Date: 20031014

Docket: A-534-02

Citation: 2003 FCA 378

CORAM: **DESJARDINS J.A.**
NOËL J.A.
MALONE J.A.

BETWEEN:

KELLY BRIAN EDWARDS

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Ottawa, Ontario, on September 24, 2003.

Judgment delivered at Ottawa, Ontario, October 14, 2003.

REASONS FOR JUDGMENT BY: NOËL J.A.

CONCURRED IN BY: DESJARDINS J.A.
MALONE J.A.

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REASONS FOR JUDGMENT

NOËL J.A.

[1] This is an appeal from a decision of Rip J. of the Tax Court of Canada (2002 D.T.C. 1856), in which he dismissed the appeal filed by the appellant with respect to the assessment made by the Minister of National Revenue (the Minister) for the 1997 taxation year.

[2] The issue is whether the Agreement for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income between Canada and the People's Republic of China (enacted by S.C. 1986, c. 48, Part III) (Canada-China Tax Treaty, Agreement,

Treaty, or Convention) applies to the Hong Kong Special Administrative Region (HKSAR) of the People's Republic of China (PRC). If the Treaty applies, the appellant's 1997 employment income, which he earned from employment as an airline pilot with a commercial airline company based in the HKSAR, would be exempt from taxation in Canada pursuant to Article 15(3) of the Treaty, and the appellant would be entitled to a corresponding deduction under subparagraph 110(1)(f)(i) of the *Income Tax Act* (the Act).

[3] Article 15(3) of the Tax Agreement provides in its relevant part that "remuneration in respect of an employment exercised aboard a[n] aircraft operated in international traffic by an enterprise of a Contracting State, shall be taxable only in that Contracting State". The term "enterprise of a Contracting State" is defined as an enterprise carried on by "a resident of a Contracting State" (Article 3(1)(g)) which term is defined in turn as "a person ... liable to tax therein", i.e., in that state (Article 4).

[4] Subparagraph 110(1)(f)(i) in its relevant part provides:

110(1) For the purpose of computing the taxable income of a taxpayer for a taxation year, there may be deducted such of the following amounts as are applicable:	110. (1) Pour le calcul du revenu imposable d'un contribuable pour une année d'imposition, il peut être déduit celles des sommes suivantes qui sont appropriées:
...	[...]
(f)	(f)
...	[...]

(i) an amount exempt from income tax in Canada because of a provision contained in a tax convention or agreement with another country that has the force of law in Canada,	(i) une somme exonérée de l'impôt sur le revenu au Canada par l'effet d'une disposition de quelque convention ou accord fiscal avec un autre pays qui a force de loi au Canada,

[5] In dismissing the appeal, Rip J. found that, although, since July 1, 1997, the HKSAR has formed an inalienable part of the People's Republic of China (PRC), the Treaty was not intended by the parties to apply to the HKSAR. It followed that the appellant's employer was not a "resident of a Contracting State" nor an "enterprise of a contracting state" within the meaning of Article 4 and Article 3(1)(g) respectively and, consequently, that the appellant could not rely on Article 15(3) of the Treaty in the computation of his 1997 income.

Facts

[6] The matter proceeded before the Tax Court on the basis of a Partial Statement of Agreed Facts and Documents, segments of which have been reproduced in Annex I to these reasons as background. The essential facts are outlined in the following paragraphs.

[7] The *Canada-China Income Tax Agreement Act*, 1986 implements the Treaty, which was signed on May 12, 1986.

[8] The appellant, Kelly Brian Edwards, was a commercial airline pilot employed by Veta Ltd. (Veta), a wholly-owned subsidiary of Cathay Pacific Ltd. (Cathay Pacific). During the relevant time, the appellant was a resident of Canada.

[9] Under the terms of subsection 8(1) of the Inland Revenue Ordinance, Ordinance 112, the appellant was required to pay salaries tax to Hong Kong prior to July 1, 1997, and to the HKSAR of the PRC from July 1, 1997 on his income from employment with Veta.

[10] Cathay Pacific is incorporated, registered and resident in Hong Kong. During the relevant time, Cathay Pacific was liable to pay profits tax to Hong Kong in accordance with the Inland Revenue Ordinance before July 1, 1997 and to the HKSAR in accordance with the Inland Revenue Ordinance, Ordinance 112 from July 1, 1997.

