Tax Treaties with Tax Havens: The Hidden Tax Break

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One of the founding principles of democratic government is that voters should be free to determine collectively the levels of taxation and spending. A necessary corollary of this principle is that voters should be informed of where the tax burden lies. New Zealand's recently adopted double tax agreement (DTA) with Hong Kong flouts this principle, by introducing a selective, and hidden, tax break into the tax system.[1]

DTAs or, more colloquially, "tax treaties", are designed to ameliorate the problem of double taxation. Double taxation occurs when the tax systems of two or more countries overlap and a person is subject to taxation in both jurisdictions. To prevent double taxation, DTAs set boundaries on these two tax systems to ensure that only one has the ability to impose tax.

Hong Kong is a tax haven. It does not tax foreign-sourced income and its tax system never exceeds the limits proscribed by DTAs. Imposing a DTA on Hong Kong does not affect its tax system. The situation is different for the other contracting party: a country that enters into a DTA with Hong Kong will give up significant tax revenue. Furthermore, the tax revenue that it relinquishes does not relieve double taxation.

DTAs with tax havens differ in two main respects from DTAs with ordinary countries, in effect even if not in form. First, the economic concessions are unequal: Hong Kong gives up much less tax revenue than the states with which it contracts. Secondly, these treaties subvert the main purpose of DTAs: the effect is to reduce taxation on Hong Kong investments in New Zealand, often resulting in a total tax burden in both countries of exactly zero.

Of course, treaties of this kind are not uncommon. Switzerland is useful as a tax haven precisely because of its sprawling treaty network. Hong Kong has concluded 21 DTAs, 14 of these with Organisation for Economic Co-operation and Development (OECD) member countries.

While the tax system can often be difficult to decipher, especially for a layperson, this concessionary treatment is opaque to all but the most specialist of tax practitioners. Not only is the treaty between Hong Kong and New Zealand called a treaty "for the Avoidance of Double Taxation", it is concluded on the same terms as most other tax treaties. The effective tax

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1 Agreement between the Government of the Hong Kong Special Administrative Region of The People's Republic of China and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (1 December 2010) [Double Taxation Agreement].

subsidy by the New Zealand government is only apparent after substantive evaluation.

The unusual nature of tax treaties with tax havens merits further consideration. This article uses the New Zealand–Hong Kong treaty as a springboard to analyse tax haven DTAs more generally. In addition, since these treaties do not relieve double taxation, this article examines the parties' other motivations for entering into DTAs.

Despite these treaties being beneficial to havens, some havens have been reluctant to enter into them. The colonial Hong Kong government, for example, refused to negotiate any tax treaties. Thus, the first three parts of this article establish the historical and political background that has recently pushed havens to embrace tax treaties. The OECD is the most prominent force behind the adoption of haven DTAs. The OECD's project against harmful tax competition, which evolved into the project for information exchange, is the major catalyst for the change in international tax policy in Hong Kong and other tax havens. As will be seen, not all havens can benefit from tax treaties to Hong Kong's extent. Most of them have been forced to adopt Tax Information Exchange Agreements (TIEAs) — a poor substitute for a tax haven DTA.

The second part of this article examines Hong Kong as a particular example of a tax haven that enters into tax treaties. Hong Kong is a useful case study for several reasons: it is, of course, a tax haven; it has a rapidly growing treaty network that seems to have been provoked by the OECD project; and it has not entered into any TIEAs. The section will explain how the OECD project influenced Hong Kong and how Hong Kong's status as a tax haven has affected the treaties it has entered into.

The final part of this article builds on the detailed analysis of Hong Kong's tax treaties to comment on tax treaties with tax havens generally. First, it considers the traditional explanations — that DTAs are designed to avoid double taxation and curb fiscal evasion — and explains how these motivations are not particularly relevant in this situation. Next, it examines other potential reasons why both parties enter into these tax treaties. Finally, it offers some criticism of the tax haven double tax agreement, explaining how these DTAs mislead the public, breach democratic principles of transparency and benefit the tax haven much more than the higher-tax country.

I HOW THE INFORMATION EXCHANGE PROJECT AROSE

This part of the article explores the historical context that drove tax havens to enter into tax treaties. It focuses on the OECD's project against harmful tax competition. Though the OECD launched this project with much bombast, as the project lost momentum, exchange of information (EOI) was all that remained. In large part, this loss of momentum was due to the

fickle winds of the United States' fiscal policy: the change of the United States government in 2000 marked a change in tack for the OECD.

The Project Against Harmful Tax Competition

The OECD's project against harmful tax competition began in 1998, when it released a report entitled *Harmful Tax Competition: An Emerging Global Issue* (the Report).[2] The project aimed to remove harmful features of tax systems from the globe, including most of the activities of tax havens. The Report was not ideologically neutral:[3]

> [It] is intended to develop a better understanding of how tax havens and harmful preferential tax regimes ... erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally.

The Report divided jurisdictions that perpetrate "harmful tax competition" into two groups — tax havens and harmful preferential tax regimes. The Report did not attempt to define the term "tax haven" but did outline some factors to identify one. The first (and necessary) condition is that the jurisdiction imposes "no or only nominal taxes (generally or in special circumstances)".[4] A haven may also lack EOI and financial transparency laws. The Report identified the three main functions of tax havens: first, they provide a location for holding passive investments; secondly, they provide a destination to ship profits; and thirdly, they enable tax evasion by shielding taxpayers' affairs from the scrutiny of other countries' tax authorities.[5]

The Report incited action against harmful tax competition: "[g]overnments cannot stand back while their tax bases are eroded".[6] It focused on geographically mobile activities, particularly financial services. It outlined a number of solutions that governments could unilaterally enact. These solutions include the adoption of Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) rules (which attribute income earned by foreign companies to their local owners),[7] the harmonisation of transfer pricing rules (which prevent related companies from trading with each other at artificial prices)[8] and the empowering of tax authorities to override banking secrecy laws.[9]

2 *Harmful Tax Competition: An Emerging Global Issue* (Organisation for Economic Co-operation and Development 1998) [*Harmful Tax Competition Report*]. Luxembourg and Switzerland abstained from this report.
3 Ibid, at [4].
4 Ibid, at [52].
5 Ibid, at [49].
6 Ibid, at [85].
7 Ibid, at [97]–[103].
8 Ibid, at [111].
9 Ibid, at [112].

The Report recognised the potentially harmful effects of tax treaties, and made a number of recommendations as to their adoption and content.[10] In particular, it recommended that treaties should include the EOI provision.[11] The Report advised the inclusion of anti-avoidance provisions in treaties to curb "treaty shopping" — that is, the use of beneficial treaty provisions by taxpayers who typically would not be entitled to those benefits due to their residency.[12] It also recommended greater cooperation between states in enforcing each other's tax claims, and that members should consider terminating their existing treaties with havens and not entering into further treaties with havens.[13] It is clear from the very subject of this article that few have heeded this last recommendation.

The Push for Exchange of Information

In 2000, the newly established Forum on Harmful Tax Practices published an update to the Report.[14] This update contained a list of jurisdictions that met the tax haven criteria in the 1998 Report. Six havens — Bermuda, the Cayman Islands, Cyprus, Malta, Mauritius and San Marino — were removed from the list before its publication, because they agreed to cooperate with the OECD. This offer to cooperate likely changed the OECD's tactics — the list was no longer intended to be a basis for concerted action by OECD members. Instead, it would publish a list of "uncooperative" tax havens for that purpose.

The 2001 Progress Report marked a shift in tone.[15] It modified the OECD's criteria for what constituted an uncooperative tax haven by removing the "substantial activities" test (that the jurisdiction does not require a person to carry out "substantial activities" in the country in order to take advantage of its tax laws).[16] Since it had never been a decisive factor that a jurisdiction had "no or only nominal taxes", the report concluded that "commitments will be sought only with respect to the transparency and effective exchange of information criteria".[17]

This rapid about-face was met with less than unanimous approval. Belgium and Portugal abstained from the 2001 Progress Report, joining Luxembourg and Switzerland. Their abstention was largely because the

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10 Ibid, at [113]–[137].

