen in Circular Guoshuifa [2006] No.70 released by SAT of the Mainland of China and Departmental Interpretation and Practice Notes No. 47 ("Notes No. 47") issued by IRD of Hong Kong in 2014.

- In Circular Guoshuifa [2006] No.70, the SAT of the Mainland of China lays down the operational details in carrying out automatic EOI, spontaneous EOI and EOI on request among different levels of Chinese tax authorities, and states that the other 3 types of EOI, i.e. simultaneous tax examinations, industry-wide exchange of information, and tax examinations abroad, shall be implemented under the guidance of SAT. In other words, all six types of exchange of information recommended in the Manual approved by the OECD Fiscal Committee in 2006 are accepted and put into

practice in the Mainland of China. In contrast, Hong Kong's EOI policy is that information will only be exchanged upon request, and Hong Kong has not yet agreed to exchange information on an automatic or spontaneous basis. Information, including bank information, will only be supplied upon specific and bona-fide requests received from the competent authority of a treaty partner in justifiable cases.

- In order to safeguard taxpayers' rights, both Circular Guoshuifa [2006] No.70 and Notes No. 47 put in place strict confidentiality rules. Nonetheless, Circular Guoshuifa [2006] No.70[22] provides that tax authorities can inform taxpayers, withholding agents or other relevant parties of the purpose, source, and content of the exchanged tax information, but does not indicate whether a notification or appeal mechanism is applicable in the Mainland of China. Hong Kong, however, states in Notes No. 47 that the Commissioner must, prior to the disclosure of any information in response to a disclosure request, notify the person who is the subject of the request by a written notice, unless the Commissioner has reasonable grounds to believe that all the addresses of the person known to the Commissioner are inadequate for the purpose of giving the notification, or the notification is likely to undermine the chance of success of the investigation in relation to which the disclosure request is made. Furthermore, the person may request the Commissioner, in writing, to amend any part of the information to be exchanged, and specify the manner in which he requests the information to be amended and the grounds for the request, and submit any documentary evidence in support. If the Commissioner refuses the request of the person to amend any part of the information to be disclosed in response to the disclosure request, that person may request the Financial Secretary to review the Commissioner's decision and to direct the Commissioner to make the amendments. The Financial Secretary may approve, either fully or partially, or refuse the request. A written decision together with the reasons therefore will be given to the person, and the decision of the Financial Secretary is final. Compared with the Mainland of China, Hong Kong seems to attach more importance to protection of the rights for those under EOI investigations.

¶9-343 Assistance in Collection of Taxes

The OECD Model Tax Convention provides in Article 27 that contracting states shall lend assistance to each other in the collection of tax. Despite the fact that the Mainland of China has not included this article in any of its tax treaties, it signed the Multilateral Convention in August 2013, which "represented another significant step in the strengthening

[22] See Article 27 of Circular Guoshuifa [2006] No.70, namely Manual on International Exchange of Tax information.

offset any amount of tax payable in Hong Kong. Under Hong Kong's source principle, if an employment contract is made in Hong Kong or governed by Hong Kong law, compensation paid under the contract – whether received within or without the territory – is chargeable under Salaries Tax. When a Hong Kong manufacturer has moved its production across the border, but maintains its management, design or other functions in Hong Kong, its profits may be apportioned on a 50/50 basis, meaning, half of the profits are subject to Hong Kong tax. By the way, Article 4 of the Mainland-HK Tax Arrangement has a similar provision allowing a Mainland Chinese taxpayer to claim a credit for direct taxes paid in Hong Kong, although presumably such credit is already allowed under Chinese domestic law.

¶10-320 Tax Treaty Networks

Apart from domestic laws, double taxation agreements or arrangements ("DTAs") between governments help avoid double taxation problems by delineating and allocating their respective taxing powers on specific incomes in cross-border activities. A comprehensive DTA ("CDTA") deals with a wide range of income and property taxes while a limited DTA covers tax in specific areas such as income from international transportation activities. As of March 2014, China concluded 101 CDTAs including those with Hong Kong and Macau with 99 being in effect.[16] In addition, the country has entered into over 30 limited DTAs on air transportation, about 30 on maritime transportation, and over 20 on other international transportation matters. Hong Kong, on the other hand, has much fewer DTAs overall. As of November 2014, the territory has signed CDTAs with 31 governments including the one with Mainland China; of which, 27 are effective.[17] Even with CDTA negotiations in progress with 14 other governments,[18] Hong Kong's CDTA network is less than half the size of Shanghai's. Hong Kong does have limited DTAs covering air services and/or shipping income with over 30 governments.[19]

Hong Kong's narrower treaty network in comparison with that of Mainland China/Shanghai is due not just to its schedular system and territoriality basis of taxation which gives rise to few instances of double taxation, but also to a lack of incentives or even reluctance on the part of foreign governments to sign CDTAs with the territory. First, as Hong Kong taxation system causes few double taxation problems for foreign citizens and businesses, foreign governments feel little pressure to engage the

16 State Administration of Taxation (China), Tax Treaty (税收条约), available at http://www.chinatax.gov.cn/n810341/n810770/index.html (last visited on 10 November 2014).

17 Inland Revenue Department (Hong Kong), *Comprehensive Double Taxation Agreements Concluded*, available at http://www.ird.gov.hk/eng/tax/dta_inc.htm (last visited on 10 November 2014).

18 Inland Revenue Department (Hong Kong), *Negotiation in Progress*, available at http://www.ird.gov.hk/eng/tax/dta3.htm (last visited on 10 November 2014).

19 Inland Revenue Department (Hong Kong), *Limited Double Taxation Agreements*, available at http://www.ird.gov.hk/eng/tax/dta_ldta.htm (last visited on 10 November 2014).

territory for treaty negotiations. Secondly, as reliefs for double taxation are reciprocal under DTAs, there is little reason, from a reciprocity viewpoint, for a foreign government to hand out tax benefits to Hong Kong residents and businesses through a CDTA which would bring, however, little benefits to its own citizens and businesses. Thus, Hong Kong has had more success with limited DTAs, because limited DTAs address real double taxation problems for both Hong Kong and foreign transportation companies. Hong Kong's signing of CDTAs took off only after the first Mainland-HK Tax Arrangement in 1998, while the territory started to conclude limited CDTAs since 1980s.

