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CONTENTS

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

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

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

2. BACKGROUND

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

2.1 Comparison of Australian and Hong Kong tax systems

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

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

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

[2] Linda Tsang, 'Tax agreement between Hong Kong and Australia – negotiations', *IBFD* (online), 24 June 2011 <www.ibfd.org>
[3] *Income Tax Assessment Act 1997* (Cth) ss 6-5, 6-10.
[4] Ayesha MacPherson and Garry Laird,

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

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

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

Australia's treatment of dividends is rather unique and worthy of discussion. Under the classical system of taxation, company profits are taxed at the company level. When the profits are distributed to shareholders in the form of dividends, the dividends are also taxed. This effectively results in economic double taxation – with the same amount of income being taxed twice, albeit in the hands of different taxpayers. In 1987, Australia introduced what is known as an imputation system[13] in an attempt to eliminate the effect of double taxation. Under this system, tax paid by a company can be attributed ('imputed') to shareholders. When a company pays a dividend out of profits on which tax has already been paid, they can attach a 'franking credit' to the dividend (a dividend with a franking credit attached is a 'franked dividend'). The franking credit reflects the tax that has been paid by the company. If a dividend is paid from profits which have not been subject to tax at the company level (or the company decides not to attach franking credits to the dividend), it is known as an unfranked dividend. When a resident shareholder receives a franked dividend, they are required to include both the dividend received and the franking credit in assessable income. However, this franking credit then becomes a tax offset, which reduces the

[6] *Income Tax Rates Act 1986* (Cth) s 12(1), Sch 7 Pt 1.
[7] *Income Tax Rates Act 1986* (Cth), s 23(2). Most Australian resident individuals are also subject to an additional 1.5 percent tax (the Medicare Levy) to help fund Australia's public healthcare scheme. See *Medicare Levy Act 1986* (Cth).
[8] *Inland Revenue Ordinance 1947* (HK) Schs 2, 8.
[9] *Inland Revenue Ordinance 1947*

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

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

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

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

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

2.3 Hong Kong DTA network

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

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

Hong Kong entered into its first DTA with China in 1998.[46] Following this first treaty, Hong Kong's DTA network was very slow to develop. No further DTAs were signed until December 2003, when a DTA was signed with Belgium. From that point until 2009, only three new DTAs were signed: Thailand (2005), Luxembourg (2007) and Vietnam (2008).

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

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

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

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

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

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

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

In regards to the amending legislation, the Commissioner of Inland Revenue, Chu Yam-Yuen, stated that "Hong Kong has entered a new phase in supporting the international effort to enhance tax transparency". The Commissioner further stated "Our target is to sign the new comprehensive agreement with all our trade partners.

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

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

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

Table 1: Hong Kong's trade and investment with Australia[58]

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

[53] Stephen Smith (Australian Minister for Foreign Affairs and Trade), 'The Australia Hong Kong Connection' (Speech delivered at the Australian Chamber of Commerce, Hong Kong and Macau, 6 May 2008) <http://www.foreignminister.gov.au/speeches/2008/080506_austcham_hong_kong.html>.
[54] Ibid.
[55] Department of Parliamentary Services, *Foreign Investment in Australia: Recent Developments* (1 April 2011) Parliament of Australia <http://www.aph.gov.au/library/pubs/bn/eco/AustForeignInvestment.pdf>.
[56] Hong Kong Regional Cooperation Division, Trade and Industry Department, *Hong Kong Australia Trade Relations* (April 2011) Hong Kong Economic and Trade Office Sydney <http://www.hketosydney.gov.hk/hkaustraderel.php>.
[57] Ibid.
[58] Sourced from Hong Kong Regional Cooperation Division, Trade and Industry Department, above n 56.

