International treaty examination of the Agreement between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Report of the Finance and Expenditure Committee

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International treaty examination of the Agreement between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Recommendation

The Finance and Expenditure Committee recommends that the House takes note of its report.

We have conducted an international treaty examination of the Agreement between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

Double tax agreements reduce tax impediments to cross-border services, trade, and investment, and provide more certainty of tax treatment. We are advised that it is anticipated that this agreement would foster growth in economic activity between New Zealand and Hong Kong.

The national interest analysis for the agreement is appended to this report.

Appendix A

Committee procedure

The committee met on 3 and 10 August 2011 to consider the agreement. It heard evidence from the Inland Revenue Department.

Committee members

Amy Adams (Chairperson)
David Bennett
Brendon Burns
Hon David Cunliffe
Hon Sir Roger Douglas
Aaron Gilmore
Hon Shane Jones
Rahui Katene
Peseta Sam Lotu-Iiga
Stuart Nash
Dr Russel Norman
Michael Woodhouse

Appendix B

National Interest Analysis

Agreement between the Government of Hong Kong and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income

Executive summary

Negotiations have been successfully concluded for a double tax agreement and accompanying protocol with Hong Kong (collectively, the Hong Kong DTA). The Hong Kong DTA was signed on 1 December 2010.

Hong Kong is a significant trading partner for New Zealand and an important source of investment. In the year to December 2010, it was New Zealand's ninth largest export market, and total trade with Hong Kong for the period was worth $1.01 billion. The Hong Kong DTA is expected to enhance New Zealand's cross-border trade and investment by:

- providing greater certainty in the taxation of cross-border investment income;
- reducing compliance costs for New Zealand taxpayers and investors into Hong Kong, and Hong Kong investors investing into New Zealand; and
- setting limits for withholding taxes on dividends, interest and royalties (with rates in line with New Zealand's broader tax treaty strategy).

An important feature of the Hong Kong DTA is that it will enable information exchange with the tax authorities in Hong Kong. The Hong Kong DTA will therefore enhance the ability of tax officials to detect and prevent tax avoidance and evasion.

The Hong Kong DTA represents a compromise between the starting positions of New Zealand and Hong Kong, with New Zealand's key negotiating objectives secured. The key area of compromise was the taxation of pensions.

The revenue cost to New Zealand as a result of the reduction in withholding rates is expected to be relatively small, at approximately $0.5 million per year.

On balance, officials are satisfied that the potential advantages to New Zealand of a DTA with Hong Kong outweigh the potential disadvantages.

It is proposed that the Hong Kong DTA be incorporated into domestic legislation through an Order in Council. The DTA would be then brought into force through an exchange of notes. The DTA would enter into force on the date that the latter note is exchanged.

Nature and timing of the proposed binding treaty action

The Agreement between the Government of New Zealand and the Government of the Hong Kong Special Administrative Region of the People's Republic of China[1] for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its accompanying Protocol (collectively, the Hong Kong DTA) was signed on 1 December 2010 by New Zealand's Minister of Finance and Hong Kong's Financial Secretary.

In accordance with Parliament's Standing Order 388(1)(d), it is proposed that the Hong Kong DTA now be presented to the House for treaty examination.

Following the successful completion of Parliamentary treaty examination, the Hong Kong DTA will be incorporated into domestic legislation through an Order in Council, pursuant to section BH 1 of the Income Tax Act 2007. Once the Order in Council is effective (generally 28 days after the Order is made), all of New Zealand's domestic processes for entry into force will be complete and New Zealand will be able to advise Hong Kong accordingly by exchange of notes.

Hong Kong must similarly complete its domestic processes for entry into force and advise New Zealand by exchange of notes. Article 26 of the Hong Kong DTA provides that the DTA will enter into force on the date of the later of the two notes.

It is expected that the Hong Kong DTA will enter into force by the end of 2011.

The Hong Kong DTA will not apply to Tokelau, the Cook Islands or Niue.

Reasons for New Zealand becoming party to the treaty

Hong Kong is a significant trading partner for New Zealand and an important source of investment.

In the year to December 2010, it was New Zealand's ninth largest export market, and total trade with Hong Kong for the period was worth $1.01 billion. Hong Kong is also an important international finance centre and source of investment capital. In the same period, it was New Zealand's sixth largest source of foreign direct investment. (Further information about investment and trade flows between New Zealand and Hong Kong is attached as Appendix 1.)

The Hong Kong DTA is expected to enhance New Zealand's cross-border trade and investment by:

- providing greater certainty in the taxation of cross-border investment income;
- reducing compliance costs for New Zealand taxpayers and investors into Hong Kong, and Hong Kong investors investing into New Zealand; and

[1] Hong Kong is a special administrative region of the People's Republic of China, and New Zealand already has a double tax agreement with China. However, the agreement with China does not apply to Hong Kong. Hong Kong maintains separate tax laws and concludes its own double tax agreements.

- setting limits for withholding taxes on dividends, interest and royalties (with rates in line with New Zealand's broader tax treaty strategy).

An important feature of the Hong Kong DTA is the inclusion of a standard Organisation for Economic Co-operation and Development (OECD) information exchange article, which will give New Zealand the ability to request and exchange information with the tax authorities in Hong Kong. The Hong Kong DTA will therefore enhance the ability of tax officials to detect and prevent tax avoidance and evasion.