11 Ibid, at [114]–[117]. Article 26 of Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital: Condensed Version* (Organisation for Economic Co-operation and Development, Paris, 2003) [*Model Tax Convention 2003*] was subsequently amended to remove the requirement that the requested information be related to taxes that are the subject of the treaty.

12 *Harmful Tax Competition Report*, above n 2, at [118].

13 Ibid, at [129]–[132].

14 *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs: Progress in Identifying and Eliminating Harmful Tax Practices* (Organisation for Economic Co-operation and Development 2000).

15 *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (Organisation for Economic Co-operation and Development 2001).

16 Ibid, at [27].

17 Ibid, at [28].

1998 Report urged them to eliminate their own harmful tax practices, and having done so, they were perturbed at the reduction of the project to mere information exchange.

The cause of this change in policy was in no small part due to the United States withdrawing its support. Though the Clinton Administration had supported the project, the Bush Administration disagreed with the project's goals. The then Secretary of the United States Department of the Treasury, Paul O'Neill, said that the Report "implicated fundamental internal tax policy decisions" of both OECD and non-OECD countries by criticising the adjustment of tax rates to attract investment, "even though such systems provide a more attractive investment climate without facilitating non-compliance with the tax laws of any other country".[18]

Tax havens also resisted. The Commonwealth Secretariat and the OECD jointly convened a meeting in Barbados in early 2001. Commonwealth nations, many of which were havens or (like the United Kingdom and New Zealand) had dependencies that were havens, took issue "with the actions of the OECD in challenging the right of non-member States to manage their domestic sovereign tax affairs; and in particular to the threat of sanctions".[19]

The havens were particularly concerned about EOI. The Prime Minister of Antigua and Barbuda, Lester Bird, said that offshore financial centres would "effectively be dead" if they agreed to EOI while OECD members like Switzerland did not.[20] Poorer havens, such as those in the Caribbean, were particularly aggrieved, as they had been told by institutions like the International Monetary Fund to remove tariffs and diversify their economies by attracting more financial services, only to be threatened suddenly with sanctions when their financial markets became too competitive. These havens did not have infrastructure to fall back on once their offshore markets were gone.

Nevertheless, information exchange became the focus of the project. O'Neill announced that the United States had "made substantial progress in focusing the initiative on its core element of effective information exchange".[21] Easson argues that the United States had "hijack[ed] the initiative" to focus on "its own preoccupation with obtaining information to combat money laundering and terrorism".[22]

Havens that pledged to cooperate with the OECD initiative agreed

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18 Paul O'Neill "OECD Harmful Tax Practices Initiative" (statement to the Senate Committee on Governmental Affairs Permanent Subcommittee on Investigations, Washington DC, 18 July 2001) cited in James Jackson *The OECD Initiative on Tax Havens* (Congressional Research Service 2010) at 11.

19 Don McKinnon "Commonwealth Secretary General calls for multilateral dialogue" (speech to the High-Level Consultations On OECD Harmful Tax Competition Initiative, Barbados, 8 January 2001), transcript available at <www.itio.org>.

20 "Caribbean is urged to withdraw from OECD harmful tax competition project" *BBC Monitoring International Reports* (1 November 2003), cited in Alex Easson "Harmful Tax Competition: An Evaluation of The OECD Initiative" (2004) 34 Tax Notes Intl 1037 at 1065 note 222.

21 O'Neill, above n 18, cited in Easson, above n 20, at 1073.

22 Easson, above n 20, at 1073.

to implement EOI for criminal matters (that is, tax fraud and tax evasion) by the end of 2003 and for civil matters (that is, tax avoidance) by 2005. In 2002, the OECD published a model Tax Information Exchange Agreement (TIEA),[23] but stressed that havens could use other mechanisms (such as a DTA) to satisfy their EOI obligations.[24]

TIEAs are bilateral treaties that oblige each party to exchange information about taxpayers on the request of the counterparty. While these are, at first blush, even-handed — they impose the same obligations on both parties — the desire (and capacity) of a high-tax jurisdiction such as the United Kingdom to extract delinquent taxpayers vastly outstrips that of small island tax havens.

Unfortunately for them, the majority of tax havens have had no choice but to sign up to TIEAs, as their small economies mean that they have nothing significant, other than information exchange, to offer prospective treaty partners. Additionally, any sanction imposed concertedly by OECD members would ruin them economically.

The Internationally Agreed Tax Standard

The project proceeded at a relatively slovenly pace for the rest of the Bush Administration. However, in February 2008, the German Federal Intelligence Service (the Bundesnachrichtendienst) uncovered evidence that hundreds of individuals were evading German tax using Liechtenstein trusts. The international condemnation that followed resulted in a torrent of TIEAs — 25 in 2008 alone, more than doubling their number.

The publication of the OECD's "grey list" in April 2009 put more pressure on tax havens to live up to their promises. This report, entitled *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard*,[25] comprised three lists in a "name and shame" technique. The "white" list contained countries that had agreed to the standard and had signed more than 12 TIEAs or DTAs with the modern EOI article. The "grey" list contained countries that had agreed to the standard, but had failed to sign the requisite number of treaties (including, to their outrage, a number of OECD members: Austria, Belgium, Luxembourg and Switzerland). The "black" list had countries that had not yet agreed to the standard.

The reason for the timing of the lists is probably due in large part to the worsening of the global financial crisis in 2008. Tax evasion was contributing to a significant loss of government revenue at a time when governments, especially the United States, were bailing out the very

23 *Agreement on Exchange of Information on Tax Matters* (Organisation for Economic Co-operation and Development, 2002).

24 Ibid, Introduction at [6].

25 *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (Organisation for Economic Co-operation and Development April 2009) [*The Grey List*].

banking institutions that likely facilitated the evasion in the first place. The OECD estimates this deficit to be in the billions of euros for many developed countries.[26]

Just as the change in United States leadership from 1999 to 2000 affected the fate of the Harmful Tax Competition project, the new Democratic President in 2008 probably bolstered the project. The new President was known for his anti-haven stance, having sponsored the Stop Tax Haven Abuse Bill as a senator in 2007.[27] This anti-haven position has found new life in the recently enacted Foreign Account Tax Compliance Act 2010 enacted as part of the Hiring Incentives to Restore Employment Act 2010), or "FATCA", which forces offshore financial institutions to divulge the identities of their United States account holders or pay a steep withholding tax.[28]

The standard to be removed from the OECD grey list (the "internationally agreed tax standard") is set out in the *Terms of Reference for the Global Forum for Transparency and Exchange of Information for Tax Purposes* (*Terms of Reference*).[29] It contains criteria largely detailing the information collection facilities that the jurisdictions are required to have, and secrecy laws that they are permitted to keep. The important requirement for these purposes is C.2, which states that "[t]he jurisdiction's network of information exchange mechanisms should cover all relevant partners".[30]

To have "substantially implemented" the standard, jurisdictions must enter into at least 12 TIEAs or DTAs with EOI clauses. However, "this benchmark was recognised as part of a staged process" and re-evaluation would occur "as circumstances evolved".[31] In addition "[i]t is apparent that, for some jurisdictions, 12 agreements are likely to be too few".[32] For such jurisdictions, the test requires something different:[33]

> Ultimately, the standard requires that jurisdictions exchange information with all relevant partners, meaning those partners who are interested in entering into an information exchange agreement. Agreements cannot be concluded only with counterparties without economic significance. If it appears that a jurisdiction is refusing to enter into agreements or negotiations with [other] partners ... this ... may indicate a lack of commitment to implement the standards.

26 *The Global Forum on Transparency and Exchange of Information for Tax Purposes: Information Brief* (Organisation for Economic Co-operation and Development 2011) at [4].

27 Stop Tax Haven Abuse Act of 2007, S. 506, 110th Cong. (2009).

28 Hiring Incentives to Restore Employment Act 26 USC § 1471.

29 *Terms of Reference to Monitor and Review Progress towards Transparency and Exchange of Information for Tax Purposes* (Organisation for Economic Co-operation and Development 2010).