Absence of a broad treaty network would first and foremost disadvantage Hong Kong-based businesses and investors. Among common features in a CDTA are mechanisms for passive income such as interest, dividends and capital gains in the forms of reductions or exemptions in withholding its source. Take example of the China-US tax treaty which provides for a maximum allowable 10% tax on gross dividend and interest paid by a resident company if the recipient is a resident of the other country and is the beneficial owner. Absent such treaty provisions, the US federal tax law imposes a flat 30% withholding rate on the US-source interest, dividend or other fixed or determinable annual or periodical ("FDAP") income earned by a foreign person. As the US treats Hong Kong as a tax jurisdiction separate from Mainland China and there is no tax treaty between the US and Hong Kong governments, a Hong Kong resident investing in the US would be treated unfavourably compared to a Mainland China-based investor for his US-source interest, dividend or other FDAP income. The absence of a CDTA also leads to uncertainty. For inbound investment, profits are taxed according to Hong Kong's source principle, which is not subject to a single test or factor. If a CDTA exists, profits of foreign investment can be taxed only if they are associated with a permanent establishment ("PE"). As a PE has been better defined and understood, there is more certainty with regard to the tax position of investors who are resident in a tax treaty country. The same problem arises for outbound investment. Under US federal law, a foreign person is subject to US tax rates on net income that is effectively connected with the conduct of trade or business in the US. For the resident of a country having a CDTA with the US, its profits are not subject to US tax unless attributable to a PE in the US. Again there is more predictability for the investor based on a jurisdiction benefiting from a CDTA with the US.

¶10-330 Tax Information Exchange

International tax cooperation also aims at combating tax evasion through information exchange and other judicial and administrative assistance. CDTAs typically contain exchange of information ("EoI") clauses requiring governments to provide information to each other upon request, automatically, or spontaneously, for purposes of administering their respective tax laws. Tax information exchanges may also be achieved

Chapter 10 Hong Kong v Shanghai: A Tale of Two Tax Jurisdictions

Zhaodong Jiang*

Hong Kong and Shanghai have been locked into a rivalry-cooperation comparison for twenty years. Hong Kong was a British colony until 30 June 1997, and is a special administrative region ("SAR") of the People's Republic of China ("China") ever since. It has played a critical role in helping the country's opening-up and reform in the last three and half decades. Historically, Shanghai was China's modernisation pioneer and model. After decades of economic autarky, the city began its revival in the 1980s. Today, it is the country's most prosperous sub-national unit. Hong Kong and Shanghai rival in finance and business location. Hong Kong is, on a par with New York and London, a top international financial hub, but the rise of Shanghai Stock Exchange, the opening of Shanghai Head Office of the People's Bank of China and the launch of Shanghai Free Trade Zone ("SFTZ") are omens that the city could eclipse Hong Kong's prominence in finance. As a prime

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location of choice for multinationals' regional headquarters, Hong Kong feels heat as businesses and entrepreneurs flocked to East China in recent years. Shanghai's GDP has overtaken Hong Kong's since 2009. As of 2013, it was about 23% larger. Though, Hong Kong still enjoys an edge over Shanghai for GDP per capita. Meanwhile, the two cities also work together for win-win outcomes. A recent example of cooperation is the Shanghai-Hong Kong Stock Connect which both liberalises Mainland investment in Hong Kong stocks and opens A shares listed in Shanghai for Hong Kong investment.

Tax is a subject of interest and comparison for understanding the two cities. Tax burdens affect a business's bottom line. Hong Kong's simple taxation system and low taxes are well known to investors. Taxation is about more than a matter of cost to taxpayers. As an important link between a government and its constituents, it not only shapes their relationship but also reveals key features of governance. Taxation mirrors governance, and governance embodies taxation. Comparisons of the two cities in terms of tax administration and policies lead to deeper insights into their respective business environments in general and taxation systems in particular. Finally, issues like international tax cooperation and business reputation unavoidably come to the mind of corporate executives and investors. It is therefore amiss not to have comparative perspectives on those issues.

Keeping in mind that an apple for apple comparison of the two tax jurisdictions is neither sensical nor feasible as Hong Kong and Shanghai have been moving along different trajectories for over one and half century, this short paper focuses on selected themes that matter most from the perspectives of businesses and observers. It starts with differences in tax regimes, rates, policies and procedural features, followed by discussions on subjects of laws and institutions that affect tax law-making, tax administration, and dispute resolution in the two cities. It then focuses on double taxation problems and reliefs, treaty networks, commitments to tax information exchange, as well as interactions between domestic law and treaty rules in Hong Kong and Mainland China. It's worth noting that China is a unitary country with the central government firmly in control of tax matters, leaving a sub-national unit like Shanghai little say on most tax matters. Also, specific information about taxation in Shanghai is not as transparent and publicly available as that in Hong Kong. For those reasons, information and discussion on taxation in China as a whole or in other parts of the country can shed lights on tax situations in Shanghai as well.

¶10-100 Tax Regimes, Rates, Preferences, and Procedural Characteristics

¶10-110 Hong Kong Tax Regimes and Rates

The "One Country, Two Systems" formula allows Hong Kong to maintain a separate and independent taxation system, which has little changed after the sovereignty handover of 1997. The territory's tax system is best known for its simplicity, with only about a dozen of taxes currently effective. Direct taxes include: Property Tax, taxing real property rentals; Salaries Tax, levied on individuals' employment-related income; and Profits Tax, affecting business income of individuals and corporations. Among indirect taxes with revenue significance are: Stamp Duty which is levied on property transactions, stock trading, and real property leasing; Betting Duty which is charged on receipts or proceeds from betting on horse racing, football matches, lotteries and cash sweeps; and a levy on the ownership of real property, called "Rates".

There are no general sales or consumption taxes except for those on hydrocarbon oil, tobacco, alcoholic products, and motor vehicles.[1] Estate Duty or "death tax" was abolished since 2006. Moreover, Hong Kong has no gross income concept. Its income taxes follow the "schedular system" under which an income is taxable only if it is specifically subjected to tax by law. Thus, as none of Property Tax, Salaries Tax or Profits Tax covers income or gains from investment activities, one's capital gains, dividends and interest payments are tax-free unless such income is derived from one's business operations. As a result, shareholders face no double taxation for their dividend incomes. Hong Kong also adheres to the source/territorial principle to determine taxable incomes, with no tax on incomes of Hong Kong residents and companies derived from outside the territory.