By way of comparison, it is noted that Hong Kong and New Zealand signed a tax treaty in December 2010, which entered into force in November 2011. On the one hand, the existence of a Hong Kong-New Zealand DTA may be considered irrelevant from Australia's point of view. On the ot

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

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

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

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

3.1 Residency

3.1.1 Residence of individuals

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

Australian taxation of Hong Kong people who came to Australia for relatively short periods of time. This is because Australia's multiple tests of residency for tax purposes and the way they have been administered are very wide and verge on the aggressive. For example, based on TR 98/17,[63] a person who spends very little time in Australia may be regarded as a resident for tax purposes if they are working in Australia. Given the very significant numbers of people from Hong Kong who come to Australia for a variety of work, study and leisure activities, this approach would certainly have been a

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

3.1.2 Corporate residence

As with individuals, the introduction of a Hong Kong DTA results in the introduction of a corporate residence concept for Hong Kong tax purposes that is not generally

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

3.2 Active income

3.2.1 Employment income

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

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

In addition to providing certainty in relation to the source of employment income, a DTA will also impact Australian taxing rights in relation to work done in Australia by non-residents. It will do this by restricting Australia's taxing rights in relation to persons who do short term work in Australia. Under current Australian law, non-residents will be taxed on their Australian sourced employment income even if they worked in Australia for a very short time.

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

As with Australia, a DTA prima-facie makes little difference to the taxation of employment income by Hong Kong as Hong Kong generally only taxes employment income sourced in Hong Kong.[90] However, a more detailed analysis demonstrates that a DTA significantly alters the concepts that Hong Kong employs in taxing

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

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

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

3.2.3 Business profits

As noted in Section 2.4, Australia and Hong Kong have a substantial business relationship making the taxation of business profits of key interest. With business profits, as with employment income, a DTA between Australia and Hong Kong would bring the significant benefit of creating a higher degree of certainty in relation to

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

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

Under its Profits Tax, Hong Kong will seek to tax a business profit when a trade, business or profession is carried on in Hong Kong and then to the extent that the profit arises in Hong Kong.[101] The concept of a profit arising in Hong Kong is very similar to the concept of an Austrian sourced business profit in Australia and courts in both jurisdictions have looked to similar precedents in deciding on these matters. Consideration of when a trade, business or profession is carried on in Hong Kong has

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

3.3 Passive income

3.3.1 Interest income

The taxation of interest income in both jurisdictions would remain largely unchanged by the conclusion of a DTA but there are some notable points for consideration. Australia's tax claim on interest through its withholding tax regime is structurally very similar to that allowed by a DTA. In Australia, interest derived by non-residents is taxed at 10 percent (withholding on gross) unless it is connected to a PE in Australia.[106] If it is, then it is taxed by assessment. This is little different to what occurs under most DTAs except that there may be minor differences as to what constitutes a PE.[107] In these unusual circumstances the DTA may alter outcomes. One area in which a DTA may make a significant difference is when interest is sourced in Australia under common law principles but not subject to the withholding tax regime because it is not paid by an Australian or a non-resident's Australian establishment. nrisduse it 03

3.3.2 Royalties

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

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

The final point above is something that Australia should consider carefully if it is going to conclude a DTA with Hong Kong and offer a low rate of withholding tax for royalties unconnected to Australian PEs. The reduced tax claim together with Hong Kong's narrow tax base means that a DTA with Hong Kong may create significant treaty shopping possibilities for residents of third countries who can structure their Australian involvement through Hong Kong.

have to curtail its claims in relation to royalties derived by Australian residents if it concludes a DTA with Australia. Under s 15 of the *Inland Revenue Ordinance*, royalties as well as rents for moveable property are deemed to be business profits and sourced in Hong Kong if the property they relate to is used in Hong Kong. However, as outlined above, a DTA would restrict Hong Kong taxation of royalties derived by

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

Income from real property and from the alienation of real property should be minimally impacted by the conclusion of a DTA between Australia and Hong Kong. A DTA is likely to allow the country where the real property is situated to retain full primary taxation rights over both rents and gains on disposal. As both Australia and Hong Kong are unlikely to exceed this jurisdiction under their domestic rules, this would not be a constraint. Australia generally only taxes gains made on Australian real property and rents from real property in Australia when these are derived by a non-

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

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