30 Ibid, at 8.

31 Ibid, at 8 note 26.

32 Ibid.

33 Ibid.

It is unclear what "economic significance" means, though it seems aimed at ensuring that havens do not just sign 12 TIEAs with fellow havens who will never exercise the information exchange ability. If we consider Hong Kong's treaty network, are Brunei, Kuwait or Liechtenstein economically significant treaty partners? Does Hong Kong's lack of a TIEA with the United States indicate that it is unwilling to implement the transparency standards, given that the United States is its biggest foreign trade partner? The *Terms of Reference* do not clearly answer these questions.

Regardless of the clarity of the requirements, the publication of the lists spurred action. All four members of the black list — Costa Rica, Malaysia, the Philippines and Uruguay — pledged cooperation with the OECD and were moved to the grey list five days later. Havens on the grey list entered swiftly into negotiations with potential treaty partners and made significant changes to their domestic law to enable effective EOI. Six jurisdictions — Bahrain, Belgium, Bermuda, the British Virgin Islands, the Cayman Islands and Luxembourg — were removed from the grey list upon publication of the updated list only five months later (in September 2009).[34] Even Switzerland, a country renowned for its banking secrecy, made changes to its domestic law in 2009 to allow it to enter into comprehensive EOI agreements.[35]

In late 2009, the project changed again. As the result of a Global Forum meeting in September 2009, the Global Forum started to implement a "peer review" programme, which would survey each jurisdiction and examine its compliance with the EOI standards.[36] The OECD also changed the benchmark for substantial implementation of the international standard to the signing of at least 12 EOI agreements *with OECD members*.[37] This new benchmark is no less arbitrary than the previous standard but it at least gives some guidance as to what the OECD meant by "economically significant". In essence, "economically significant" seems to mean "high-tax and likely to lose revenue to that tax haven".

Summary

The focus on EOI is largely a result of historical accident. The project against harmful tax competition initially focused on essentially eliminating tax haven activity by threatening sanctions should the havens continue

34 *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (Organisation for Economic Co-operation and Development September 2009) [*The Updated Grey List*].

35 For an excellent discussion of this development, see Markus Huber and Fabian Duss "Switzerland: Recent Developments in International Tax Law — Part 1" (2009) 63 BFIT 567; Markus Huber and Fabian Duss "Switzerland: Recent Developments in International Tax Law — Part 2" (2010) 64 BFIT 28.

36 The procedure of this review is set out in Organisation for Economic Co-operation and Development *Implementing the Tax Transparency Standards: A Handbook for Assessors and Jurisdictions* (OECD Publishing, Paris, 2010).

37 *Tax Co-operation 2009: Towards a Level Playing Field: 2009 Assessment by the Global Forum on Transparency and Exchange of Information* (Organisation for Economic Co-operation and Development 2009) at 18.

to entice geographically mobile financial services away from high-tax jurisdictions.

The large critical backlash and the withdrawal of United States support caused the OECD radically to scale back its approach. The United States saw EOI as a corollary of terrorist financing laws, and steered the OECD's focus to promoting information exchange, through either DTAs or TIEAs. However, the OECD seemed largely satisfied with havens broadly agreeing to cooperate with its aims, rather than undergoing any substantive reform.

The OECD's satisfaction with the status quo changed in 2009, when the global financial crisis enabled OECD members to find the political will to tackle tax evasion. The publication of the grey list pressured tax havens to comply with their earlier pledges and enter into treaties with information exchange provisions. This pressure also likely encouraged Hong Kong to modify its domestic laws and tax treaty policy to allow it to enter into a rapidly expanding tax treaty network.

II HONG KONG'S TAX TREATIES

This section of the article will explore Hong Kong as a particular example of a tax haven that enters into DTAs. It will first examine how the OECD project outlined above affected Hong Kong politically: Hong Kong has developed from a state staunchly opposed to tax treaties, to one that has embraced them wholeheartedly. This change of heart is significant for a country that is typically reluctant to do much other than make small adjustments to its tax rates. This section will next canvass the salient features of Hong Kong's tax treaty network to highlight the harmful (or advantageous) effects that the treaties have.

Hong Kong's Domestic Tax Law

Hong Kong was, until 1997, a British colony, and has been a major international financial centre for the past three decades. It has always been characterised by low taxes and low public spending. These policies are largely due to the predominance of business interests in the government: for example, the Legislative Council consists explicitly of members chosen from business constituencies.

Hong Kong does not have a comprehensive income tax. Instead, it has a "schedular" system, under which tax is payable on company profits (but not on dividends the company receives, or capital gains it makes), on rental income and other income from property, and on the salaries of employees and officeholders. (It also levies rates and a stamp duty, but no other major taxes except for the defunct estate duty.) These taxes are very low: Hong Kong levies all three at a maximum rate of 15 per cent, save

for the 16.5 per cent profits tax if the business is incorporated. Very few taxpayers pay the salaries tax rate of 15 per cent, as reduced rates apply for 99 per cent of taxpayers.[38]

It is not these low rates, however, that draw the stern attention of high-tax jurisdictions to Hong Kong. Instead, it is the broad jurisdictional exemption from Hong Kong tax: income is not taxable in Hong Kong if it is derived from any place other than Hong Kong.[39] In other words, although most modern countries base their tax systems on the twin pillars of residence (a person resident in the country must pay tax on income he or she earns, regardless of its source) and source (a person, regardless of his or her residence, must pay tax on income sourced from the country), Hong Kong's tax system is based solely on source.

Recent Changes to Hong Kong's Treaty Policy

Hong Kong's colonial government was wary of entering into double tax treaties. This wariness was presumably because Hong Kong, as a tax haven, was acutely aware of the attractiveness of strict banking secrecy laws. The Swiss banking system is testament to how strong secrecy laws can facilitate criminal activity such as tax evasion. The Germany–Liechtenstein scandal, discussed earlier, was only possible because of trust secrecy laws. Hong Kong attracted business in three main ways: first, because of its importance as a financial centre in Asia and cheap labour costs; secondly, by facilitating tax avoidance by means of its remarkably light tax burden; and thirdly, by facilitating tax evasion.

One of the guarantees during the hand-over from British to Chinese rule was that Hong Kong would remain largely autonomous, including the ability to maintain its own tax laws. One of the few changes that have happened, however, is the Special Administrative Region (SAR) government's decision to enter into tax treaties. Under art 151 of the Basic Law,[40] Hong Kong is entitled to negotiate and enter into DTAs, but it cannot take advantage of treaties entered into by Mainland China.

The SAR government began to consider entering into DTAs with "major trading partners" in its 1998 Budget, but only concluded one treaty in that year, with Mainland China. Hong Kong's next treaty was with Belgium in 2003. In a press release, the Secretary for Financial Services and the Treasury stated:[41]

> [The treaty will] translate into tax savings to Belgian and Hong Kong investors doing business in each other's area, through the

38 Michael Littlewood *Taxation Without Representation: The History of Hong Kong's Troublingly Successful Tax System* (Hong Kong University Press, Hong Kong, 2010) at 4.

39 Inland Revenue Ordinance 1947 (HK), s 14(1).

40 The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China 1990, art 151.

41 Inland Revenue Department (Hong Kong) "Government signs Comprehensive Agreement for Avoidance of Double Taxation with Belgium" (press release, 10 December 2003).

> allocation of taxing rights between the two places and the provision of tax relief in case of double taxation.

It is likely that most of the tax savings result from the allocation of rights, rather than any hypothetical double taxation relief.

In a brief to Hong Kong's Legislative Council,[42] the Inland Revenue Department (IRD) acknowledged that double taxation is usually circumvented by Hong Kong's "territorial concept of taxation". It may arise when Belgium taxes Belgian residents on Hong Kong-sourced income, but most countries provide unilateral relief, "thus avoiding or reducing double taxation of foreign residents in most cases".[43]

Preventing double taxation is not a motivation for entering into DTAs for either Hong Kong or Belgium. Instead, there were other benefits to Hong Kong: first, DTAs provide "enhanced certainty and stability to investors";[44] secondly, the relief afforded to Hong Kong investors under the treaty is heftier than Belgium's unilateral relief;[45] thirdly, there is a reduction of withholding rates on interest and dividends;[46] and fourthly, the formal relationship between the tax authorities can be used to "resolve difficulties" with international taxation.[47] The treaty is useful in "further enhancing [Hong Kong's] competitiveness in attracting investment".[48]

Hong Kong entered into its DTA with Belgium before 2004, so the DTA did not contain a comprehensive EOI provision that would contribute towards the OECD standard of 12 treaties. At this point, the model EOI article did not prohibit treaty partners from refusing information requests because a bank held the requested information, and was thus subject to banking secrecy laws. A jurisdiction could even refuse a request if it had no domestic interest in collecting that information.[49]

Hong Kong only signed three further treaties over the next four years. None of these contained the 2004 version of the EOI article. It was not until July 2009 (three months after the publication of the OECD's grey list) that Hong Kong introduced legislation to allow it to adopt the modern EOI article.

