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In practice, the Hong Kong Inland Revenue Department assesses tax, in certain circumstances, on income that is attributable to activities occurring outside Hong Kong. For example, if an employee has a Hong Kong resident employer, and the employment contract was negotiated and concluded in Hong Kong, all of the income from the employment will be assessed to tax as Hong Kong-sourced income regardless of where the employee's services were rendered, unless the employee can prove that he or she spent no more than 60 days visiting Hong Kong during the year of assessment.[5] Another example: if a Hong Kong-based company purchases products located in a foreign country and sells them to customers in another foreign country, and the products never enter Hong Kong, the resulting profits will generally be assessed to tax as Hong Kong-sourced profits if the authority to conclude the contracts of purchase and sale was exercised by someone in the home office in Hong Kong.[6]

As international business activity expanded in the Asia-Pacific region in the 1970s and 1980s, Hong Kong-incorporated companies began to be used for tax avoidance purposes by investors based in high-tax countries. The combination of a limited tax system, an English legal system, and low-cost, efficient business and banking services performed by English-speaking staff made Hong Kong an unusually attractive location in which to establish an investment holding company or trading company for international business.

For many years, most of the high-tax countries in the world (with the notable exception of the United States) tolerated their residents' use of companies formed in low-tax business and financial centres, even though domestic tax revenue was certainly being lost, or at least deferred, as a result. This complaisant attitude changed gradually. By 1990, nine high-tax countries had enacted controlled foreign company

Meanwhile, the British and Mainland Chinese governments were negotiating the terms of the handover of Hong Kong on 1 July 1997. Three points that emerged from the negotiations were (1) Hong Kong's legal system would continue for at least 50 years, (2) Hong Kong would be independent in financial and tax matters, and (3) Hong Kong would maintain the low-tax policy that it had followed prior to the handover.[10] These matters were decided against a backdrop of rapid economic growth and legal development in the Mainland during the 1990s. Hong Kong's economy was becoming increasingly integrated with that of southern Guangdong province, particularly the manufacturing towns of Shenzhen and Dongguan, where many Hong Kong manufacturing companies had relocated their manufacturing operations.

In these circumstances, it is not surprising that the Hong Kong and Mainland China governments concluded an agreement in 1998 for the avoidance of double taxation.[11] The agreement—which was called an "arrangement" in order to avoid the implication that the two governments were equals—was limited in scope, dealing only with taxable business presence (ie permanent establishments), transportation income, and income from personal services. But it marked a milestone in Hong Kong's tax history: its first DTA applicable generally to individuals and companies from all sectors of the economy.

At around this time, the Hong Kong government decided to pursue DTAs with other countries in an effort to build a worldwide treaty network. Competition with Singapore was undoubtedly a factor in the decision, given the fact that Singapore had a wide network of DTAs already in place. Potential treaty partners were reluctant, however, to conclude DTAs that did not provide for the exchange of information regardless of a domestic tax interest in the information requested.

Between 2004 and 2009, Hong Kong concluded DTAs with four countries:

Belgium (2004)
Thailand (2005)
Vietnam (2009)
Luxembourg (2009)

In addition, the double tax "arrangement" with Mainland China was expanded and refined, first in 2006 and again in 2008.

A significant change occurred in April 2009, when the G-20 group of nations threatened to punish countries that fail to cooperate in the effective exchange information on tax matters.[12] Failure was defined as having fewer than twelve agreements in place providing for the exchange of information under the terms of Article 26 of the 2004 OECD Model DTA.[13] In conjunction with the G-20's announcement, the OECD Committee on Fiscal Affairs published a list of

[10] Basic Law of the Hong Kong Special Administrative Re

uncooperative countries. At China's request, Hong Kong and Macau were not in the list but were named in a footnote, which stated that they were committed to compliance with the international standard for information exchange and were in the process of amending their laws to permit full compliance in practice.

Soon after these events, the Hong Kong government introduced legislation in June 2009 empowering the Inland Revenue Department to obtain information, pursuant to a request under a DTA, in which it has no domestic tax interest.[14]

4. ISSUES ARISING UNDER THE DTAS

Although Hong Kong continues to have the limited tax system described at the outset of this article, its DTAs contain most of the provisions of the OECD model DTA. In order of importance to Hong Kong, these include:

- Exchange of information on request, regardless of domestic tax interest
- Permanent establishment (PE) provisions
- Reduction of withholding taxes on dividends, interest and royalties
- Provisions relating to individual residents and employment income
- Limitation on benefits provisions
- Allocation of taxing rights on capital gains
- Provisions on transactions between associated enterprises

Issues are already beginning to arise under some of the DTAs. For example, some treaties expressly preserve the right of the parties to apply the anti-avoidance provisions of their domestic tax laws to items of income covered by the treaty.[16] This can cause a problem if, for example, anti-avoidance provisions in domestic law require full withholding tax on deductible payments to a nonresident that is not subject to tax on receipt of the payment under the tax laws of the nonresident's home country. As discussed earlier, Hong Kong profits tax does not apply to income arising outside Hong Kong, under the terms of the Inland Revenue Ordinance. Consequently, Hong Kong-based companies may encounter difficulty in obtaining withholding tax reductions under DTAs with certain countries, Indonesia being one example.

Mainland China has also denied the benefits of the PRC-Hong Kong double tax arrangement to a Hong Kong company in at least one case. The Hong Kong company in question owned 15.6 percent of the shares in a PRC company, and sold some of the shares, realizing substantial gains. The Hong Kong company claimed that it was exempt from taxation in the Mainland under Article 13(5) of the double tax arrangement, which provides a tax exemption for gains on share sales if the recipient of the gains owns less than 25 percent of the company whose shares were sold. The Fujian tax authorities denied the claim on the ground that the "recipient of the gains" was not the Hong Kong company but rather its sole shareholder, an individual who also owned all of the shares of a second Hong Kong company that owned 22.49 percent of the shares of the same PRC company.[17]

Exchange of information will undoubtedly give rise to issues in practice. Under the Inland Revenue (Disclosure of Information) Rules and the sta.169o1.0005 Teic25 -1to tapa(a6d3ost)

Financial Secretary. It is too early to tell how all of this will play out in practice, but it is reasonable to expect that taxpayers will do all in their power to resist information