Direct tax rates in Hong Kong are low and simple. The rates for Profits Tax are fixed: 15% for unincorporated businesses; and 16.5% for corporations. So is that of Property Tax (15%). Salaries Tax adopts two sets of rates: a progressive set from 2% to 12% on the first three HK$40,000 segments of net income; and 17% on the remaining net income; and a fixed rate of 15% on income before deductions and allowances. Tax is computed under both sets of rates and payable according to the lower one.

¶10-120 Tax Regimes and Rates in Shanghai

In Mainland China, the central government legislates on all matters concerning taxation in the country. Since the mid-1990s, on the basis of which treasury the collected revenues should go, taxes have been divided into national taxes ("国税") which finance the central government budget; local taxes ("地税") which go to the coffers of sub-national and lower level governments; and shared taxes ("分享税") which provide revenues to be shared between the central and local governments. Two lines of tax agencies now exist in the country: National tax bureaus ("国税局") from the national to county levels which are in charge of collecting and administering national and shared taxes; and local tax bureaus ("地税局") from the sub-national to county levels which act on concerns of local taxes. At the top is the State Administration of Taxation ("SAT") ("国家税务总局"), which works

[1] Other indirect taxes are air passenger departure tax, royalties and concessions, and certain fees and charges that can be classified as taxes. A hotel accommodation tax is currently waived.

closely with the Ministry of Finance ("MOF") ("财政部") to regulate matters of national taxation and make policies for matters of local taxation. However, the central government allows sub-national and local governments to regulate certain local tax matters. Shanghai is the only sub-national unit which combines Shanghai Municipal Office, SAT and Shanghai Municipal Bureau of Taxation into a single unit, yet officially wearing two separate hats, respectively.

Shanghai like the rest of China collects no less than sixteen taxes, ranging from main revenue sources such as Value Added Tax ("VAT") ("增值税"), Business Tax ("营业税"), consumption tax ("消费税"), Enterprise Income Tax ("EIT") ("企业所得税") and Individual Income Tax ("IIT") ("个人所得税") to less important ones like Fixed Assets Investment Orientation Regulation Tax ("固定资产投资方向调节税") and Resources Tax ("资源税"). China embraces the concept of gross income for EIT and, to some extent, for IIT as well. Both the residence and source (or territorial) principles apply to determine taxable incomes. The residence principle taxes a Chinese resident's income whether originated within or without the Chinese territories, whereas under the source or territorial principle, income from a domestic source is taxable no matter whether the recipient is a Chinese resident or not. Unlike the US tax system which extends its reach to all citizens, however, the residence principle as adopted in China is confined to those who maintain habitual residence through household registration, family, economic, or other relationships. The fact that an individual holds the Chinese passport does not automatically make the person tax resident.

Tax rates in China are neither low nor simple. Apart from a standard rate of 17% and a lower rate of 13%, VAT has a zero rate for exports, a 3% rate for small VAT taxpayers, and other rates for transactions such as those not eligible for tax credits. Business Tax contains nine sectors or categories of activities with rates ranging from 3% to 20%. While resident enterprises' incomes are subject to a 25% flat rate and non-resident enterprises' incomes to a nominal 20% rate, reduced rates may also apply to taxable incomes of enterprises under various preferential arrangements. Rates under IIT are most complex: a progressive rate from 3% to 45% applies to salaries and wages; a progressive rate of 5% to 35% to individuals' business and production incomes; a 14% effective rate to royalties from publications; a progressive rate of 20% to 40% to income from labour and services other than salaries and wages; a flat rate of 25% to incomes such as licensing fees, interest, dividends, rents, capital gains and other one-time incomes; a 10% preferential rate for rentals of residential properties.

¶10-130 Features of Two Tax Regimes

Apart from rates, Hong Kong rules tend to reduce tax burdens in other ways. Taxable income under Salaries Tax typically excludes incomes in kind (except for stock options), whereas IIT includes incomes both in cash and in kind. Like most developed economies, Hong Kong provides an allowance for taxpayers themselves as well as allowances for members of family and dependents when computing Salaries Tax liabilities. Taxpayers may also claim deductions for outgoings and expenses for the production of assessable income, and deductions, subject to caps, for expenses for self-education, home loan interest, contributions for retirement funds, and charitable donations. A Chinese salary or wage earner is given a universal basic allowance, but no allowances for spouse and other dependents. In Hong Kong, as only Salaries Tax provides progressivity, deductions and allowances, an individual is entitled to what is known as "Personal Assessment", which allows the taxpayer to benefit from progressivity, deductions and allowances even for the incomes that are taxed under Property Tax and Profits Tax.

For calculating business earnings and profits, while both jurisdictions allow deductions for a number of items, EIT rules in Mainland China tend to be more restrictive than those in Hong Kong. For instance, Mainland Chinese law allows interest deduction only to the extent of the comparable rates charged by financial institutions in the Mainland, whereas Hong Kong law contains no such restrictions. While both jurisdictions require, for determining deductibility, interest expenses to be incurred for the production of taxable income, Hong Kong's Court of Final Appeals ("CFA") has taken a more liberal view that such expenses are deductible even if their purposes were not wholly or exclusively for income production.[2] While losses can be carried over for a maximum of five years under EIT, there is no limitation on how long they can be carried over under Profits Tax.

¶10-140 Tax Preferences

The start of China's economic reform and opening-up in the late 1970s was accompanied, first and foremost, by tax preferences offered to overseas investors. The importance of tax incentives was underscored by the fact that the country did not even have any modern income tax systems in place at that time. So foreign experts were invited to advise the authorities on new tax rules and legislations specifically applied to foreign investment were adopted to show that the post-Mao leadership would embrace overseas capital and technology with open arms. In the next several years, preferential tax treatment proliferated with various schemes and multiple targets.[3] Although Shanghai was not among the first four special economic zones ("SEZs"), it became in 1984 one of the fourteen cities designated as "Coastal Open Cities" with special tax treatments for promoting high-tech development and industrial revitalisation. By early 1990, the Pudong New District was established with preferential tax schemes comparable to those of SEZs. With mounting problems of tax

[2] *Zeta Estates Limited v Commission of Inland Revenue* [2007] 2 HKC 527.

[3] Zhaodong Jiang, *China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts*, Northwestern Journal of International Law & Business (1998), Vol. 18 No. 3, 549, pp549, 550-51.

equity, domestic discontent and revenue concerns, however, the Chinese government gradually started, since late 1990s, to do away with many of preferential tax measures reserved for foreign investment.