[11] On July 1, 1997, sovereignty over Hong Kong reverted to the PRC, at which time it became the HKSAR of the PRC. Since then, all the laws of the HKSAR derive their authority from the PRC.

[12] Up to the time of devolution, Hong Kong was a source based low tax jurisdiction recognized as an international financial centre which did not tax its residents on their universal income. As such, Hong Kong had no interest in entering into comprehensive double taxation avoidance agreements and was not a party to any such agreement with any country

[13] In conformity with the Sino-British Joint Declaration concluded in 1984, the Basic Law of the HKSAR of the PRC promulgated on April 4, 1990, with effect July 1, 1997 (the Basic Law), had the effect of preserving Hong Kong’s legal system including its taxation system and its vocation as an international financial centre.

[14] Specifically, Article 8 of the Basic Law provided for the continuation of the laws previously in force in Hong Kong and Article 108 provided for the preservation of its tax system as an independent taxation system.

[15] The HKSAR has been governed accordingly since 1997. It has not entered into any double taxation avoidance agreement since devolution (except with the Mainland of the PRC), and does not consider itself bound by any of the international tax treaties to which the PRC is a party (there were 54 such treaties as of 1997).

[16] Similarly, the PRC has not extended any of the double taxation avoidance agreements to which it is a party to the HKSAR although Article 153 of the Basic Law empowers it to do so.

[17] In an exchange of correspondence taking place in March 2001, the governments of Canada, PRC and HKSAR each took the position that the Treaty did not apply to the HKSAR.

[18] In November 2001, a representative of the Canadian Department of Foreign Affairs sent a third person diplomatic note to the Chinese Ministry of Foreign Affaires stating the Canadian government's position that the Treaty did not apply to the HKSAR and requesting that the PRC confirm its agreement in this respect. A similar note was sent to the Hong Kong Department of Justice.

[19] The Chinese government replied stating its agreement in the following terms:

> [TRANSLATION]
>
> Article No. 108 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China governs that HKSAR implements an independent taxation system. Therefore, the aforementioned agreement does not apply to the Hong Kong Special Administrative Region, and a company incorporated and resident in, and with its place of head office and place of management in, the Hong Kong Special Administrative Region, is neither a "resident of a Contracting State" nor an "enterprise of a Contracting State" within the meaning of Article 4 and Article 3, paragraph 1(g), respectively of the Agreement.

[20] The reply from the Hong Kong Department of Justice also confirmed the Canadian government's position.

Analysis

[21] The interpretation of international taxation treaties requires an approach which differs from that employed in the interpretation of ordinary statutes as regard must be had to the intention of the parties to the Treaty. In *Crown Forest Industries Ltd. v. Canada* [1995] 2 S.C.R. 802, the Supreme Court of Canada held that courts must use a purposive approach. Writing for the Court in that case Iacobucci J. stated:

> In interpreting a treaty, the paramount goal is to find the meaning of the words in question. This process involves looking to the language used and the intention of the parties.

[22] Looking first at the language used in the Treaty (the relevant provisions can be found in Annex I), it does not appear that it was intended to apply to Hong Kong or to the HKSAR. While the Treaty contains no explicit statement to this effect, articles 2(1)(b) and 3(1)(b) when read together make this relatively clear: Article 3(1)(b) of the Treaty defines the PRC in terms of

where the laws relating to Chinese tax apply, while article 2(1)(b) lists the four Mainland taxes (i.e., taxes not having application in Hong Kong or elsewhere outside of the Chinese Mainland) to which the Treaty shall apply. Indeed, this was the opinion expressed by Professor Baker with respect to the corresponding provisions in the China-United Kingdom taxation treaty:

> Similarly, the convention with China defines "China" as "all the territory...in which the laws relating to Chinese tax are in force..."; Chinese tax is defined to cover only those taxes in force in the Mainland (so as to exclude Hong Kong, Macao and Taiwan – thus avoiding a difficult diplomatic issue in making it relatively clear that China's treaties will not apply to Hong Kong after June 30, 1997). (PP. Baker, Double Taxation Convention and International Tax Law, 2nd edition, (London: Street and Maxwell, 1994) paragraph E-03).