The revenue cost to New Zealand as a result of the reduction in withholding rates is expected to be relatively small, at approximately $0.5 million per year.

What double tax agreements do

Double tax agreements (DTAs) foster growth in economic activity between countries by reducing tax impediments to cross-border services, trade and investment. Essentially, DTAs provide bilateral solutions to problems that are difficult to solve unilaterally. They provide greater certainty of tax treatment, provide a basis for sharing the cost of relieving double taxation, provide a bilateral basis for limiting withholding taxes on cross-border investment returns, reduce compliance costs for business, and exempt certain short-term activities from tax in the jurisdiction in which the activities are conducted.

New Zealand concluded its first DTA in 1947 with the United Kingdom. Since then, New Zealand has progressively developed a network of DTAs, predominantly with its main trading and investment partners, with 35 DTAs now in force.

New Zealand enters into DTAs in large part on the basis of self interest. That is, because DTAs create favourable conditions for increased economic activity between countries, they are expected to be beneficial to New Zealand in economic and fiscal terms at a national level.

More generally, however, DTA networks also make an important contribution to the expansion of world trade and to the development of the world economy. These are also key objectives of the OECD. The OECD has assumed a leading role, internationally, in promoting the entering into of DTAs.

In particular, the OECD has produced a Model Tax Convention, together with a comprehensive commentary, for member and non-member countries to use as a basis for concluding DTAs. The OECD Council has also issued an express recommendation to all member countries:

> to pursue their efforts to conclude bilateral tax conventions … with those member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions …

when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon.[2]

DTAs provide the following general benefits:

- Benefits to taxpayers. A key concern for any taxpayer wanting to enter into commercial activity in another jurisdiction is the requirement to comply with the tax and other legal obligations of two separate jurisdictions. This can be perplexing, and obtaining professional advice or tax rulings can be costly and time consuming. Unique issues also arise from cross-border activities. These range from the complex, such as transfer pricing disputes, to the mundane, such as whether taxes paid in the other jurisdiction are creditable against home jurisdiction tax. DTAs help alleviate many of these problems. For example, they establish a framework for the taxation of cross-border activity, prohibit the application of discriminatory taxes, and establish a mutual agreement procedure for resolving tax disputes. The mutual agreement procedure is a key benefit for taxpayers. It is not a full disputes resolution mechanism as it only obliges the two tax authorities to endeavour to resolve issues. However, it enables tax authorities to have a dialogue about the taxpayer's issues. It also provides a low compliance-cost alternative to seeking redress through the Courts for taxpayers concerned that they have not been taxed correctly in either or both jurisdictions (including in transfer pricing cases).
- Benefits to investors. Investing across an international border often involves risk. Amongst other things, tax laws tend to be very complex and can change suddenly. DTAs assist investors by specifying the maximum rates of withholding taxes that can be applied to dividends, interest and royalties. These "headline" rates reduce compliance costs for investors by making it easier to determine the after-tax returns on potential investments. The fact that the rates are "locked in" by treaty means that investors can make business decisions with more confidence.
- Benefits to governments. Low tax rates can lead to increased foreign investment and a reduction in the cost of importing capital. Countries may lower their tax rates unilaterally. However, a benefit of lowering tax rates in a bilateral treaty setting is that it ensures that the rates are also lowered on a reciprocal basis by the treaty partner. This secures benefits for domestic investors. In addition, the reduced foreign tax can flow through to the New Zealand tax base through a reduced need to provide foreign tax credits.

[2] The recommendation was issued by the OECD Council on 23 October 1997, but follows similar recommendations that have been in place since before New Zealand joined the OECD.

- Relief of double taxation. Double taxation distorts business decisions and generally hinders cross-border economic activity. In recognition of this, most jurisdictions unilaterally relieve double taxation of their tax residents. This is typically achieved by means of a tax credit mechanism, but some jurisdictions prefer an exemption method. However, in the absence of a DTA, a jurisdiction bears the full cost of relieving double taxation itself. DTAs allow the cost of relieving double taxation to be shared. They do this by allocating taxing rights between the jurisdictions concerned, on the basis of internationally accepted principles as set out in the OECD Model Tax Convention.

- Bilateral co-operation. It is an internationally accepted principle that countries do not assist each other in the enforcement of tax laws.[3] However, most countries tax their residents on income earned worldwide. International co-operation between tax authorities is therefore needed to enable tax authorities to verify that offshore income is being correctly reported by their tax residents. DTAs resolve this problem by establishing bilateral treaty arrangements for the exchange of tax-related information such as tax records, business books and accounts, bank information and ownership information. The information that is exchanged assists tax authorities to detect and prevent tax evasion and tax avoidance. More generally, the mere existence of DTAs can deter evasion and avoidance. This is one of the key benefits of DTAs for governments. The recent global financial crisis has highlighted the importance of bilateral co-operation in the form of exchange of information, and there is now a very strong international imperative (driven by the G-20 and the OECD) for all Governments to enter into comprehensive exchange of tax information networks with relevant partners.

Background to the double tax agreement with Hong Kong

As noted above, Hong Kong is a significant trading and investment partner. The significance of the economic relationship between New Zealand and Hong Kong was highlighted by the signing of a Closer Economic Partnership (CEP) agreement on 29 March 2010. In addition, negotiations towards an Investment Protocol to that agreement are currently in progress.