Today, numerous tax preferences targeting sectors such as hi-tech, renewable energy and agriculture still exist, but they may not particularly favour foreign investment. Some of them in fact discriminate against foreign business. For example, it is reported that certain tax exemptions are available to domestic authorised securities investment funds, but not to foreign funds.[4] The recently launched SFTZ has yet to announce tax measures to attract business. On the other hand, a number of tax benefits for foreign employees remain in place. Thus, expats are tax exempt for a number of fringe benefits including housing, meal and laundry allowances received in a non-cash form or on a reimbursement basis, reimbursement of relocation expenses, travel allowance, home leave allowance, language training and children education allowance. Also, a foreign individual who lives in China for more than one year but less than five years may not be taxed for his foreign-source income, even if the individual should have otherwise met the threshold of being a PRC tax resident.

Hong Kong has never been enthusiastic about granting preferential tax treatment to attract foreign investment. If Hong Kong tax regimes are business-friendly, they are open and available to both domestic and foreign businesses and do not discriminate against particular industries. Several reasons underlie Hong Kong's shyness from tax preferences. There is a belief that government should not be the one to pick business winners. Carving out special treatment might undermine the integrity of tax law. It is also concerned that an attempt to use tax preferences might add to the perception that Hong Kong engages in harmful tax practices. On the other hand, in the absence of targeted tax policies, as a recent study argues, Hong Kong might not be able to effectively promote the development of industries such as shipping and financial services where Hong Kong can excel.[5] In contrast, the SAT, in an effort to promote Shanghai as an international maritime centre, decided in 2009 to exempt Business Tax for shipping operations in a bounded area of the city.

¶10-150 Procedural Differences

Procedural differences which might look trivial could also have substantive impact on taxpayers. For instance, in Shanghai as in the rest of China, salaries and wages are reported, and taxes are calculated and

[4] KPMG, *The Impact of Tax Treaty Trends in the Asia-pacific Funds Sectors*, available at https://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/tax-treaty-aspac-funds-O-0902.pdf (last visited on 25 March 2015).

[5] The Taxation Institution of Hong Kong, *Study on the Competitiveness of the Hong Kong Tax System*, February 2014, available at http://www.tihk.org.hk/v2/news/tihk/7 (last visited on 25 March 2015).

payable, on a monthly basis in contrast to the yearly filing and reporting in Hong Kong. A monthly filing and reporting system is not only more cumbersome but also disadvantageous to taxpayers whose incomes from wages and salaries are volatile throughout the year. Employers in Mainland China are required to withhold taxes on wages and salaries on a monthly-basis whereas employers in Hong Kong are not. The latter only have to report the earnings of employees to the territory's tax authorities yearly. Compliance costs under China's IIT are likely higher for both employers and employees than those under Hong Kong's Salaries Tax.

¶10-200 Law, Institutions, Tax Administration and Dispute Resolution

A comparison of the two tax jurisdictions would be incomplete without examining how legal and institutional factors influence and interact with tax administration. Tax is a matter of law in modern societies, as all tax issues should be fixed by law and not subject to the whims of those in power. One way to evaluate the relationship between taxation and law is through the prism of the rule of law. The rule of law typically comprises the following key concepts: separated law making and law executing powers; meaningful constraints on officials' act; and an independent judiciary.

¶10-210 Tax Laws

Hong Kong inherits a common law tradition. Its tax laws refer to the legislation (*Inland Revenue Ordinance, Stamp Duty Ordinance*, etc.), subsidiary legislation like the Inland Revenue rules, – both adopted by the Legislative Council – and relevant orders by the Chief Executive whose continuing binding force needs legislative approval. Hong Kong judiciary's interpretations of tax legislation form case law. Hong Kong's tax legislation, like those in other modern tax systems, often uses broadly wording provisions which, without interpretations or rules for implementation, could lead to uncertainties. While the Inland Revenue Department ("IRD"), the executive branch's arm in charge of administering and collecting tax, plays a central role in preparing tax legislative bills, it cannot unilaterally make laws without legislative approval. The IRD has indeed issued documents commonly known as Departmental Interpretation and Practice Notes ("DIPNs") to explain its views on statutory provisions. DIPNs have no binding force on taxpayers. But IRD officials are expected to follow them. The Commissioner of Inland Revenue ("Commissioner") can assess up to a maximum of three times an additional tax as a form of penalty and the IRD has published guidelines regarding the discretion to be exercised by the Commissioner. Under the IRD guidelines, one part of the additional tax is called "normal loading" which ranges from 5% to 210%. To impose the maximum 210%, an intentional disregard of law on the part of the taxpayer need be shown. Another part is intended for commercial restitution with a rate fixed according to the best lending practice. The statute of limitation for the IRD to make tax assessment is generally 6 years; but if fraud is involved, it is extended to 10 years.

Mainland China started to embrace a modern legal system relatively recently. Despite Beijing's efforts to promote the rule of law, the idea that government power is subject to law has not taken root. What counts as tax law in China must take into account the country's tradition. The country's traditional legal system identifies with its political hierarchy. Thus, a superior's order is binding on his subordinates in the sense that disobedience is punishable. While China's formal constitutional order today embraces modern institutional features such as a more or less specialised law making body, the legacy of the order-qua-law tradition continues under the one-party political system. Under China's constitution today, not only the legislature, but also the executive branch as well as its various departments can issue normative documents binding on their subordinates. For decades, VAT, Business Tax, Consumption Tax and most other indirect taxes have been regulated, not by legislation, but by the provisional regulations of the State Council. Meanwhile, the SAT and MOF have the power to issue rules and regulations for tax officials and taxpayers across the country to follow. As tax legislation and the State Council's regulations lay down general principles often with undefined concepts and sparse provisions, it is the role of the SAT and MOF to provide definitions, interpret rules, and fill up gaps. Therefore, what constitutes China's VAT law is not limited to the State Council's provisional regulations, but must include a myriad of piecemeal notifications ("通知"), announcements ("公告"), letters ("函") and other similar documents issued by the SAT and/or MOF, the substance of which can be changed any time. The same can also be said with regard to Business Tax, Consumption Tax and many other taxes. Only a handful of taxes like EIT and IIT are based on an enactment of the country's legislature. While a sub-national tax bureau like the one in Shanghai has not been constitutionally authorised to issue rules of its own to bind its subordinates, it may do so as a matter of practice within its jurisdiction and as long as what it said has not been disapproved by its superiors.