[23] The appellant accepts the opinion of Professor Baker insofar as the China-UK Agreement is concerned but points out that while the definition in the UK Treaty does not use the words "when used in a geographical sense", the Canadian Treaty does. According to the appellant, this qualification restricts the definition of the PRC in the Canadian Treaty to one that is strictly geographical. As the PRC is otherwise undefined, the appellant argues that it must be understood in its juridical or political sense which, since July 1, 1997, includes Hong Kong.

[24] In making this argument, the appellant loses sight of the fact that both the Canada and UK Treaties define the PRC in a geographical sense, that is by reference to where, within the territory over which the PRC asserts its sovereignty, Chinese taxes apply. The fact that the Canadian Treaty says so explicitly and that the UK Treaty does not is in my view immaterial. Both delineate the scope of the respective treaties by reference to the same geographic definition of the PRC.

[25] In this respect, reference may usefully be made to the technical interpretation of the comparable provisions in the USA-China Tax Convention which was signed at approximately the same time as the Canadian Treaty. This Treaty bears the same language as the Canada Treaty including the geographical qualification which the UK Treaty omits. Despite this, the US competent authorities have expressed the view that Hong Kong is excluded from the definition of the PRC based on the same reasoning as that advanced by Professor Baker in relation to the UK Convention:

> The geographical territory of the two Contracting States is defined to include their continental shelf areas to the extent consistent with international law and their respective domestic laws. ... The "People's Republic of China" does not include Hong Kong, as Chinese tax laws are not in effect there. Moreover, in accordance with the Agreement between the United Kingdom and China on the future of Hong Kong, the taxes imposed by the Hong Kong Special Administrative Region will continue to be independent of the tax laws of the Central People's Government, and therefore the Agreement will not apply to Hong Kong even after 1997 (Treasury Department technical explanation - U.S.-China Treaty for the avoidance of double taxation).

[26] The appellant has been unable to demonstrate why this reasoning, which flows from the language of the Convention, should not apply to the Canada-China Tax Treaty.

[27] With respect to the intention of the parties, this case is straight forward in that the contracting states have expressed their agreement, by exchange of diplomatic notes, that the Treaty was not intended to apply to the HKSAR. The appellant argues that little weight should be given to this expression of intent. This argument, which was vigorously pursued during the hearing, is best stated by reproducing paragraph 97 of the appellant's memorandum of fact and law:

> ...such [diplomatic] notes should not be given such weight in the interpretation of the Tax Agreement as to effectively override retroactively the natural meaning of the text of the Tax Agreement which is, by reason of the Canada-China Tax

> Agreement Act, 1986, a Canadian law. It would be an unusual (and undesirable) result if the rights of a Canadian resident under a law of Canada could be affected by agreements between Canada and another country which are not enacted into Canadian law, not published and occur after the time at which the such rights have arisen.

[28] I reject this argument without hesitation. First of all, I do not accept that the construction advocated by the parties goes against the natural meaning of the Tax Agreement. As indicated, the definition of the PRC in terms of where "Chinese Tax" apply, lends itself to the common view expressed by the parties. Second, the evidence reveals that the Canadian government has consistently maintained that the Treaty does not apply to Hong Kong or to the HKSAR and this position has been known in tax circles and accessible to anyone interested since at least 1997. To the extent that the appellant claims to have been surprised by the Canadian position, it can only be because he did not see fit to inform himself.

[29] As was stated by Laforest J. in a passage quoted by Iacobucci J. in *Crown Forest* (*supra*) at paragraph 63:

> It would be odd if in construing an international treaty to which the legislature had attempted to give effect, the treaty were not interpreted in the manner in which the state parties to the treaty must have intended.

In my view, the commonly expressed intention of the parties is entitled to great weight and should not be ignored unless a contrary intent can be shown in either the words of the Treaty or in some other expression by the parties. No such contrary intent has been shown.

[30] I would dismiss the appeal with costs.

"Marc Noël"

J.A.

"I concur.
Alice Desjardins J.A."

"I concur.
B. Malone J.A."

Annex 1

Partial Statement of Agreed Facts and Documents

A. Facts about the Canada-China Income Tax Agreement

1. The Canada-China Income Tax Agreement Act, 1986 being Part III of S.C. 1986 c. 48 promulgates in Canada the Agreement between the Government of Canada and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (the "Canada-China Income Tax Agreement").