New Zealand has an established network of DTAs with its main trading and investment partners. The absence of a DTA with Hong Kong is a notable omission in New Zealand's DTA network.

However, despite interest from both sides in concluding a DTA, Hong Kong's previous stance of refusing to agree to unrestricted exchange of information provisions in its DTAs precluded the commencement of negotiations. Other countries generally shared New Zealand's view[4] and prior to 2010, Hong Kong had only entered into five DTAs.

[3] In New Zealand, this principle is stated in *Connor v Connor* [1974] 1 NZLR 632.

[4] Compliance by all countries with global standards for transparency and exchange of information in tax matters has increasingly come under international scrutiny in recent years. As noted above, the importance of unrestricted exchange of information was highlighted during the recent global financial crisis, and prompted the G-20 governments to take measures to ensure full compliance by all jurisdictions.

In 2010, however, Hong Kong changed its stance on information exchange and enacted legislation that would enable it to enter into full information exchange with its treaty partners, removing this obstacle for countries that wish to conclude a DTA with Hong Kong. Further, the Hong Kong Government has followed and is continuing to follow an intensive programme of DTA negotiations to bring in to line with OECD standards.

Accordingly, many countries are now concluding DTAs with Hong Kong. Hong Kong has signed 16 DTAs since 2010 (including with New Zealand), of which 12 are with OECD member countries.[5] They include significant OECD economies such as France, Japan, and the United Kingdom.[6]

Hong Kong has a territorial-based tax system. Unlike most other jurisdictions which impose tax on the worldwide income of their tax residents, Hong Kong generally only taxes income sourced from Hong Kong. However, Hong Kong law deems certain income streams derived offshore, such as interest income, to be sourced from Hong Kong. Although this means that Hong Kong residents deriving income from New Zealand only face double taxation in limited circumstances, New Zealand residents deriving income from Hong Kong still face double taxation in both jurisdictions. Therefore, OECD countries generally do not see Hong Kong's territorial tax system as obviating the need for a DTA.

Advantages and disadvantages to New Zealand of the treaty entering into force and not entering into force for New Zealand

As a bilateral instrument, the Hong Kong DTA involves a trade-off between advantages and disadvantages to New Zealand. On balance, however, the Hong Kong DTA is expected to be beneficial to New Zealand.

Advantages of the treaty entering into force

The advantages of the Hong Kong DTA entering into force can be summarised as follows:

- It can be expected to foster all forms of bilateral economic activity (such as services, trade and investment). This will benefit New Zealand in terms of employment opportunities and offshore earnings. The $0.5 million revenue cost of the Hong Kong DTA may be offset by increased tax from these activities.
- For investors in both jurisdictions, it will reduce compliance costs and provide the certainty of low headline withholding tax rates, locked in by the treaty.
- For foreign investors, it will reduce New Zealand withholding tax rates in areas where they have not already been reduced under domestic law (that is, in respect of dividends that are not fully-imputed and royalties).
- For New Zealand business it will reduce the cost of importing capital.

[5] As at 7 June 2011.

[6] Apart from New Zealand, Hong Kong has signed DTAs with the Czech Republic (2011), Portugal (2011), Spain (2011), Austria (2010), Brunei (2010), France (2010), Hungary (2010), Indonesia (2010), Ireland (2010), Japan (2010), Kuwait (2010), Liechtenstein (2010), Netherlands (2010), Switzerland (2010), United Kingdom (2010), Vietnam (2008), Luxembourg (2007), China (2006), Thailand (2005), and Belgium (2003).

- For investors, business and taxpayers from both jurisdictions, it will provide safeguards such as a prohibition against discriminatory taxes and a mutual agreement procedure which will facilitate the resolution of tax disputes (including in complex areas such as transfer pricing).
- For taxpayers engaged in certain short-term income-earning activities in the other jurisdiction, it will reduce compliance costs and provide cash flow advantages by eliminating the need to pay tax in that jurisdiction and then claim that tax against the tax liability in their home jurisdiction.
- For New Zealand it will provide an equitable framework for sharing the cost of relieving double taxation between the two jurisdictions.
- In some circumstances, New Zealand will no longer need to provide credits for foreign tax paid.
- For tax authorities, the exchange of information mechanism will assist in the detection and prevention of tax evasion and tax avoidance. The mechanism will also have a general deterrent effect in respect of evasion and avoidance activity, and will further reduce the opportunities available to residents to escape legitimate New Zealand tax.

More generally, the Hong Kong DTA will fill a notable omission from New Zealand's network of DTAs with its main trading and investment partners. Hong Kong is a significant economic partner, both in terms of trade and investment. Hong Kong is an important international finance centre and an important source of inward investment for New Zealand business. In addition, Hong Kong is seen by business as a key entry point into Asia for

New Zealand external investment. (See the National Business Review article of 29 October 2010, attached as Appendix 2.) Because New Zealand is a net importer of foreign capital (that is, New Zealand's investment needs typically exceed domestic supply, and additional capital must be sought offshore), the possibility of increased inwards investment resulting from the Hong Kong DTA is an important consideration. Accordingly, New Zealand has long viewed Hong Kong as a jurisdiction with which a DTA could be expected to produce national economic benefits.

The significance of developing New Zealand's trade and investment relationship with Hong Kong is underlined by the recently signed CEP and by the current negotiations for an Investment Protocol to the CEP. The Hong Kong DTA will complement these other initiatives.