¶10-220 Tax Officials' Discretion

China's order-qua-law tradition has deep imprints on tax administration. As part of its political power over subordinates, a superior can set revenue targets for tax collectors. It is common practice that tax officials are tasked with collection quotas to be fulfilled. As no one can effectively serve two masters, the question rises as to whether tax officials follow law's requirements or carry out collection targets set by their superiors. Presumably, if tax officials are strictly bound by law, they may miss their revenue targets, especially, when such targets are too ambitious.

To address this dilemma, Chinese laws give tax authorities discretions to assess taxes and determine taxpayers' liabilities. First, tax officials' discretion for assessing penalties is broadly stated. Penalties up to five times the amount of tax due can be imposed whenever taxpayers are found not to report incomes or pay taxes. There are no known standards on how this wide range of discretion should be constrained. Secondly, Mainland Chinese finance and tax authorities maintain tight regulations over the distribution and usage of business invoices (tax receipts). For instance, only sub-national tax authorities can designate printers to produce invoices; no one can produce invoices without such authorisation; only qualified individuals and entities have access to official invoices; only the one who is the lawful recipient can be the user of an invoice and only for an authorised purpose. Fines are imposed on those who committed infractions. Controls are tighter and penalties more severe in the case of violations of regulations on VAT invoices. Officials' broad discretion can also been seen in how tax liabilities are assessed. Formally, tax liability is to be determined on the basis of accounting information on turnovers, incomes, profits, etc. But tax officials may also assess tax liability by assuming or deeming income or profits in the absence of accounting information. The statute of limitation is three or five years for ordinary cases of tax deficiencies. There is no time limitation, however, if tax evasion, resistance to pay tax or tax fraud is involved.

Giving tax collectors too much discretion is risky for abuse, undermining law's authority and causing resentment and confusion among taxpayers. It has been a time-honoured practice for lower officials to report those cases where there is a difficulty or uncertainty on points of law and policy to their superiors for instructions. Cases with most difficulty and uncertainty can go all the way to the SAT for instructions. Instructions or opinions of the superior bind officials at lower levels. They also provide guidance for future similar cases. This report-for-instruction practice becomes an effective way of tax law making. In taxation, law and government administration are intertwined.[6]

¶10-230 Tax Dispute Resolution

In Hong Kong, the taxpayer may object to the Commissioner's tax assessment by filing an appeal with the Board of Review, an independent tribunal composed of businessmen, legal and accounting professionals, and academics. The decision of the Board of Review panel is final unless a party makes an application requiring the Board of Review to state a case on a question of law for the opinion of the Court of First Instance. Members of the Board of Review have not hesitated to rule against the Commissioner if law requires. In one case in which this author was a panel member, the Board of Review allowed the taxpayer's appeal against the IRD's assessment that taxed holiday allowance.[7] While such allowance was tax-exempt under the then legislation, the IRD's longstanding view was that certain conditions should be satisfied before the allowance could be accepted. The panel rejected this view because it was unwarranted under the relevant legislative provision.

[6] Zhaodong Jiang, *The Administrative Use of Law in China: The Baori Golf Club Tax Case*, Columbia Journal of Asian Law (1998) Vol. 12 No. 2, 191, pp191-249.

[7] *Inland Revenue Board of Review Decisions Case No. D21/00*, available at http://www.info.gov.hk/bor/en/docs/d2100.pdf (last visited on 24 March 2015).

The Hong Kong judiciary gets involved in adjudicating tax disputes through a transfer of appeals from the Board of Review to the court or by way of case stated after the Board of Review's decision. Hong Kong courts often take positions contrary to those of the revenue authorities. In the recent case of *Nice Cheer Investment Limited v Commissioner of Inland Revenue*, the highest court of the SAR agreed with the lower courts that unrealised gains on the revaluation of trading investments were not taxable, but unrealised losses on the same investments in another year were deductible for purposes of computing profits tax.[8] Other high-profile court decisions in favour of taxpayers include: *ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue*,[9] in which the CFA ruled that commissions, placement fees and marketing income derived from securities traded on stock exchanges outside the territory were not taxable under the territorial principle, and *Commissioner of Inland Revenue v Li & Fung (Trading) Ltd.*,[10] where the Court of Appeal dismissed the Commissioner's appeal, and upheld the judgement of the lower court that the net commissions earned on orders from overseas customers were not chargeable to Profits Tax. Of the 11 CFA cases on Profits Tax since 1999, five were decided for the revenue authorities, and in the other six cases, the taxpayers were vindicated either wholly (four cases) or partly (two cases).

Under Chinese law, when taxpayers disagree with tax authorities' decisions, they can apply for administrative reconsideration ("行政复议") with the superior organisations of the officials who have made the decisions. If they are dissatisfied with the results of administrative reconsideration, they can file administrative litigation ("行政诉讼") against the tax authorities. Administrative reconsideration can be bypassed if taxpayers object to the authorities' decisions concerning penalties, enforcement or temporary protective measures.

The role of Chinese courts in handling tax disputes – whether nationwide or in Shanghai – was minimal and, in any event, discouraging to taxpayers. In 2013, out of a total of 123,194 administrative litigation cases decided nationwide, 362 (or less than 0.3%) involved tax authorities as defendants. Among them, 40 cases were summarily dismissed and 198 were withdrawn by their plaintiffs. For those that reached the merits, only about 30 were decided somehow favourably to the plaintiffs.[11] In 2011,[12] 405 out of 136,353 administrative litigation cases were classified as tax-related; 25 were dismissed, 225 withdrawn, and in only about 15 cases did the plaintiffs

[8] *Nice Cheer Investment Limited v Commissioner of Inland Revenue* [2012] HKCA 257.

[9] *ING Baring Securities (Hong Kong) Ltd v Commissioner of Inland Revenue* [2007] HKCFAR 417.

[10] *Commissioner of Inland Revenue v Li & Fung (Trading) Ltd.* [2012] HKLRD 8.

[11] *The Situation of First Instance Administrative Cases in Courts 2013* (2013 年全国法院审理行政一审案件情况), available at http://www.lawyee.net/OT_Data/Judicial_Stat_Display.asp?StatID=923 (last visited on 24 March 2015).

[12] This author has been unable to locate any corresponding statistics for the year of 2012.

appear to be able to claim some victories.[13] For Shanghai, on average around 2,000 administrative litigation cases were brought in the city annually in recent years,[14] while a breakdown on how many of them concerned tax disputes is unavailable. This author has located Shanghai courts' decisions or judgments in 25 cases concerning tax administration and collection since 1999: eight ended by the plaintiffs' withdrawals and the remaining 17 were all decided against the plaintiffs.