2. The Canada-China Income Tax Agreement was signed on May 12, 1986 by the Prime Ministers of Canada and the People's Republic of China ("PRC") on behalf of their respective governments. The Canada-China Income Tax Agreement is generally patterned on the 1977 Model Double Taxation Convention prepared by the Organization for Economic Co-operation and Development ("OECD") (the "OECD Model Convention") and the Model Double Taxation Convention between Developed and Developing Countries adopted by the United Nations Ad Hoc Group of Experts in 1979 (the "UN Model Convention").

3. The Appellant relies upon Articles 1, 2, 3, 4(1) and 15(3) of the Canada-China Income Tax Agreement as being relevant to the determination of this appeal. Those Articles provide:
The Government of Canada and the Government of the People's Republic of China, desiring to conclude an Agreement for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows:

ARTICLE 1: Personal Scope
This Agreement shall apply to persons who are residents of one or both of the Contracting States.

ARTICLE 2: Taxes Covered

1. The existing taxes to which this Agreement shall apply are, in particular:
(a) in the case of Canada:
the income taxes imposed by the Government of Canada, (hereinafter referred to as "Canadian tax");
(b) in the case of the People's Republic of China:
(i) the individual income tax:
(ii) the income tax concerning joint ventures with Chinese and foreign investment:
(iii) the income tax concerning foreign enterprises; and
(iv) the local income tax;
(hereinafter referred to as "Chinese tax").

2. This Agreement shall also apply to any identical or substantially similar taxes which are imposed after the date of signature of this Agreement in addition to, or in place of, those referred

to in paragraph 1. The relevant authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective taxation laws within a reasonable period of time after such changes.

ARTICLE 3: General Definitions

1. For the purposes of this Agreement, unless the context otherwise requires:
(a) the term "Canada" used in a geographical sense, means the territory of Canada, including any area beyond the territorial seas of Canada which, in accordance with international law and under the laws of Canada, is an area within which Canada may exercise rights with respect to the seabed and subsoil and their natural resources;
(b) the term "the People's Republic of China", when used in a geographical sense, means all the territory of the People's Republic of China, including its territorial sea, in which the laws relating to Chinese tax apply, and all the area beyond its territorial sea, including the seabed and subsoil thereof, over which the People's Republic of China has jurisdiction in accordance with international law and in which the laws relating to Chinese tax apply;
(c) the terms "a Contracting State" and "the other Contracting State" mean Canada or the People's Republic of China, as the context requires;
(d) the term "tax" means Canadian tax or Chinese tax, as the context requires;
(e) the term "person" includes an individual, a company and any other body of persons;
(f) the term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;
(g) the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
(h) the term "nationals" means all individuals having the nationality of a Contracting State and all legal persons, partnerships and other bodies of persons deriving their status as such from the law in force in a Contracting State;
(i) the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
(j) the term "competent authority" means, in the case of Canada, the Minister of National Revenue or his authorized representative, and in the case of the People's Republic of China, the Ministry of Finance or its authorized representative.

2. As regards the application of this Agreement by a Contracting State any term not defined in this Agreement shall, unless the context otherwise requires, have the meaning which it has under the law of that Contracting State concerning the taxes to which this Agreement applies.

ARTICLE 4: Resident

1. For the purposes of this Agreement, the term "resident of a Contracting State" means any person who, under the laws of that Contracting State, is liable to tax therein by reason of his

domicile, residence, place of head office, place of management or any other criterion of a similar nature.

...

ARTICLE 15: Dependent Personal Services

...

3. Notwithstanding the provisions of paragraphs 1 and 2, remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State, shall be taxable only in that Contracting State.
...

D. Facts about the HKSAR of the PRC

16. The Sino-British Joint Declaration on the Question of Hong Kong (the "Joint Declaration") was signed at Beijing on December 19, 1984 by the Prime Ministers of the United Kingdom and the PRC.

17. In the Joint Declaration, the Government of the PRC declared that it had decided to resume the exercise of sovereignty over Hong Kong with effect from July 1, 1997, and the Government of the United Kingdom declared that it would restore Hong Kong to the PRC effective July 1, 1997.

18. On July 1, 1997 sovereignty over Hong Kong reverted to the PRC, at which time Hong Kong became the Hong Kong Special Administrative Region of the People's Republic of China. The Hong Kong Special Administrative Region has formed part of the PRC since July 1, 1997.