In addition, the Global Forum on Transparency and Exchange of Information for Tax Purposes has recently concluded a review of New Zealand's legal and administrative frameworks for tax information exchange, and has specifically recommended that New Zealand should continue to develop its exchange of information network (in particular, with countries of economic significance to New Zealand). As Hong Kong is one of New Zealand's key trading partners, entering into the Hong Kong DTA will help New Zealand to meet this recommendation.

A final advantage of the Hong Kong DTA is that New Zealand and Hong Kong share many treaty policy positions. As a result, New Zealand was able to secure virtually all of its key negotiating positions, and the DTA represents a good precedent for New Zealand in future negotiations with other countries. As such, the Hong Kong DTA will strengthen New Zealand's position on its key negotiating positions.

Disadvantages of the treaty entering into force

As noted above, DTAs offer bilateral solutions to problems that are difficult to solve unilaterally. However, a potential downside to DTAs is that those solutions are then locked in place by treaty and are difficult and costly to change. This can create difficulties if treaty provisions need to be changed urgently. Practical experience indicates that in genuine cases treaty partners are usually amenable to making necessary changes. However, in extreme cases, if the treaty partner was to refuse to co-operate, termination of the treaty could be required.

A second general disadvantage of DTAs is that they give rise to an up-front revenue cost. This is because DTAs lower withholding tax rates on investment income and allocate taxing rights between the two jurisdictions. The allocating of taxing rights means that New Zealand will lose the ability to tax some income streams that it previously could tax (this applies on a reciprocal basis). This means that New Zealand prima facie loses some tax revenue when it enters into a DTA. The revenue cost to New Zealand arising from the reduction in withholding taxes is estimated to be $0.5 million per year.

A third general disadvantage of entering into DTAs is that costs will then need to be incurred in administering the exchange of information provisions of the DTA. That is, to the extent that the treaty partner makes requests for information under a New Zealand DTA, New Zealand will incur costs in complying with those requests. However, New Zealand already has exchange of information arrangements in force with 39 other jurisdictions (including 35 DTAs and four Tax Information Exchange Agreements) and has systems in place for administering those arrangements. The costs of providing information to Hong Kong under the Hong Kong DTA will therefore be marginal.

As noted above, Hong Kong is a significant international finance centre, and Hong Kong also has a territorial-based tax system. These features tend to make Hong Kong a favoured location for non-residents to establish companies. This, in turn, potentially raises "treaty shopping" concerns. Treaty shopping occurs when a resident of a third jurisdiction obtains the benefits of a DTA, such as lower withholding rates, by interposing a shell company in one of the two jurisdictions party to the DTA. Accordingly, it could be argued that a disadvantage of concluding a DTA with Hong Kong is that New Zealand opens itself up to treaty shopping opportunities. However, treaty shopping is an issue for all DTAs. It is generally addressed by applying general anti-avoidance law. In the Hong Kong DTA, this protection is supplemented by the inclusion of specific anti-abuse rules in the key articles.

In a typical DTA, both sides would make reciprocal withholding tax rate reductions. However, Hong Kong generally does not levy withholding taxes. (It does impose a low rate of withholding tax on royalties, but at the same rate specified in the Hong Kong DTA.) Therefore, Hong Kong will not actually forego any withholding tax. While this may be thought of as a disadvantage, officials consider that a better analysis is that it is not a disadvantage. Hong Kong has already effectively reduced its withholding tax rates below

the normal level of a DTA, to the benefit of New Zealand outward investors. As noted above, in respect of New Zealand's reduction of withholding tax rates, DTAs provide a better policy setting for lowering withholding rates than domestic law.

As is always the case in negotiations, some compromises to the starting positions of the two sides had to be made. In general, Hong Kong shared many of New Zealand's views and positions as regards taxation of income at source, and the compromises that needed to be made were not as many or as significant as is often the case in negotiations. The key compromise was in relation to pensions.

New Zealand generally prefers to allocate a sole taxing right over pensions to the jurisdiction where the recipient resides, as this compensates that jurisdiction for the provision of services such as healthcare to the pensioner. This preference was secured with Hong Kong. However, New Zealand agreed that certain lump sum retirement payments from Hong Kong will be taxable only in Hong Kong. New Zealand also agreed that the taxing right on some periodic government service pensions will be shared by both jurisdictions, although this is limited to specified schemes which are closed to new members. New Zealand has made similar compromises, allowing for source or shared taxation of some types of pensions as part of a treaty package in some of its other DTAs, such as with Australia and Singapore. In addition, New Zealand does not tax many lump sum pensions under domestic law.

Conclusion

It is an option to not have a DTA with Hong Kong. On balance, however, officials are satisfied that the potential advantages of concluding a DTA with Hong Kong outweigh the potential disadvantages.

Legal obligations which would be imposed on New Zealand by the treaty action, the position in respect of reservations to the treaty, and an outline of any dispute settlement mechanisms

Summary of key legal obligations

DTAs do not impose requirements on taxpayers. The Hong Kong DTA will not (and cannot) require the imposition of a tax that is not already imposed under domestic law. The obligations that DTAs impose are on the contracting parties.