This legislation[50] was designed to incorporate the OECD *Model Tax Convention* (OECD Model)[51] into Hong Kong's future DTAs. The most obvious reason for this incorporation was to avoid the possibility

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42 *Legislative Council Brief: Specification of Arrangements (Government of the Kingdom of Belgium) (Avoidance of Double Taxation on Income and Capital and Prevention of Fiscal Evasion) Order* (Financial Services and the Treasury Bureau (Hong Kong) 2003) <www.legco.gov.hk> [*Legislative Council Brief: Specification of Arrangements*].

43 Ibid, at [5].

44 Ibid, at [7].

45 Ibid.

46 Ibid, at [9].

47 Ibid, at [11(b)].

48 Ibid, at [13].

49 *Model Tax Convention 2003*, above n 11, art 26.

50 Inland Revenue (Amendment) (No 3) Bill 2009 (HK).

51 *Model Tax Convention 2003*, above n 11.

of sanctions and any detriment to its reputation from remaining on the OECD's grey list.

In a report by the Bills Committee (Committee) in 2009, the fear of sanctions was one of Hong Kong's motivations for adopting EOI:[52]

> According to the Administration, while the international community has generally accepted that Hong Kong should not be compared to those jurisdictions which seek to attract tax evading foreign capitals through zero or nominal tax rates, complicated and opaque tax rules, as well as bank secrecy laws, any negative perceptions on the transparency of Hong Kong's tax regime would harm its reputation as an international financial centre, and could lead to sanctions imposed by other economies.

Another reason was that many of Hong Kong's potential treaty partners (most notably the United States) refused to sign DTAs with Hong Kong, due to its stance on EOI. At the time of signing its treaty with Belgium in 2003, Hong Kong had approached 30 major trading partners to negotiate DTAs.[53] However, by May 2009, Hong Kong was only negotiating with a mere 11 jurisdictions, and had only signed 3 further treaties.[54] Given that Hong Kong would only be too happy to agree to any non-EOI provision in the OECD Model (as it would not sacrifice any tax revenue by doing so), this lack of success in concluding treaties is likely due to one of two reasons: either Hong Kong refused to agree to comprehensive EOI, or the counterparties refused to forfeit their tax revenue needlessly.

The Committee noted that a number of business representatives supported the Bill, and "some call[ed] for early enactment of the Bill to enable Hong Kong to catch up",[55] though a number of others expressed concerns about safeguards for privacy and confidentiality of information gathered. The Committee was emphatic that tax periods before the entering into force of any treaty with the liberalised EOI provision would be exempt from the more comprehensive EOI requirements.[56] This emphasis is reflected in many of Hong Kong's treaties and in the Commentary to art 26 of the OECD Model.

The Committee also advised restricting information exchange in all of its DTAs, from "taxes of every kind and description" to "taxes covered by the Agreement".[57] It said that despite "anticipated difficulties in the negotiation process, [Hong Kong] will insist in confining the scope of

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52 Inland Revenue (Amendment) (No 3) Bill 2009 (HK) (Bills Committee Report) at [5] [Bills Committee Report].

53 *Legislative Council Brief: Specification of Arrangements*, above n 42, at [25].

54 KPMG *Tax Alert: Hong Kong moves to facilitate exchange of information* (KPMG, Hong Kong, 2009).

55 Bills Committee Report, above n 52, at [11].

56 Ibid, at [21].

57 Ibid, at [23].

information exchange to income taxes".[58] So far, every country with which Hong Kong has signed a DTA has agreed to this modification.

The Bill came into force in January 2010. In the next two months, Hong Kong signed treaties with Brunei, the Netherlands and Indonesia. By the end of June, it had signed five more with Hungary, Kuwait, Austria, the United Kingdom and Ireland, and by the end of the year, it entered into DTAs with Liechtenstein, France, Japan, New Zealand and Switzerland. In March 2011, it signed treaties with both Portugal and Spain. In June 2011, it signed one with the Czech Republic.

Hong Kong's Tax Treaty Network

Hong Kong now has 21 comprehensive DTAs. This section will canvass the common features among these treaties, in an attempt to determine how Hong Kong benefits and what it sacrifices in exchange.

References in this section to art 7 of the OECD Model are to the 2008 version, as no Hong Kong treaty has incorporated the 2010 changes to that article.

This section will refer to the "residence jurisdiction" and the "source jurisdiction". The residence jurisdiction is the jurisdiction in which the taxpayer or business resides (usually defined in art 4). The source jurisdiction is the jurisdiction from which the taxpayer derives the income in question.

1 Business Profits

Central to understanding the OECD Model (the basis of Hong Kong's treaties) is the interplay between arts 5 and 7. Article 7 provides that the source jurisdiction cannot tax business profits unless they are attributable to a permanent establishment (PE) of the business.[59]

However, the residence jurisdiction may still tax the business profits if there is a PE in the source jurisdiction. This feature often occurs in the OECD Model: it frequently gives exclusive taxing power to the residence jurisdiction, but when it gives the source jurisdiction the ability to tax, the residence jurisdiction may still tax (though usually the residence jurisdiction must give relief for double taxation).[60] This feature reflects the OECD Model's roots as a treaty designed mainly by capital-exporting jurisdictions, which are residence jurisdictions more often than they are source jurisdictions.

Article 5 defines "permanent establishment" as a "fixed place of

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58 Ibid, at [27].

59 Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital: Condensed Version* (Organisation for Economic Co-operation and Development, Paris, 2008) art 7(1).

60 For example, art 6(1) gives the right to tax income from land to the source state whilst still allowing the residence state to tax. Article 12(1), on the other hand, specifies that royalties may "only" be taxed in the residence state.

business through which the business ... is wholly or partly carried on".[61] The article also lists particular examples of PEs: a place of management, a branch or office, a factory or workshop and any place that extracts natural resources.[62]

In the OECD Model, construction projects are PEs if they last more than 12 months. However, Hong Kong reserves its position on this provision,[63] stating that it will consider these projects PEs if they last more than six months. This reservation has been implemented as either 6 months or 183 days in all treaties, save those with Japan, Liechtenstein, Spain and Switzerland. The treaties with Liechtenstein and Japan keep the OECD standard of 12 months, while the treaties with Spain and Switzerland compromise with tests of 9 months and 270 days, respectively.

Hong Kong also reserves the right to treat a business as having a PE if it furnishes services through employees or contractors for more than 6 months in a 12 month period.[64] Hong Kong has adopted figures of 6 months, 180 days, or 183 days in all treaties save those with Japan, Spain and Switzerland. Treaties with the Czech Republic, Liechtenstein and the United Kingdom restrict this reservation to construction projects.

"Permanent establishment" is defined not to include the storage or display of goods, the holding of goods to be processed, a purchasing office, a place that merely carries on activities of a "preparatory or auxiliary character", or any merely auxiliary combination of the above.[65]

If an agent of the business has, and habitually exercises, authority to conclude contracts for the business, then the business has a PE. However, there is no PE if this activity is limited to the auxiliary activities outlined in the previous paragraph, and there is no presumption that the use of an independent agent in the ordinary course of business constitutes a PE.[66] Finally, the article clarifies that the holding of a subsidiary in another jurisdiction does not necessarily constitute a PE.[67]

The adoption of the permanent establishment rules helps Hong Kong. Hong Kong companies wishing to conduct business overseas can now operate untaxed in treaty partner jurisdictions, as long as they arrange their affairs so as not to constitute a PE in that jurisdiction. This increases Hong Kong's attractiveness markedly as a centre for holding companies and as a base for international businesses.

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61 Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital: Condensed Version* (Organisation for Economic Co-operation and Development, Paris, 2010) art 5(1) [*Model Tax Convention 2010*].