One reason for the paucity of tax litigation cases both nationwide and in Shanghai is that the authorities strive to handle tax disputes administratively. Shanghai's tax authorities have been promoting the use of settlement and mediation to resolve problems with taxpayers during the administrative reconsideration procedure. Typically, if the officials can exercise discretion in a case, and their decision is challenged, they would be willing to compromise in order for the taxpayer to withdraw their objections. The fact that nationwide more than half of tax administrative litigation cases ended with the plaintiffs' withdrawal hints the willingness of tax authorities to reach a compromise even pending litigation. The official attempt of avoiding open disputes in court stems from the perception that litigation is bad for the image of the tax authorities; and that litigation occurs either because tax officials have not done a good job or because the taxpayer has unreasonable demands. To show they do a good job, tax officials are encouraged to nip disputes in the bud. Meanwhile, Chinese taxpayers try to avoid legal confrontations with tax officials as well. Apart from the influences of an anti-litigation culture, Chinese taxpayers are acutely aware that their chances of winning against the tax authorities in court were minuscule. Despite a constitutional promise for judicial independence, tax administrative litigation cases testify to the country's difficulty to establish the credibility of an independent judiciary as far as disputes between officials and taxpayers are concerned. As mentioned earlier, administrative officials have been actively and extensively involved in the country's tax law making. Judicial deference is the rule rather than the exception. Even if they could win, taxpayers must have dreaded the consequences of a legal victory over tax authorities. In taxpayers' own words, "you may win once in court but will lose for the rest of your life". This refers to a justified fear that after losing the lawsuit, the local tax authorities could harass the taxpayer with repeated audits.

[13] *The Situation of First Instance Administrative Cases in Courts 2011* (2011年全国法院审理行政一审案件情况), available at http://www.lawyee.net/OT_Data/Judicial_Stat_Display.asp?StatID=840 (last visit on 24 March 2015).

[14] There were 2710 cases in 2013, see *Shanghai Municipality Higher People's Court Work Report 2014*, available at http://shfy.chinacourt.org/article/detail/2014/02/id/1216293.shtml (last visited on 24 March 2015); 1803 cases in 2011, see *Shanghai Municipality Higher People's Court Work Report 2012* http://shfy.chinacourt.org/article/detail/2012/10/id/672008.shtml (last visited on 24 March 2015); and a total of 9976 cases during five years between 2008 and 2012, see *Shanghai Municipality Higher People's Court Work Report 2013, available at* http://shfy.chinacourt.org/article/detail/2013/04/id/933258.shtml (last visited on 24 March 2015).

¶10-240 Certainty and Predictability of Tax Law

For observers, China's tax laws can change fast and drastically over a short period of time. The current VAT and Business Tax were introduced in 1994, with the former mainly applying to sales of goods and the latter covering provision of services, sales of real property, and transfers of intangibles. Yet, starting from 2012, a major overhaul of the two indirect taxes has taken place, with transportation, and many services being moved from Business Tax to VAT. Like many other reforms in China, this one began on a trial basis in Shanghai first, and has since quickly spread to other cities. The two taxes differ not only in rates (VAT's rates are typically higher than those under Business Tax) but more importantly in how the amount of tax payable is calculated. While both taxes are collected at each stage in the supply chain, most VAT taxpayers can typically claim a credit for input VAT paid, but taxpayers of Business Tax cannot. However, for many businesses, additional staff costs to handle complexity of VAT and rigid rules for claiming VAT input credit would likely outweigh any benefits gained from VAT credit allowances. As two tax practitioners have noted, the reform "has the unfortunate consequences of placing an undue burden on taxpayers, particularly those businesses which are required to comply with (potentially burdensome) regularly requirements, when only short notice is given".[15]

Fast and drastic tax law changes are unimaginable in Hong Kong where any attempt to overhaul the tax system must go through a lengthy public consultation process first before it can be tabled for legislative debates. Several years ago, a government proposal for introducing a general sales tax modelled on VAT was shot down after strong public opposition emerged. Admittedly, taxation is a politically sensitive matter, subject therefore to changes whenever politics warrants. No one should expect tax laws to be fair and just to the satisfaction of everyone. On the other hand, precisely because of tax's central role in the government-citizen relationship, there should be mechanisms to make it possible for taxpayers to have an idea about the likely tax consequences of a planned action. This has been partly achieved in Hong Kong through advance ruling.

A taxpayer may apply for a fee to the Commissioner for a ruling on how tax law applies to him/her or an arrangement, plan or a proposal he/she submits. Falling within advance ruling are issues concerning service companies, profit locality, stock borrowing and lending, royalty payment, collective investment schemes, general anti-avoidance provision including transfer pricing issues, etc. After a ruling is made, it is final and the Commissioner will apply it in relation to the applicant and the arrangement in question. On the other hand, the taxpayer is still able to object to an assessment made in accordance with the ruling. Advance

[15] Sarah Chin and Polly Wan, *How is China's VAT Reform Progressing?*, Asia-Pacific Journal of Taxation (2013), Vol. 17 No. 2, pp22, 27.

ruling can therefore provide predictability of tax law, promote consistency in tax administration and minimise tax disputes. In China, businesses may conclude advancing pricing arrangements with tax authorities in relation to pricing principles and calculation methods for intercompany transactions in the future. But otherwise, tax bureaus may not provide services similar to Hong Kong's advance ruling to taxpayers, although it seems that the advance ruling channel may be available to selected taxpayers on a trial basis. In any event, the legal effect of an arrangement with the tax authorities in Mainland China can be subject to uncertainty if there is a change of personnel within the tax bureau in question or a superior organisation chooses to intervene.

¶10-300 Reliefs for Avoiding Double Taxation, Tax Treaty Networks and Information Exchange

¶10-310 Double Taxation and Reliefs

As China embraces both the residence and source principles in its income tax systems, double taxation problems likely arise for inbound and outbound businesses. This is the case when a foreign investor earns profits from its China operation and at the same time its home country taxes its income earned overseas. Meanwhile, the profits of a China-based company from a foreign jurisdiction are taxable in both the foreign jurisdiction under the source principle and China under the residence principle. As double taxation imposes additional costs on taxpayers and distorts business decisions, domestic law may provide reliefs by permitting taxpayers to claim either a foreign tax credit subject to certain limits or deduction for income tax paid in foreign jurisdictions. Chinese law contains both reliefs. The amount of such credit is limited to the amount of tax liable under Chinese law for that year. Any excess credit may be carried over for five years. Moreover, if a taxpayer has taxable income from two or more foreign jurisdictions, the amount of credit must be calculated separately for the tax paid in each jurisdiction. There is no distinction, however, between different types of income such as general v passive categories under Chinese law.