When income is derived from one jurisdiction (the source jurisdiction) by a tax resident of the other jurisdiction (the residence jurisdiction) both countries often impose tax on that income. A key impact of DTAs is to allocate taxing rights. The Hong Kong DTA will require New Zealand to comply with the following allocation of taxing rights:

- Business profits of an enterprise will be taxable only in the jurisdiction where the enterprise is a resident unless profits are derived through a permanent establishment in the jurisdiction of source. In that case, the profits may be taxed in the source jurisdiction. A permanent establishment generally exists in the jurisdiction in question when there is a fixed place of business where the business of an enterprise is carried on. New Zealand's preferred approach relating to business profits is to follow the 2007 version of the OECD Model Tax Convention, with certain modifications to the definition of a permanent establishment to retain source taxation in certain circumstances. (Articles 5 and 7 refer.)
- Income from services will be taxable only in the jurisdiction where the enterprise or person deriving the income is a resident, unless there is a permanent establishment in the source jurisdiction. An enterprise will be deemed to have a permanent establishment if services are performed in that other jurisdiction for at least 183 days in any 12-month period. The deeming provision for services is a departure from the OECD Model Tax Convention, but is usual treaty practice for New Zealand. (Article 5 refers.)
- Income from real property will generally be taxed in the jurisdiction where the property is situated. (Article 6 refers.)
- Profits of an enterprise of a jurisdiction from the operation of ships or aircraft in international traffic will be taxable only in that jurisdiction. However, the Hong Kong DTA ensures that the taxation of domestic carriage will be taxed on the same basis as any other business. (Articles 7 and 8 refer.)
- Under New Zealand's preferred approach, dividends, interest and royalties may generally be taxed in both countries. The residence jurisdiction must reduce its own tax on the payment to compensate for any withholding tax that was imposed in the source jurisdiction. This enables both jurisdictions to tax the payment, whilst ensuring that it is not excessively taxed. (Articles 10, 11 and 12 refer.)
- The maximum withholding tax rate that each jurisdiction can impose on dividends at source is:

  0% if it is paid to a company that owns (directly or indirectly) 50% or more of the shares in the company paying the dividend and meets certain other requirements. The 50% share ownership threshold is lower than the 80% threshold in some of New Zealand's other recent treaties;

  0% if paid to the other jurisdiction's government or a specified entity wholly owned by the government in the other jurisdiction. This is a non-OECD provision, although we have agreed to similar provision in respect of portfolio dividends with Australia;

  5% if paid to a company in the other jurisdiction that owns (directly or indirectly) 10% or more of the shares in the company paying the dividend;

  15% in all other cases. (Article 10 refers.)
- The maximum withholding tax rate that each jurisdiction can impose on interest at source is:

0% if the interest is paid to a lending or finance business, provided that in the case of interest that originates in New Zealand, the 2% approved issuer levy is paid;

0% if paid to the other jurisdiction's government or a specified entity wholly owned by the government in the other jurisdiction. This is a non-OECD provision, although we have agreed to similar provisions with a number of countries;

10% in all other cases. (Article 11 refers.)

- The maximum withholding tax rate that each jurisdiction can impose on royalties received by a resident of the other jurisdiction is 5%. This is lower than New Zealand's preferred rate of 10%, but is acceptable as part of the treaty package and has been adopted in other treaties such as Australia and the United States. (Article 12 refers.)
- Specific rules apply to the taxation of income or gains derived from the sale of property. Income or gains from the sale of immovable property will be taxable in the jurisdiction in which the property is situated. Capital gains from the sale of moveable property may be taxable in the jurisdiction of source. (Article 13 refers.)
- Income from employment will be taxable in the jurisdiction where the employment is exercised, unless the employment is short-term and the employer is a non-resident. (Article 14 refers.)
- Directors' fees may be taxed in the jurisdiction where the company paying the fees is resident. (Article 15 refers.)
- Income from the activities of entertainers and sportspersons may generally be taxed in the jurisdiction in which those activities are performed. (Article 16 refers.)
- Pensions will usually only be taxable in the jurisdiction where the recipient is resident. However, certain lump sum retirement payments from Hong Kong will be taxable only in Hong Kong. The taxation of lump sum payments is a departure from the OECD Model Tax Convention. (Article 17 refers.) Taxing rights on some periodic government service pensions will be shared by both jurisdictions, although this is limited to pensions from specified schemes which are closed to new members. This is a departure from New Zealand's usual treaty practice and is closer to the OECD Model Tax Convention which provides for sole source taxation of these pensions. (Article 18 refers.)
- Salaries and wages for services to a Government of one jurisdiction will generally be exempt from tax in the other jurisdiction. (Article 18 refers.)
- Students from one jurisdiction living in the other jurisdiction will not generally be taxed on payments received from outside that other jurisdiction if those payments are for maintenance or education. (Article 19 refers.)
- The Hong Kong DTA follows New Zealand's preferred approach in that income not otherwise dealt with in the DTA may be taxed in the source jurisdiction. (Article 20 refers.)

Where the Hong Kong agreement permits both jurisdictions to tax an item of income, the agreement will require New Zealand to relieve double taxation of its residents by allowing a

credit for source taxes paid in Hong Kong. (Article 21 refers.) This is consistent with the unilateral relief mechanism that already applies under New Zealand domestic law.