62 Ibid, art 5(2).

63 Ibid, at 434.

64 Ibid, at 435.

65 Ibid, art 5(4).

66 Ibid, art 5(6).

67 Ibid, art 5(7).

2 *Withholding Taxes*

The main benefit that accrues to Hong Kong residents through DTAs is the "ceiling" on withholding rates that they impose. The OECD Model imposes modest limits on withholding taxes, which of itself would result in considerable tax savings for Hong Kong investors.

Article 10 provides the residence jurisdiction with the non-exclusive right to tax dividends. If the "beneficial owner" of the dividends is resident in the other treaty partner jurisdiction, the source jurisdiction may only withhold up to 15 per cent tax on those dividends. If the beneficial owner owns at least a quarter of the company, the ceiling falls to five per cent. "Beneficial owner" here is an anti-avoidance mechanism — it is designed to stop persons who are not resident in Hong Kong from establishing a company solely to obtain the reduced treaty rate.

Similarly, art 11 gives the residence jurisdiction the non-exclusive right to tax interest, and subjects the source jurisdiction's withholding rate to a 10 per cent ceiling if the beneficial owner is a resident of the counterparty to the DTA. Article 11 contains an additional anti-avoidance measure: the ceiling on the withholding rate will not apply if the parties are related (by common ownership or otherwise), and the interest rate is one they would not have agreed to, if they were not related.

Article 12 provides the residence jurisdiction with the exclusive right to tax royalties. The source jurisdiction may not withhold tax. This article contains the same related parties restriction as art 11.

Hong Kong's treaties often have additional anti-avoidance provisions. The treaties with Brunei, France, Indonesia, New Zealand, Portugal, Spain, Switzerland and the United Kingdom all contain paragraphs in these articles which provide that the withholding ceilings will not apply if the purpose of the creation or assignment of the relevant rights was to take advantage of the ceiling.

Hong Kong's treaties provide for adjusted ceilings that are lower for both dividends and interest (which benefits Hong Kong, as it does not have withholding taxes, or generally, any tax on them at all) and higher for royalties (which also benefits Hong Kong, as it has a 4.95 per cent withholding tax on them). All treaty partners that provide a reduced dividend rate for larger shareholdings have modified the threshold to a 10 per cent shareholding. These rates are contained in the table on the following page. A zero per cent ceiling means that the source jurisdiction cannot impose withholding taxes at all.

As can be seen from the table, Hong Kong profits immensely from these ceilings. Only one third of Hong Kong's treaty partners require it to reduce its withholding tax on royalties. Those that do so only reduce it from 4.95 to 3 per cent. Additionally, Hong Kong-resident investors save considerably as withholding on dividends and interest is very low, usually below the OECD Model's ceilings. (The Liechtenstein and United Kingdom treaties are particularly generous in this respect.)

In many cases, planning opportunities arise for residents of other countries to interpose a Hong Kong company to receive dividends or interest, and re-route the payments to that country, as Hong Kong will not withhold tax on the second payment (though the scheme may still be caught by the anti-avoidance provisions). In some cases, planning opportunities arise out of the operation of the treaty itself: interest paid to most Hong Kong-resident individuals from a United Kingdom company, for example, is not subject to tax in Hong Kong, not subject to withholding tax in the United Kingdom and is deductible in the United Kingdom.

Country	**Dividends**	**Dividends (10 percent of s/holding)**	**Interest**	**Royalties**
OECD Model	15%	-	10%	0%
Austria	10%	0%	0%	3%
Belgium	15%	10%/0%[i]	10%	5%
Brunei	0%	-	10%/5%[ii]	5%
Czech Republic	5%	-	0%	10%
France	10%	-	10%	10%
Hungary	10%	5%	10%	5%
Indonesia	10%	-	10%	5%
Ireland	0%	-	10%	3%
Japan	10%	5%	10%	5%
Kuwait	5%	-	5%	5%
Liechtenstein	0%	-	0%	3%
Luxembourg	10%	0%	0%	3%
Mainland China	10%	-	7%	7%
Netherlands	10%/0%[iii]	-	0%	3%
New Zealand	15%/0%[iii]	5%	10%/0%[ii]	5%
Portugal	10%	5%	10%	5%
Spain	10%	10%/0%[i]	5%/0%[ii]	5%
Switzerland	10%	0%	0%	3%
Thailand	10%	-	15/10%[ii]	15%/10%/5%[iv]
United Kingdom	0%/15%[v]	-	- /0%[vi]	3%
Vietnam	10%	-	10%	10%/7%[vii]

i The 0 per cent rate applies if the shareholder has more than a 25 per cent shareholding.

ii The lower rate applies to interest paid to financial institutions.

iii The zero per cent rate applies to shares in companies registered on a recognised stock exchange.

iv The 5 per cent rate applies to royalties for copyright, the 10 per cent rate to patents and trademarks, and the 15 per cent rate in other cases.

v The 15 per cent rate applies to dividends paid out of gains derived from investment vehicles.

vi There is no ceiling on interest unless its receiver is an individual, a company registered on a recognised stock exchange, a financial institution unrelated to the payer, or a company that the residence jurisdiction decides is not avoiding tax, in which case it is zero per cent.

vii The seven per cent rate applies to patents.

3 Capital Gains (or Income from the Alienation of Property)

Article 13 deals with capital gains or (in the case of jurisdictions that do not impose tax on capital gains) income from share sales and the sale of other capital assets that constitutes income. The source state (the *situs* of the property) has non-exclusive taxing rights over immovable property, movable business property connected with a PE and shares in companies that derive more than half their value from immovable property. Otherwise, the residence state has exclusive taxing rights.

All of Hong Kong's treaty partners (save China, Portugal, Thailand and Vietnam) have modified this article in their treaties with Hong Kong by adding limitations on the source jurisdiction's ability to tax income gained from share sales. Generally, these limitations have the effect that if shares are quoted on a recognised stock exchange, or alienated in a merger or reorganisation, or are held in companies that derive half their value from land or buildings where they carry out their business, the source state cannot tax the sale and the residence state has exclusive taxing jurisdiction.

These limitations are beneficial for Hong Kong. Since Hong Kong does not have a capital gains tax and its profits tax does not apply to the sale of shares outside of Hong Kong, a Hong Kong resident who realises gains from the sale of shares in anything but a property-holding company will not be taxed in the counterparty.

4 Anti-avoidance

As Hong Kong is a tax haven, its treaty partners are unusually careful about tax avoidance. In addition to the specific anti-avoidance provisions in the passive income sections of the treaty, many of Hong Kong's treaties contain articles explicitly reserving the ability of each jurisdiction to apply their anti-avoidance measures. These provisions are contained in the treaties with Austria, China, the Czech Republic, Japan, Kuwait, the Netherlands, Portugal, Switzerland, Thailand and Vietnam.

5 Administration and Non-Discrimination

Article 22 of the OECD Model prevents the tax system of each jurisdiction from discriminating against nationals of the other jurisdiction. Article 22 ignores the jurisdictional restrictions that bind the rest of the treaty: it only applies to persons who are not resident in either jurisdiction, and to taxes that are not the subject of the treaty. The tax imposed cannot be "other or more burdensome" than taxes imposed on nationals of that jurisdiction in the same circumstances. The article also prevents discrimination against stateless people, permanent establishments and foreign-owned companies (but not their owners).

Most of Hong Kong's treaties modify this protection. Just over half

of them eliminate the protection for stateless people.[68] Eight withdraw the protection from persons who are not resident in either state,[69] and all of Hong Kong's treaty partners[70] remove the protection from taxes that are not the subject of the treaty.

Article 27 states that the parties shall "lend assistance" to each other in the collection of taxes.[71] This article is meant to complement the EOI provision — for example, even if the United Kingdom tax department realises one of its residents is evading tax by keeping funds in Hong Kong, it does not help them if the resident has no funds in the United Kingdom with which to pay the tax debt.

The assistance clause has comprehensive rules concerning mutual assistance requests,[72] but it is unnecessary to discuss these here as Hong Kong has declined to include this article in all of its tax treaties.