19. Article 31 of the Constitution of the People's Republic of China authorizes the establishment of Special Administrative Regions on the terms prescribed by law enacted by the National People's Congress, as follows:
The state may establish special administrative regions when necessary. The systems to be instituted in special administrative regions shall be prescribed by law enacted by the National People's Congress in light of specific conditions.

20. The constitutional structure of the HKSAR of the PRC is prescribed by the law adopted by the 7th National People's Congress on April 4, 1990 and promulgated by decree of the President of the PRC on that date and effective July 1, 1997, which law is known as the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (the "Basic Law").

21. Article 8 of the Basic Law provides for the maintenance of the laws of Hong Kong after the resumption of sovereignty by the PRC, and for the power of the legislature of the HKSAR to continue to amend such laws, provided that such laws are not in conflict with the Basic Law. Article 8 stipulates:

> The laws previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law shall be maintained, except for any that contravene this Law and subject to any amendment by the legislature of the Hong Kong Special Administrative Region.

22. The mechanism for the adoption of the laws of Hong Kong as laws of the HKSAR of the PRC is provided in Article 160 of the Basic Law, which stipulates:
Upon the establishment of the Hong Kong Special Administrative Region, the laws previously in force in Hong Kong shall be adopted as laws of the Region except for those which the Standing Committee of the National People's Congress declares to be in contravention of this Law.

23. On February 23, 1997, the twenty-fourth session of the Eighth National People's Congress adopted the Decision of the Standing Committee of the National People's Congress on the Treatment of Laws Previously in Force in Hong Kong in accordance with Article 160 of the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, (the "Standing Committee Decision") which provided that, with the exception of 24 Ordinances set out in Annex 1 and Annex 2 of the Standing Committee Decision, the laws previously in force in Hong Kong are adopted as laws of the HKSAR. Section 1 of the Standing Committee Decision provides:
The laws previously in force in Hong Kong, which include the common law, rules of equity, ordinances, subordinate legislation and customary law, except those which are in contravention of the Basic Law, are adopted as laws of the Hong Kong Special Administrative Region.

24. The legislature of the HKSAR enacted the Hong Kong Reunification Ordinance, Gazette No. 110 of 1997, effective July 1, 1997, which declares in section 7(1) that:
The laws previously in force in Hong Kong, that is the common law, rules of equity, Ordinances, subsidiary legislation and customary law, which have been adopted as laws of the Hong Kong Special Administrative Region, shall continue to apply.

25. Article 151 of the Basic Law provides:
The Hong Kong Special Administrative Region may on its own, using the name "Hong Kong, China", maintain and develop relations and conclude and implement agreements with foreign states and regions and relevant international organizations in the appropriate fields, including the economic, trade, financial and monetary, shipping communications, tourism, cultural and sports fields.

26. Article 153 of the Basic Law provides:
The application to the Hong Kong Special Administrative Region of the international agreements to which the People's Republic of China is or becomes a party shall be decided by the Central People's Government, in accordance with the circumstances and needs of the Region, and after seeking the views of the government of the Region.
International agreements to which the People's Republic of China is not a party but which are implemented in Hong Kong may continue to be implemented in the Hong Kong Special Administrative Region. The Central People's Government shall, as necessary, authorize or assist

the government of the Region to make appropriate arrangements for the application to the Region of other relevant international agreements.

27. The HKSAR of the PRC and the Mainland of the PRC have an agreement for the avoidance of double taxation between the two Sides entitled "Memorandum for the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income". This agreement was signed by representatives of the two governments of the HKSAR of the PRC and the Mainland of the PRC on February 11, 1998.

E. Facts about the Tax Law of the Mainland of the PRC

28. Tax is imposed by the Mainland of the PRC in accordance with two basic principles. Residents of the Mainland of the PRC are generally subject to tax on world-wide income. Non-residents of the Mainland of the PRC are generally subject to tax only on income sourced to the Mainland of the PRC. Taxes in the Mainland of the PRC are administered by the State Administration of Taxation.

29. The taxes described in this Section E apply to the Mainland of the PRC. None of the taxes referred to in this Section E apply to the HKSAR of the PRC, nor is the Central People's Government entitled to levy taxes in the HKSAR of the PRC under Article 106 of the Basic Law.