In addition, New Zealand will be required to comply with various administrative requirements imposed by the Hong Kong agreement. These are as follows:

- Non-discrimination. The Hong Kong DTA includes an article that prohibits discrimination on the grounds of nationality, situs of an enterprise, ownership of capital, and, in limited circumstances, residence. The article provides greater certainty for foreign investors that they will not be treated more harshly than other taxpayers and that they will be able to compete on an equal footing in the New Zealand economy with New Zealand investors. New Zealand has traditionally approached the inclusion of non-discrimination articles in its DTAs with caution, because it is sometimes necessary for good tax policy reasons to apply different tax rules to non-residents than to residents (such as thin capitalisation rules.) The non-discrimination article agreed with Hong Kong therefore includes a number of carve-outs that are intended to protect any such existing measures, and which also allow some flexibility for future policy-making and base protection measures. New Zealand has previously agreed to a similar article and carve-outs with Australia. (Article 22 refers.)
- Mutual agreement procedure. New Zealand must comply with the procedures for settling disputes set out in the mutual agreement procedure article of the Hong Kong DTA. (Article 23 refers.) This is discussed below under "Dispute resolution".
- Exchange of information. As discussed, the Hong Kong DTA includes an article that provides for the exchange of tax-related information between tax authorities, for the purpose of detecting and preventing tax evasion and tax avoidance. New Zealand will be required to respond to requests for information that are received from Hong Kong. If Inland Revenue receives a valid request, and if it does not already hold the requested the information, it must use its information gathering powers to obtain the information. (Article 24 refers.) The arrangement agreed with Hong Kong does not extend to automatic or spontaneous exchanges.[7] This is a departure from New Zealand's usual treaty practice, but it is consistent with the Tax Information Exchange Agreements that New Zealand has signed with a number of jurisdictions (such as Jersey and the Cayman Islands).

Dispute resolution

The Hong Kong DTA contains the OECD Model Tax Convention dispute resolution process, or "mutual agreement procedure". DTAs routinely provide for taxpayer disputes to be resolved through "mutual agreement" by the revenue authorities in both countries. Rather than having to pursue a case through the courts (possibly in both countries) a taxpayer can approach the local tax authority under the mutual agreement procedure set out in article 23. If that authority considers the case to be justified, and cannot resolve it through its own actions, it shall seek to do so through mutual agreement with the tax

[7] Automatic exchange of information refers to the systematic transfer of information relating to certain categories of information, such as dividends or interest. Spontaneous exchange of information refers to information about a taxpayer held by a jurisdiction that it thinks may be of interest to the other jurisdiction, even though the other jurisdiction has not requested the information.

authority of the other jurisdiction. This bipartisan approach is particularly appropriate in the tax treaty context because a single issue will generally affect a person's tax position in both jurisdictions.

The mutual agreement procedure also requires the tax authorities of the two jurisdictions to endeavour to resolve together any difficulties or doubts about the correct interpretation or application of the Hong Kong DTA.

Reservations

The treaty does not allow parties to make a reservation upon ratification.

Measures which the Government could or should adopt to implement the treaty action, including specific reference to implementing legislation

Implementation by way of an overriding regulation

Subject to the successful completion of the Parliamentary treaty examination process, the Hong Kong DTA will be incorporated into domestic legislation by Order in Council pursuant to section BH 1 of the Income Tax Act 2007. Section BH 1 authorises the giving of overriding effect to DTAs by Order in Council. The override is, however, only in relation to tax matters, and only applies in respect of the Inland Revenue Acts, the Official Information Act 1982 and the Privacy Act 1993.

The override of the Inland Revenue Acts is necessary to give effect to the core provisions of the Hong Kong DTA, which may provide relief from tax that would otherwise be imposed under domestic law. The override of the Official Information Act is necessary to ensure that confidential communications with the other jurisdiction do not have to be disclosed. The override of the Privacy Act is necessary to ensure that information regarding natural persons can be exchanged according to the terms of the treaty.

Article 26 provides for the Hong Kong DTA to be brought into force through an exchange of notes between the Contracting States. The Hong Kong DTA will enter into force on the date of the last of these notes. New Zealand will be in a position to notify Hong Kong that all procedures required by domestic law have been completed once the Order in Council has entered into force, which is 28 days after its publication in the New Zealand Gazette.

Thereafter, the provisions of the Hong Kong DTA will have effect from various dates, according to the terms of the DTA. In New Zealand, the provisions relating to withholding taxes will have effect from 1 April in the calendar year following the year in which the DTA enters into force. The provisions relating to other taxes will have effect for income years beginning on or after 1 April in the calendar year following the year in which the DTA enters into force. In the case of Hong Kong, the provisions of the DTA will have effect for any year of assessment beginning on or after 1 April in the calendar year following the year in which the DTA enters into force.

The date of effect for the shipping and aircraft article (article 8), insofar as it relates to aircraft, is the date that the Hong Kong DTA enters into force. This is because New Zealand has an existing Air Services Agreement with Hong Kong that includes a provision preventing double taxation in respect of certain income from aircraft operations. The

provision in the Air Services Agreement is broadly similar to the provision in the Hong Kong DTA. Under the existing Air Services Agreement, that taxation provision will stop operating if and when a DTA enters into force. The shipping and aircraft article (insofar as it relates to aircraft) therefore needs to take effect from the date of entry into force so as to ensure a seamless transition between the provision in the existing Air Services Agreement and the Hong Kong DTA.