This deletion is not as surprising as it would be for other articles in the OECD Model: the Commentary lists factors that may cause a jurisdiction to decline to adopt the article. One factor is "whether assistance in the collection of taxes will provide balanced and reciprocal benefits to both States".[73] Since Hong Kong has no tax interest in the overseas investments of its residents, it will usually not require assistance to collect its own taxes. Therefore, it is unlikely that the agreement will be anything close to "balanced and reciprocal". Though it is possible that the Hong Kong Inland Revenue Department may wish to pursue a taxpayer who has absconded with an outstanding tax debt, since Hong Kong has a significantly lower tax burden than most other developed countries, it is not likely to happen often.

6 Exchange of Information

Since the OECD sees EOI as legitimising tax treaties with tax havens, it is important to examine it in detail. The OECD Model states that the tax departments of treaty partners shall exchange information that is "foreseeably relevant" for carrying out the treaty or for the administration or enforcement of their tax laws.[74] The OECD Model does not permit parties to enter into "fishing expeditions". That is, a tax department is not entitled to request information about a person unless they can reasonably foresee that the person is, for example, holding or receiving funds in that jurisdiction.

Treaty partners can exchange information by request, automatically,

68 Those with Belgium, China, the Czech Republic, Kuwait, Liechtenstein, New Zealand, Spain, Switzerland, Thailand, the United Kingdom and Vietnam.

69 Those with Austria, Belgium, France, Kuwait, Luxembourg, Thailand, the United Kingdom and Vietnam.

70 Except Austria, Hungary, Japan, Liechtenstein, Switzerland and Portugal.

71 *Model Tax Convention 2010*, above n 61, art 27(1).

72 Ibid, art 27(3)–27(7).

73 Ibid, at 411.

74 *Model Tax Convention 2010*, above n 61, art 26(1).

or spontaneously. Hong Kong, however, has decided not to exchange information automatically or spontaneously,[75] and has included statements to this effect in protocols to each of its treaties signed in 2010[76] (save the treaty with Japan, which contains a provision restricting information exchange until each jurisdiction notifies the other to the contrary).[77] In any event, it is unlikely that Hong Kong would volunteer information spontaneously even if these restrictions were not present.

Article 26 provides that arts 1 and 2 of the OECD Model do not restrict information exchange. That is, EOI is not restricted to information about residents of either jurisdiction or taxes covered by the treaty. However, all of Hong Kong's treaties remove this liberalisation, thus restricting the scope of information exchange to (typically) the income tax of the counterparty. This restriction is contemplated in the Commentary to the EOI article in the OECD Model.[78]

Article 26 contains a confidentiality safeguard, which limits the use of the information to the purposes for which it was requested. Hong Kong's treaties all contain an explicit requirement that countries do not disclose its tax information to third jurisdictions for any purpose, though the OECD considers that the article already requires this implicitly.[79]

The article clarifies that the EOI obligations do not force Hong Kong to act contrary to its administrative practices. To ensure that privacy rights are respected, the EOI rules promulgated by the Hong Kong Inland Revenue Department[80] require (among other things) a notification procedure before information is exchanged.[81] The Commentary to art 26 makes it clear that this procedure cannot be used to "prevent or unduly delay" EOI.[82] The Commentary also notes that a jurisdiction can refuse to provide information if the requesting party could not provide similar information if requested (the principle of reciprocity).[83] In practice, this constraint is of limited scope, especially given that Hong Kong is unlikely to be in the position where it has wider information exchanging abilities than the country requesting the information. Limitations of slightly broader application include the privilege against self-incrimination and solicitor–client privilege. A jurisdiction can refuse to exchange information if it would breach these privileges.

In 2005, the OECD added two new paragraphs to art 26. The first

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75 *Legislative Council Brief: Inland Revenue (Amendment) (No 3) Bill 2009* (Financial Services and the Treasury Bureau (Hong Kong) 2009) at [9(a)].

76 See, for example, Double Taxation Agreement, above n 1, at [4(a)].

77 See Agreement between the Government of the Hong Kong Special Administrative Region of the People's Republic of China and the Government of Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (adopted 9 November 2010) Protocol at [7].

78 *Model Tax Convention 2010*, above n 61, at 401–402.

79 Ibid, at 403.

80 Inland Revenue (Disclosure of Information) Rules 2010 (HK).

81 Ibid, r 5(1).

82 *Model Tax Convention 2010*, above n 61, at 404.

83 Ibid.

removes the domestic interest requirement that used to be present in the OECD Model: a jurisdiction now cannot refuse an EOI request simply because it does not have the information and does not require it for its own tax purposes.[84] If a jurisdiction could so refuse, Hong Kong would be an ideal tool for tax evasion. For example, Hong Kong does not tax dividends, so the old article would not have required it to provide information about dividends.

The second new paragraph provides that a jurisdiction may not refuse to exchange information because it would infringe banking secrecy laws.[85] Strict banking secrecy rules have long been the hallmark of tax havens like Hong Kong and Switzerland, but for an EOI request to be of any significant effect, such a request must trump them. This is clearly an inroad into the ability of tax havens to function as havens, but its full extent is yet to be seen.

III EVALUATING TAX TREATIES WITH TAX HAVENS

The previous sections have explained why havens adopt DTAs and outlined some of the key provisions that benefit them (and Hong Kong in particular). This section will evaluate tax haven treaties. Any exercise in evaluation requires some metric. The most appropriate metrics here are the two traditional motivations for entering into tax treaties: eliminating double tax and preventing tax evasion. However, as may be evident, these do not explain satisfactorily the phenomenon of tax haven treaties.

Thus, this part of the article also explores other factors that may motivate a high-tax jurisdiction to enter into these treaties with tax havens. Finally, it will conclude with some criticism of these treaties.

The Traditional Explanations

1 Elimination of Double Taxation

All DTAs, including Hong Kong's, have in their title "An Agreement ... for the Avoidance of Double Taxation". Thus, in evaluating the efficacy of a DTA, it is important to look to the extent to which it mitigates double taxation.

It is not just the name of DTAs that indicates that they should relieve double taxation. In *R (Huitson) v Revenue and Customs Commissioners*, the High Court of England and Wales held that:[86]

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84 Ibid, art 26(4).

85 Ibid, art 26(5).

86 *R (Huitson) v Revenue and Customs Commissioners* [2010] EWHC 97 (Admin), [2011] QB 174 at [76(vi)].

> It is a legitimate and important aim of UK public policy in fiscal affairs that a double taxation arrangement should do no more than relieve from double taxation, and that a double taxation arrangement should not be permitted to become an instrument by which persons residing in the United Kingdom avoid, or substantially reduce, the incidence of income tax that they would ordinarily pay on their income ... .

Tax treaties with tax havens utterly fail when evaluated on this ground. Rather than relieve double taxation, they open up new opportunities for avoidance by providing generous withholding reductions. The operation of the permanent establishment rules means that a Hong Kong company carrying on a business that does not amount to a PE pays no tax, instead of the local corporate tax rate.

Since the high-tax jurisdiction loses on this ground, it is important to turn to the other motivations that these countries may have for entering into DTAs with tax havens such as Hong Kong.

2 *Prevention of Fiscal Evasion*

The prevention of fiscal evasion is the other titular motivation for tax treaties. As discussed in the first section, prevention of tax avoidance and evasion has been the flag bearer for most of the OECD's international tax activities in the past decade. Surely it is this (if nothing else) that provides the countervailing benefits for tax havens' treaty partners?

There are two main articles that are intended to counteract tax evasion: the EOI article and the assistance with tax collection article. The effect of the latter is negligible, because it is relatively easy to exclude if either party is concerned that the assistance will not be reciprocal. Other provisions (known as "limitation of benefits" clauses) restrict the operation of tax treaties in an effort to curb evasion or avoidance schemes. These will not be discussed, as they are not relevant to the bargain between the two jurisdictions.

As noted earlier, there are a number of restrictions on the use of EOI. Many of these are present in the Commentary to the OECD Model: for example, an information exchange request cannot require that the requested government impinge on the privilege against self-incrimination, so a tax department cannot request that a tax evader reveal the location of hidden funds; or on solicitor–client privilege, so the same request cannot be made of the tax evader's lawyer.[87] Information requests also cannot constitute "fishing expeditions".