As a result of its territoriality basis of taxation and its schedular system, Hong Kong is faced with much less double taxation problems than Shanghai. But problems may nevertheless arise. Profits which are assessable under Profits Tax may have already been taxed in a foreign jurisdiction. In such case, a deduction for foreign taxes paid is, subject to certain qualifications, allowed. Meanwhile, foreign tax credit is allowed if provided in an intergovernmental tax arrangement. Under Article 4 of the Arrangement between the Mainland China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income ("Mainland-HK Tax Arrangement") (as Hong Kong is part of China, the document is not titled "Convention", "Treaty" or "Agreement"), when a Hong Kong resident's income from Mainland China is also taxable in the territory, any tax paid in the Mainland can be allowed as a credit to offset any amount of tax payable in Hong Kong. Under Hong Kong's source principle, if an employment contract is made in Hong Kong or governed by Hong Kong law, compensation paid under the contract – whether received within or without the territory – is chargeable under Salaries Tax. When a Hong Kong manufacturer has moved its production across the border, but maintains its management, design or other functions in Hong Kong, its profits may be apportioned on a 50/50 basis, meaning, half of the profits are subject to Hong Kong tax. By the way, Article 4 of the Mainland-HK Tax Arrangement has a similar provision allowing a Mainland Chinese taxpayer to claim a credit for direct taxes paid in Hong Kong, although presumably such credit is already allowed under Chinese domestic law.

¶10-320 Tax Treaty Networks

Apart from domestic laws, double taxation agreements or arrangements ("DTAs") between governments help avoid double taxation problems by delineating and allocating their respective taxing powers on specific incomes in cross-border activities. A comprehensive DTA ("CDTA") deals with a wide range of income and property taxes while a limited DTA covers tax in specific areas such as income from international transportation activities. As of March 2014, China concluded 101 CDTAs including those with Hong Kong and Macau with 99 being in effect.[16] In addition, the country has entered into over 30 limited DTAs on air transportation, about 30 on maritime transportation, and over 20 on other international transportation matters. Hong Kong, on the other hand, has much fewer DTAs overall. As of November 2014, the territory has signed CDTAs with 31 governments including the one with Mainland China; of which, 27 are effective.[17] Even with CDTA negotiations in progress with 14 other governments,[18] Hong Kong's CDTA network is less than half the size of Shanghai's. Hong Kong does have limited DTAs covering air services and/or shipping income with over 30 governments.[19]

Hong Kong's narrower treaty network in comparison with that of Mainland China/Shanghai is due not just to its schedular system and territoriality basis of taxation which gives rise to few instances of double taxation, but also to a lack of incentives or even reluctance on the part of foreign governments to sign CDTAs with the territory. First, as Hong Kong taxation system causes few double taxation problems for foreign citizens and businesses, foreign governments feel little pressure to engage the

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[16] State Administration of Taxation (China), Tax Treaty (税收条约), available at http://www.chinatax.gov.cn/n810341/n810770/index.html (last visited on 10 November 2014).

[17] Inland Revenue Department (Hong Kong), *Comprehensive Double Taxation Agreements Concluded*, available at http://www.ird.gov.hk/eng/tax/dta_inc.htm (last visited on 10 November 2014).

[18] Inland Revenue Department (Hong Kong), *Negotiation in Progress*, available at http://www.ird.gov.hk/eng/tax/dta3.htm (last visited on 10 November 2014).

[19] Inland Revenue Department (Hong Kong), *Limited Double Taxation Agreements*, available at http://www.ird.gov.hk/eng/tax/dta_ldta.htm (last visited on 10 November 2014).

territory for treaty negotiations. Secondly, as reliefs for double taxation are reciprocal under DTAs, there is little reason, from a reciprocity viewpoint, for a foreign government to hand out tax benefits to Hong Kong residents and businesses through a CDTA which would bring, however, little benefits to its own citizens and businesses. Thus, Hong Kong has had more success with limited DTAs, because limited DTAs address real double taxation problems for both Hong Kong and foreign transportation companies. Hong Kong's signing of CDTAs took off only after the first Mainland-HK Tax Arrangement in 1998, while the territory started to conclude limited CDTAs since 1980s.

Absence of a broad treaty network would first and foremost disadvantage Hong Kong-based businesses and investors. Among common features in a CDTA are mechanisms for passive income such as interest, dividends and capital gains in the forms of reductions or exemptions in withholding its source. Take example of the China-US tax treaty which provides for a maximum allowable 10% tax on gross dividend and interest paid by a resident company if the recipient is a resident of the other country and is the beneficial owner. Absent such treaty provisions, the US federal tax law imposes a flat 30% withholding rate on the US-source interest, dividend or other fixed or determinable annual or periodical ("FDAP") income earned by a foreign person. As the US treats Hong Kong as a tax jurisdiction separate from Mainland China and there is no tax treaty between the US and Hong Kong governments, a Hong Kong resident investing in the US would be treated unfavourably compared to a Mainland China-based investor for his US-source interest, dividend or other FDAP income. The absence of a CDTA also leads to uncertainty. For inbound investment, profits are taxed according to Hong Kong's source principle, which is not subject to a single test or factor. If a CDTA exists, profits of foreign investment can be taxed only if they are associated with a permanent establishment ("PE"). As a PE has been better defined and understood, there is more certainty with regard to the tax position of investors who are resident in a tax treaty country. The same problem arises for outbound investment. Under US federal law, a foreign person is subject to US tax rates on net income that is effectively connected with the conduct of trade or business in the US. For the resident of a country having a CDTA with the US, its profits are not subject to US tax unless attributable to a PE in the US. Again there is more predictability for the investor based on a jurisdiction benefiting from a CDTA with the US.