The only alternative to an Order in Council for implementing a DTA would be by the enactment of a dedicated statute. This is not preferred as it would unnecessarily increase the amount of primary tax legislation.

Economic, social, cultural and environmental costs and effects of the treaty action

No social, cultural or environmental effects are anticipated.

As noted in this National Interest Analysis, the overall economic effects are expected to be favourable. The Hong Kong DTA will enhance the existing investment and trade relationship. It will also assist Inland Revenue to detect and prevent tax evasion and tax avoidance.

Compliance costs for New Zealand businesses are expected to be reduced as a result of the treaty action. This is because New Zealand businesses will have clear guidance about when they will be liable for tax on activities in Hong Kong, in line with internationally recognised norms.

The costs to New Zealand of compliance with the treaty

New Zealand will forgo some revenue from the limitation of its taxing rights, as outlined above. This will mean that New Zealand will not be able to tax some income that is currently taxed under domestic law, and that the rate of tax that can be imposed on certain other income will be reduced.

Therefore, prima facie, DTAs are expected to result in some reduction of New Zealand tax. The revenue cost will include tax forgone in relation to short-term activities of Hong Kong residents in New Zealand, which the Hong Kong DTA will exempt from New Zealand tax. It will also include reduced withholding tax. As noted above, New Zealand already unilaterally reduces withholding taxes on fully imputed dividends and on interest paid between unrelated parties. The Hong Kong DTA will extend those reductions to dividends that are not fully imputed, to interest paid between related parties, and to royalties.

Data limitations prevent officials from accurately estimating revenue costs, and also make it impossible to accurately measure the likely cost of the reduction in withholding tax rates. However, officials estimate the reduction of tax revenue as a result of the reduced rates with Hong Kong to be $0.5 million per annum.

As discussed, the Hong Kong DTA will be expected to give rise to favourable economic benefits, such as increased trade and investment. Costs may also be offset by other impacts of the DTA. For example, there will be some offsetting effect to the New Zealand tax base from the reduction of tax in Hong Kong, and the reduced need for New Zealand to allow foreign tax credits. There will also be some revenue gains from the expected

reduction in tax evasion and tax avoidance. Overall, it is expected that the economic benefits will outweigh the costs.

It has been noted above that the exchange of information provisions of the Hong Kong DTA will result in some administrative costs for Inland Revenue arising from the need to respond to requests for information from Hong Kong. Again, these costs cannot be quantified precisely, but are expected to be small.

Consultation with the community and parties interested in the treaty action

The Treasury and the Ministry of Foreign Affairs and Trade were consulted about the terms of the Hong Kong DTA and the content of this extended National Interest Analysis, and agree with its analysis and conclusions.

The Ministry of Transport was consulted on the article relating to shipping and aircraft and its application date, and no concerns were raised.

Limited private sector consultation took place with the Hong Kong and Shanghai Banking Corporation (HCSB) prior to the negotiations and their views were taken into account.

Subsequent protocols or amendments to the treaty and their likely effects

There is no clause in the Hong Kong DTA providing for further amendment of the DTA, and no further amendments are anticipated at this time. New Zealand would consider any future amendments on a case-by-case basis. Any future amendments would be subject to New Zealand's normal domestic approvals and procedures for DTAs.

Withdrawal or denunciation provision in the treaty

Under article 27, either party may terminate the Hong Kong DTA by giving notice of termination on or before 30 June in any calendar year beginning after the expiration of 5 years from the date of its entry into force.

In such event, the Hong Kong DTA will cease to have effect for New Zealand for payments made on or after 1 April in the calendar year following the year in which the notice of termination is given (in respect of withholding tax), and for any income year beginning on or after 1 April in the calendar year following the year in which the notice of termination is given (in respect of other New Zealand tax).

The Hong Kong DTA will cease to have effect for Hong Kong for any year of assessment beginning on or after 1 April in the calendar year following the year in which the notice of termination is given.

Agency Disclosure Statement

Inland Revenue has prepared this extended national interest analysis. It has undertaken an analysis of the issue of implementing the new Hong Kong DTA and the legislative and regulatory proposals arising from that implementation. As part of that process, it has considered the option of not entering into the treaty. Inland Revenue is of the view that there are no significant constraints, caveats or uncertainties concerning the regulatory analysis. The policy aligns with the Government Statement on Regulation.

The Hong Kong DTA represents a good outcome for New Zealand. It is broadly consistent with the New Zealand negotiating objectives.

The key area where compromise was reached was in respect of pensions. New Zealand generally prefers to allocate a sole taxing right over pensions to the jurisdiction where the recipient resides. This preference was secured with Hong Kong. However, New Zealand agreed that certain lump sum retirement payments from Hong Kong superannuation schemes will be taxable only in Hong Kong. New Zealand also agreed that the taxing right on some periodic government service pensions will be shared by both jurisdictions (although this is limited to specified schemes which are closed to new members). Officials consider this to be acceptable given that New Zealand has made similar compromises in other DTAs. Further, New Zealand does not tax many lump sum pensions under domestic law.

An important feature of the Hong Kong DTA is that it provides for the exchange of tax-related information between tax authorities, for the purpose of detecting and preventing tax evasion and tax avoidance. This means that New Zealand will be able to request tax-related information from Hong Kong. The arrangement agreed with Hong Kong does not extend to automatic or spontaneous exchanges. This is a departure from New Zealand's usual treaty practice, but it is consistent with the Tax Information Exchange Agreements that New Zealand has signed with a number of jurisdictions.