Hong Kong further limits EOI by only providing information under the article if requested to do so. Requests must relate to a particular

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87 In his or her capacity as a solicitor. A lawyer can, of course, be forced to divulge information he or she holds as a nominee or a trustee, as this information is not privileged.

taxpayer; it will not grant "wholesale" exchanges of information about large groups of taxpayers or industries.[88] With some exceptions, it will not grant requests until it has notified the person that she or he is the subject of the inquiry and the requesting jurisdiction has provided justification for believing the information is relevant to its taxes.[89]

These restrictions may, to a limited extent, protect tax evaders. In particular, the rule against fishing expeditions may make it difficult for the requesting party to find evidence of tax evasion without first knowing particular details about the location of the funds. For example, if the requesting tax department is aware that one of its residents has funds sequestered overseas, and that such funds are earning undeclared interest, but the tax department is unaware of the jurisdiction in which the funds are located, it will not have sufficient grounds to make a request. Some degree of specificity is required.

Banking secrecy poses more difficulty to the requesting tax department. The Inland Revenue (Amendment) Ordinance 2010 did not abolish banking secrecy. It merely gave the Hong Kong Inland Revenue Commissioner power to override it for the purposes of an EOI request.[90] This means that it will be very difficult for a foreign revenue department to obtain information about the bank that services the tax evader and even, for example, the name of the account holder.

Of course, the construction of "foreseeably relevant" cannot be so narrow as to preclude effective information exchange altogether (though, since the tax haven is the one that is able to refuse requests, it will undoubtedly construe it strictly). Evidence that the taxpayer habitually banks at a particular bank and is holding funds in that jurisdiction, for example, may be enough.

There are other examples of avoidance or evasion of which EOI requests may be considerably easier to make. The OECD Model Commentary cites the example of a request for details about the price for particular purchases, so the tax authority can make appropriate transfer pricing adjustments.[91] A haven would have given this information before the 2005 changes, as it relates to enforcement of the tax treaty and is not protected by secrecy rules.

Tax havens are free to restrict EOI articles to income taxes, as Hong Kong has done. This means that evasion and avoidance with respect to value added taxes could still be a lucrative business. For example, artificially inflating the purchase prices of goods sold to a New Zealand company would entitle that company to a large input tax credit. However, the New Zealand Inland Revenue Department could not request information under

88 *Legislative Council Brief: Inland Revenue (Amendment) (No. 3) Bill 2009* (Financial Services and the Treasury Bureau, Hong Kong, 2009) at 4.

89 Inland Revenue (Disclosure of Information) Rules, above n 80, r 5.

90 Inland Revenue (Amendment) Ordinance 2010, s 5(2).

91 *Model Tax Convention 2010*, above n 61, at 399.

the Hong Kong–New Zealand treaty about the price the Hong Kong company paid for the goods, as that information relates to New Zealand's value added tax (GST), not to New Zealand's income tax.

Non-Tax Related Motivations

1 Encouraging Closer Diplomatic Relations

Tax treaties, like any other type of treaty, help foster closer diplomatic ties between states. As Dagan notes:[92]

> Treaties serve as proof of good faith and signal a certain respectability of the contracting country in the eyes of the other contracting country (and thus in the eyes of other countries). The United States, for example, used to sign tax treaties with countries as a first step towards establishing wider diplomatic relations.

Diplomatic relations are undoubtedly important, but it is unlikely this consideration alone can form a basis on which to conclude a tax treaty, especially if the tax haven signs the treaty under what is essentially OECD coercion.

In any case, the increased prominence of international organisations (such as the OECD) means that countries are already engaged in long-term cooperative relationships aimed at solving problems that plague both jurisdictions. Though it can be disputed whether the OECD is an appropriate body to carry out this type of project, it is true that its presence has led to greater international cooperation in tax matters (especially if one counts the groups established in opposition to the Harmful Tax Project). The increased dialogue between jurisdictions in areas other than formal diplomatic relations diminishes (though by no means eliminates) the usefulness of treaties in this respect.

2 Spurring Cross-Border Trade and Investment

One of the most common justifications tax departments give for entering into tax treaties is to facilitate trade between the two countries. For example, on the same day as the New Zealand–Hong Kong treaty was signed, the New Zealand Finance and Revenue Ministers issued a press release explaining that the DTA would "strengthen [the] economic relationship with Hong Kong" by making "New Zealand a more attractive investment destination for Hong Kong investors" as well as making "it easier for New Zealand businesses to invest in Hong Kong".[93]

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92 Tsilly Dagan "The Tax Treaties Myth" (2000) 32 NYU J Intl L & Pol 939 at 986.

93 Bill English and Peter Dunne "New Zealand–Hong Kong tax agreement signed" (press release, 1 December 2010).

The havens agree. For the same treaty, the Hong Kong Financial Secretary said that it would "encourag[e] the flow of investment and talents between Hong Kong and New Zealand".[94] When Hong Kong announced its intention to enter into DTAs in 1998, it only aspired to enter into them with its 30 biggest trading partners. This is because treaties are costly and time-consuming to negotiate, and the savings Hong Kong's taxpayers experience are directly proportional to the flow of capital between the jurisdictions.

The line of reasoning for high-tax jurisdictions is the same. New Zealand, for example, must consider the deterrent effect that its higher withholding rates (compared with common treaty rates) have on prospective investors, as well as the cost of providing unilateral double taxation relief (admittedly, the latter is not very weighty in Hong Kong's case). Both of these costs will increase with the size of the capital flow between the jurisdictions. The New Zealand Minister of Revenue noted:[95]

> [E]ntering into double tax agreements is not without cost. They are complex technical agreements. They are time consuming and costly to negotiate. They give up revenue, lock in certain positions, and affect our ability to change tax policy. Accordingly, we do not enter into tax agreements lightly… .
>
> Obvious considerations [for entering into a DTA] are the significance of the economic relationship, the likelihood of increased trade and investment and whether particular issues of double taxation are at stake. We also look at broader strategic issues, and factors such as whether information exchange and other types of co-operation would be useful. … For the last two years, our main focus has been on securing lower withholding tax rates on dividends and royalties in our existing double tax agreements with key trading and investment partners.

However, if double taxation is not an issue, the high-tax jurisdiction is not levelling the playing field. Rather, it is providing a tax *incentive* to investment in the haven. It is not relieving the distortion of economic activity caused by too much tax, but actively creating a distortion by providing exemptions from tax.

This deserves further clarification. The justification for reduced withholding rates in DTAs, for example, is that the high-tax jurisdiction can be assured tax is not avoided; so-called "capital export neutrality" is preserved. That is, the total tax burden does not depend on where the income is earned. An Australian resident earning dividends from New Zealand shares does not care about New Zealand's withholding rate: the

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94 Inland Revenue Department (Hong Kong) "Hong Kong, New Zealand sign tax pact" (press release, 1 December 2010).

95 Peter Dunne, Minister of Revenue "Address to the New Zealand Papua New Guinea Business Council" (Auckland, 15 December 2010).

Australian tax department will credit the taxpayer with the tax paid in New Zealand, so the taxpayer's total tax liability does not typically depend upon the withholding rate in New Zealand. The result is, as long as the New Zealand withholding rate is less than Australian corporate rate of 30 per cent, that the taxpayer will only pay 30 per cent tax in total.

On the other hand, with Hong Kong, a reduction in the withholding rate *does* reduce the total tax burden. A Hong Kong-resident taxpayer pays no tax on his or her New Zealand-sourced income, so concessions in the DTA effectively provide reductions or exemptions from tax. Reduced withholding tax, in circumstances where the counterparty does not tax offshore income, is just a selective reduction in tax rates.

This may be a credible reason for a high-tax jurisdiction to enter into a DTA with a tax haven. It is evident that lower taxes will lead to increased trade between the jurisdictions. However, it is more ideologically problematic — the recent approach to taxation in Western countries has been to have a broad base with few exemptions; the effective subsidisation or exemption of investment in tax havens via tax law is contrary to these principles.

3 Reclaiming Lost Capital

The final non-tax reason for entering into a DTA is closely linked to preventing tax evasion. If taxpayers are not able to evade tax as easily, more funds will remain in the residence jurisdiction as they can no longer be deposited in secret offshore bank accounts. While OECD countries may have been willing to tolerate such an exodus in the first part of the last decade, since the recent economic crisis, they have been more concerned with the flight of capital from their economies.