¶10-330 Tax Information Exchange

International tax cooperation also aims at combating tax evasion through information exchange and other judicial and administrative assistance. CDTAs typically contain exchange of information ("EoI") clauses requiring governments to provide information to each other upon request, automatically, or spontaneously, for purposes of administering their respective tax laws. Tax information exchanges may also be achieved through standalone tax information exchange agreements ("TIEAs") between governments. Again, as tax regimes vary, not every country shares the same interest or incentive in exchanging tax information. Jurisdictions like the US and China – both embracing the residence principle and a concept of gross income – are facing more tax evasion problems as information about their residents and citizens' foreign source incomes is harder to come by than that on their domestically-sourced income. They naturally support a strong and extensive network of tax information exchanges between governments. Apart from tax information exchange clauses in its CDTAs, China has entered into TIEAs with ten governments, nine of them taking effect. It signed the Convention on Mutual Administrative Assistance in Tax Matters pending approval by the country's legislature. It has also accepted the Model 2 Intergovernmental Agreement to exchange financial information with the US. China's tax authorities successfully collected over one billion Yuan in overdue tax in 2012 thanks to information exchanges.

Hong Kong's schedular and territorial taxation system has no interest in its residents' investment income as well as foreign-source income. An obligation to exchange tax information with foreign governments would add costs and burdens to both government and businesses, and at the same time threaten to infringe upon taxpayers' freedom and rights, poisoning therefore the tax environment for commerce. At the same time, however, as other countries are interested in getting tax information from the territory concerning their tax residents, the issue of information exchange can serve as leverage by Hong Kong to broaden its CDTA network. The U.S. is a particularly difficult case for Hong Kong's efforts to expand CDTA because it is a US policy not to conclude a CDTA with a non-sovereign entity and/or a territoriality-only tax jurisdiction. As a result of mounting pressure,[20] Hong Kong amended its law in 2013 so its government now has power to sign TIEAs. So far it concluded TIEAs with seven governments and the one with the U.S. is in effect now. By concluding TIEAs first, Hong Kong hopes that some of those countries may eventually agree to negotiate CDTAs with the territory. Finally, the Hong Kong government has promised to implement automatic tax information exchange by the end of 2018.

Assuming an obligation to exchange tax information with foreign governments has led to concerns about privacy and individual rights. Businesses likely incur additional costs and shoulder greater burdens when asked to produce and transmit tax information in their possession. On the other hand, Hong Kong's commitment to an internationally agreed regime of tax transparency is a plus for the territory's reputation as a top financial centre and an ideal place for investment. It can further persuade foreign governments which might have frowned upon the territory's tax system to change their views and conclude CDTAs with Hong Kong. As I and my

[20] For a background of the Hong Kong legislative development on TIEAs, see Zhaodong Jiang and Daniel K. C. Cheung, *Tax Information Exchange under Ever-Evolving External Demands: Hong Kong's Responses and Solutions*, Global Tax Weekly (2013), Issue 33, pp5-14.

co-author have previously argued, EoI clauses in CDTAs or TIEAs only create a legal framework the effectiveness of which will ultimately depend on domestic law and institutions. With the territory's rule of law tradition, there is reason for believing that concerns for privacy and confidentiality can be properly handled through legislation and judicial practices.[21]

¶10-340 Interaction between Domestic Law and Treaty Provisions

The purpose of a tax treaty, as generally understood, is to impose obligations on one government vis-à-vis another government and its residents. Such obligations take precedence over contrary domestic laws. Tax treaties should not, however, create taxpayers' liabilities which may not otherwise exist under domestic law. This is the understanding in Hong Kong, but whether it is accepted by Mainland Chinese authorities has been doubtful.

In a 2004 case involving the payments of fee by China Central Television to a US company for the use of satellite data transmission services, the Beijing Municipal High Court held that the payments were royalties subject to the country's withholding tax.[22] Under Chinese domestic law, such payments are more likely to be treated as business income than royalties and therefore were taxable only if the US party had a PE in the country, which it did not. The Chinese tax authorities invoked the China-US tax treaty which defines royalties broadly to include payments for the use of industrial, commercial or scientific equipment, arguing that the treaty's definition covered the payments to the US party. The High Court agreed.

While the issue of whether a payment is business income or royalty is a difficult and controversial one, the Beijing High Court's decision is troubling for, at least, two reasons. First, it characterised the payments as royalties according to a treaty, creating therefore a non-resident taxpayer's liability, which was nowhere to be found in domestic law. The way in which the tax treaty in question was applied was contrary to the general understanding of its purposes. Secondly, as the legal basis for such liability is the China-US tax treaty, it seems that how another similar case would be decided might depend on how royalties are defined in the applicable tax treaty. As treaty definitions may vary, so would the outcomes, thus creating uncertainties and encouraging treaty shopping.

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21 Jiang and Cheung, supra note 20, pp10-12.

22 *Pan-American Satellite International System Ltd. v Second Office of Foreign Bureau of Beijing Municipality State Administration of Tax, an Objection to Tax Levy Decision Case* (泛美卫星国际系统责任有限公司诉北京市国家税务局对外分局第二税务所不服所得税征收决定案), available at http://www.fsou.com/html/text/fnl/1176278/117627866.html (last visited on 16 December 2014).

¶10-400 Conclusion

The above comparisons reveal two sets of factors that matter to businesses, taxpayers, and observers. The first one comprises those with direct tax impacts such as what taxes the system imposes on taxpayers, what income or revenue is taxable, what the rates are, whether any preferential treatment is available, whether any tax credit can be claimed, and how complicated or cumbersome compliance procedures or documentation requirements are. The second set refers to less tangible but nevertheless critical institutional factors, and most important one is whether and to what extent the taxation system adheres to the rule of law.

On the first one, although Hong Kong has certain distinctive advantages thanks to its simple tax regimes and low rates, Shanghai may claim an edge in offering more preferential tax treatment and more expansive tax treaty benefits including those for doing business in the US. On the second set of factors, Hong Kong's reputation due to its rule of law tradition has been well established. While Shanghai, like the rest of the country, has made impressive progress since the late 1970s, how soon it can truly catch up with Hong Kong remains to be seen (assuming it is emulating Hong Kong's model of the rule of law). As shown, the rule of law is not just about setting up law-making, administrative and judicial organisations and enacting new rules. It is reflected in the public opinion and expectations as well as in the attitude of government and officials toward businesses and taxpayers.

Tax is a crucial factor, among others, in planning one's business and many ones' life. For taxpayers, potential investors, and observers, sometimes a trade-off takes place between the first and second sets of factors. For instance, a system generous with tax preferences may not concern itself very much about the rule of law and fairness. Tax planners and business decision makers should be aware of such trade-offs and may not always expect to get the best of both worlds.