As noted above, Hong Kong is a significant international finance centre, and Hong Kong also has a territorial-based tax system. These features tend to make Hong Kong a favoured location for non-residents to establish companies. This, in turn, potentially raises "treaty shopping" concerns. Treaty shopping occurs when a resident of a third country obtains the benefits of a DTA, such as lower withholding rates, by interposing a shell company in one of the two jurisdictions party to the DTA. Accordingly, it could be argued that a disadvantage of concluding a DTA with Hong Kong is that New Zealand opens itself up to treaty shopping opportunities. However, treaty shopping is an issue for all DTAs. Treaty shopping is generally addressed by applying general anti-avoidance law under New Zealand's domestic law. This protection is supplemented by the inclusion of specific anti-abuse rules in the key articles of the Hong Kong DTA (which follows New Zealand's normal treaty practice).

The Treasury and the Ministry of Foreign Affairs and Trade have been consulted about the terms of the Hong Kong DTA and the content of this extended national interest analysis and no material concerns were raised. The Ministry of Transport was consulted on the article relating to shipping and aircraft and its application date, and no concerns were raised.

Inland Revenue is of the view that the policy options considered will not impose additional costs on business; nor impair private property rights, market competition, or the incentives for business to innovate and invest; nor override fundamental common law principles (as referenced in chapter 3 of the Legislation Advisory Committee Guidelines).

An Order in Council will be required to give the Hong Kong DTA effect under New Zealand law. The Order in Council will override the Inland Revenue Acts, the Official

Information Act 1982 and the Privacy Act 1993; this is authorised by section BH 1 of the Income Tax Act 2007 and is necessary to give effect to the terms of the Hong Kong DTA.

Appendix 1

New Zealand-Hong Kong cross-border investment and trade

Direct investment

The stock of direct investment from Hong Kong into New Zealand was worth $1.15 billion as at 31 March 2010, an increase of 61.2% from 2008 ($711 million). Total investment from Hong Kong into New Zealand was worth $3.72 billion in 2010. This figure includes direct and portfolio investment and financial derivatives. Hong Kong is New Zealand's sixth largest source of foreign investment.

Investment flows from Hong Kong into New Zealand were worth $297 million in 2009.

Trade

In the year to December 2010, total bilateral trade between New Zealand and Hong Kong was worth $1.01 billion. Hong Kong is currently our ninth largest export market.

This consisted of $866 million in exports to Hong Kong and $147 million in imports (a combined increase of 42% since 2005). This was 1.2% of New Zealand's total merchandise trade, and is comparable to New Zealand's bilateral merchandise trade with Canada (1.2%), France (1.2%) and Saudi Arabia (1.1%).

Of the $866 million in exports, $776 million were of processed and unprocessed primary products (namely, food and live animals). Specifically, New Zealand's main exports were crustaceans ($180 million), mutton and lamb ($60 million), fresh fruit ($46 million), beef ($40 million), and live horses ($29 million). The remainder of the exports largely consisted of manufactures ($215 million). In 2010, this resulted in Hong Kong being New Zealand's second largest market for exports of fish and shellfish, third largest for raw hides, skins and leather products, fifth largest for paper and paperboard products, sixth largest in textiles and clothing and was one of our top 10 export markets for a range of other products, including frozen beef, sheep meat, fruits and nuts, machinery, wine, and aluminium products.

The $147 million in imports from Hong Kong consisted almost entirely of manufactures, with imported primary products worth just $4 million. New Zealand's principal imports were office machine parts ($11 million) and telephone equipment ($18 million), as well as medical equipment ($9 million).

Appendix 2

National Business Review article dated 29 October 2010

Hong Kong tax treaty to boost investment in New Zealand

Niko Kloeten

Double taxation treaty talks between New Zealand and Hong Kong will make investing in New Zealand more attractive and will also help Kiwi companies investing in Asia.

The treaty talks are taking place this week and early next month negotiation of a comprehensive Investment Protocol between the two countries will start.

Both initiatives come on the heels of a Closer Economic Partnership (or free trade agreement) signed in March this year.

Revenue Minister Peter Dunne earlier said Hong Kong's law reforms would allow full information exchange for tax purposes when he announced the double taxation talks in March. Double taxation agreements help facilitate trade and investment between countries by preventing businesses being taxed twice on income earned in the other country.

Arran Boote, an executive member of the Hong Kong New Zealand Business Association (HKNZBA) and international tax director of accounting firm William Buck, said this is a welcome development.

"It will help clarify the position of many dual residents and will also further encourage investment into New Zealand through lowering withholding tax rates," Mr Boote said.

"And very importantly, it has significant implications for any NZ company when considering their pan Asia structure too.

"New Zealand has been and continues to be an attractive investment market for Hong Kong residents. The rate of withholding tax has been the one negative factor influencing those decisions and the double tax agreement will remove this."

Mr Boote said New Zealand has long had a double tax agreement with Singapore, which has led many New Zealand companies to base their pan Asia strategy via Singapore.

But he said Hong Kong had many advantages over Singapore, from repatriation of profit, overhead cost and for entry into the China market perspectives in particular.

"Hong Kong, in its own right, is an important export market for New Zealand goods and services."

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