The success of reclaiming lost capital turns on the success of information exchange. As "fishing expeditions" are prohibited, without legitimate grounds to believe that a particular bank or institution holds the funds, Hong Kong will likely deny the request. Even if the evader thought an EOI request would be probable, it is unlikely he or she would return his or her money to a high-tax jurisdiction — he or she may simply relocate the funds to another haven with which his or her resident country does not have an EOI treaty.

Obviously the OECD's motive is to squelch avoidance and evasion altogether (or at least to the extent they are facilitated by secrecy) by ensuring that every tax haven has EOI agreements. However, given the current rate of tax treaty adoption, it is likely that a tax evader will always be able to find a tax haven that does not have an EOI treaty with his or her home country. If sanctions rest only on failing to obtain 12 TIEAs or DTAs with OECD countries, it will be practically impossible for smaller OECD countries (such as Slovenia, Estonia and New Zealand) to obtain these treaties with all relevant havens. Thus, there will always be some scope for unscrupulous taxpayers to avoid and evade domestic tax.

Criticism of Non-Tax Related Motivations

If the above analysis is correct, and tax haven tax treaties do not relieve double taxation, then both treaty partners must have been motivated to enter into the treaties for reasons other than relieving double taxation.

If New Zealand (and other high-tax jurisdictions) wishes to subsidise inbound Hong Kong investment, there are several reasons why this should not be done through a DTA. The first is clear: the subsidies have nothing to do with double taxation. The second is closely related to the principle of transparency — it is important that legislation be labelled correctly so as to enable both the public and the private sectors to access readily that information. Thirdly, since the benefit was granted in DTA negotiations, rather than international trade negotiations, Hong Kong has not given up anything of value (because its tax system barely affects New Zealand residents). If the benefits were negotiated in another environment, both sides may have given actual concessions. Fourthly, the granting of tax benefits in this way is inherently unquantifiable, at least prospectively. The balance between boosting investment and losing revenue is a fine one; a precise determination of the subsidy can be achieved in a trade agreement but not in a tax treaty.

Another problem with tax haven DTAs is transparency. In order to be held accountable by the electorate, it is fundamentally important that the government disclose its revenue and expenditure.[96] To this end, the International Monetary Fund has promulgated the International Public Sector Accounting Standards (IPSAS), which set out rules for budgetary documentation. One of these (IPSAS 23) requires the reporting of "non-exchange transactions" — that is, expenditure through the tax system.

One of the oldest and best known examples of expenditure through the tax system is the tax exemption for churches and charities. Since all residents are typically liable to tax on their income, other taxpayers effectively subsidise the tax exemptions granted to these entities. IPSAS 23 mandates that governments disclose this expenditure so taxpayers are aware of this.

New Zealand's 2011 Budget included a Tax Expenditure Statement.[97] This statement discloses concessions to a "targeted group or type of activity" that are not primarily governed by a "double taxation objective" or by a revenue motive.[98] Where uncertain, the Treasury's inclination is "towards transparency and inclusion" in the document.[99] However, New Zealand's tax treaty with Hong Kong is not in this Tax Expenditure Statement. Since it is not motivated by a double taxation objective (as there is no double

96 See generally International Monetary Fund *Manual on Fiscal Transparency* (International Monetary Fund, Washington DC, 2001).

97 "2011 Tax Expenditure Statement" (2011) The New Zealand Treasury <www.treasury.govt.nz>.

98 Ibid, at 3.

99 Ibid.

tax to relieve) or a revenue motive (as New Zealand actually *gives up* tax revenue under the treaty), the principles of the statement should mandate its inclusion.

The omission of the DTA from this statement (and the misleading way New Zealand and Hong Kong officials have described it) clearly violates the principle of transparency. Not only is the tax break to Hong Kong investors not clearly evident to the general public, even tax specialists may find it obscure, unless they have a particular interest in double tax agreements.

Even if fostering inbound investment is a legitimate goal for double tax treaties, it is misleading to claim that a treaty is designed to prevent double taxation when, in actuality, it provides a selective tax break to Hong Kong residents. If the tax system is to be held democratically accountable, tax exemptions such as this must be made explicit.

IV CONCLUSION

A tax treaty with a tax haven is an unusual legal document. It does not relieve double taxation and does not impose significant information exchange obligations. Instead, it provides selective tax relief for inbound investment into the high-tax jurisdiction. It does so in a way that is hidden to the electorates of both jurisdictions and is therefore contrary to democratic principles of transparency.

Ostensibly, one of the main reasons for adopting DTAs is the exchange of information. But the EOI procedure that binds jurisdictions like Hong Kong is slow and inefficient. The OECD knows this — EOI was not meant to be the sole tool used against havens but rather one tool among many to combat harmful tax competition. A combination of the fact that academics and developing countries received the *Harmful Tax Competition* Report very poorly and the change in support of the United States meant that a strong push to reform international taxation was unfeasible. Information exchange remained the only politically palatable vestige.

Nonetheless, once the OECD had tapped information exchange as the successor to the harmful tax project, it pursued the strategy vigorously, especially after support was rallied among its members following the Liechtenstein scandal and the global financial crisis. The publication of the grey list put pressure on havens to adopt information exchange. Most of them acquiesced to the standard of 12 TIEAs.

Hong Kong refused to enter into any TIEAs. It modified its domestic law to allow it to adopt the modern EOI article, but demanded that it be compensated for the loss of its evasion business by standard-form treaty benefits.

The result is a network of 21 tax treaties that is impressively to Hong Kong's advantage. Hong Kong benefits from significantly reduced

withholding rates — lower even than the OECD Model's ceilings (which of itself would have been a boon to Hong Kong's taxpayers) — and the exemption from tax for any business that does not constitute a permanent establishment. In exchange, it does not even have to adopt an "assistance with the collection of taxes" article; it gives up (at most) two per cent from its withholding tax on royalties; it provides limited guarantees against non-discrimination; and it only grudgingly accepts the most restrictive form of EOI allowed under the OECD Model.

These types of treaties flout the traditional justifications for DTAs. They are exactly orthogonal to double taxation: there is no problem of double taxation to solve. Rather, they are a targeted reduction in tax rates for cross-border payments. Tax treaties with tax havens effectively subsidise investments to and from those havens. Through the narrow lens of taxation, there seems to be no benefit for the high-tax jurisdiction.

The high-tax jurisdictions' motivations are principally unrelated to tax. These countries seem to be motivated by a desire to increase their economic size by subsidising investment into their jurisdiction. They also aim to benefit from forcing tax evaders to shift capital back to the high-tax jurisdiction by means of EOI, but it is more likely that evaders will either resort to more covert methods to evade tax, or will simply move to a new haven that does not have a treaty with their home country.

In fact, it is likely that Hong Kong's treaty partners are almost solely motivated by the subsidisation of investment. There are two main benefits accruing to these jurisdictions from the Hong Kong DTAs: EOI and increased cross-border investment. If EOI were worth as much to high-tax jurisdictions as the tax revenue they forfeited, then countries like Mainland China, Belgium, Thailand, Luxembourg and Vietnam lost out when they entered into treaties with Hong Kong without the modern EOI provision. It seems more likely that governments as sophisticated as these were aware that the increased investment of Hong Kong investors in their countries was worth forfeiting a slice of their revenue. It follows that Hong Kong's newer treaty partners must value increased cross-border trade and investment more than EOI.

The current approach of OECD members is not cohesive: there is an increased focus on issues such as treaty shopping, but if the problem with treaty shopping is that it facilitates tax avoidance, it is hypocritical for those jurisdictions to enter into haven treaties. Entering into tax treaties with Hong Kong has made Hong Kong a *more attractive* tax haven, not less. Haven treaties and an anti-haven, anti-avoidance stance are not logically compatible policies for a country (or an international organisation) to adopt.

Effective EOI may well turn out to be important in efforts to curb tax evasion. It makes sense to include EOI in modern double tax agreements. However, entering into DTAs with tax havens is an abuse of the purpose of tax treaties — an abuse that only facilitates international tax avoidance.