30. The "individual income tax" is referenced at Article 2(1)(b)(i) of the Canada-China Income Tax Agreement and was a tax imposed under the Individual Income Tax Law of the People's Republic of China (Adopted at the Third Session of the Fifth National People's Congress on September 10, 1980 and revised in accordance with the Decision on the Revision of the Individual Income Tax Law of the People's Republic of China adopted at the Fourth Meeting of the Standing Committee of the Eighth National People's Congress on October 31, 1993 and effective as of January 1, 1994).

31. Pursuant to the provisions of the Individual Income Tax Law of the People's Republic of China, as amended (the "Individual Income Tax Law") and the Regulations thereto (the "Implementing Regulations"):
(a) Individuals not domiciled but who reside in the Mainland of the PRC for not more than 90 days in any one tax year and whose income is not borne by a permanent establishment in the Mainland of the PRC are not subject to tax in the Mainland of the PRC (Implementing Regulations, Article 7);
(b) Individuals residing in the Mainland of the PRC for less than one year are subject to tax only on income derived from sources inside the Mainland of the PRC (Individual Income Tax Law, Article 1);
(c) Individuals not domiciled but resident in the Mainland of the PRC for more than one year and less than five years are subject to tax on income derived from sources inside the Mainland of the PRC and from sources outside the Mainland of the PRC but only to the extent that the payor is inside the Mainland of the PRC (Implementing Regulations, Article 6); and

(d) Individuals who reside in the Mainland of the PRC for more than five years are subject to tax on income from sources inside the Mainland of the PRC and from sources outside the Mainland of the PRC (i.e. on world-wide income) (Individual Income Tax Law, Article 1).
Tax under the Individual Income Tax Law is imposed at graduated rates from 5% to 45% on income from wages and salaries and at graduated rates from 5% to 35% on business income (Individual Income Tax Law, Article 3)

32. The "income tax concerning joint ventures with Chinese and foreign investment" is referenced at Article 2(1)(b)(ii) of the Canada-China Income Tax Agreement and was a tax imposed prior to July 1, 1991 under the Income Tax Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures adopted by the National People's Congress on September 10, 1980 and amended by the National People's Congress on September 2, 1983. In accordance with Article 3 of this law, the income tax was generally levied at a rate of 30% (subject to the reductions specified at Article 5 thereof) on world-wide income.

33. The "income tax concerning foreign enterprises" is referenced at Article 2(1)(b)(iii) of the Canada-China Income Tax Agreement and was a tax imposed prior to July 1, 1991 under the Income Tax Law of the People's Republic of China on Foreign Enterprises adopted by the National People's Congress on December 13, 1981 and effective January 1, 1982. Income tax under this law was generally levied at graduated rates from 20% to 40% on income derived from sources in the Mainland of the PRC.
34. The "income tax concerning joint ventures with Chinese and foreign investment" and the "income tax concerning foreign enterprises" were replaced, effective July 1, 1991 with the income tax on enterprises with foreign investment ("FIE"s) and on foreign enterprises ("FE"s) imposed under the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises adopted at the Fourth Meeting of the Seventh National People's Congress on April 9, 1991 and effective from July 1, 1991.

35. The tax imposed under the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises ("Income Tax Law on FIEs and FEs") and the Detailed Implementing Rules thereto applies to the world-wide income of FIEs and to the income of FEs to the extent that such income is derived from sources in the Mainland of the PRC. This tax is levied at a maximum rate 30% of taxable income (Article 5).

36. The tax rate under the Income Tax Laws on FIEs and FEs is reduced to 15% for FIEs with production activities in "special economic zones", and to 24% for FIEs in "coastal economic open zones" and certain other areas (Detailed Implementing Rules, Article 7 & Chapter 6 "Preferential Tax Treatment"). Subject to certain exceptions, FIEs with a term of operation of at least ten years engaged in production are exempt from tax for the first two profit-making years and granted a 50% reduction in tax in the third to fifth years (Detailed Implementing Rules, Article 8 & Chapter 6 "Preferential Tax Treatment"). Where a foreign investor in a FIE directly reinvests profits derived therefrom in the establishment or expansion of export-oriented or technologically advanced enterprises in the PRC, the investor may obtain a full refund of the enterprise income tax already paid on the reinvested amount in accordance with the relevant regulations of the State Council. (Detailed Implementing Rules, Article 81). Similarly, where a

foreign investor in a FIE directly reinvests in profits derived therefrom in order to increase the registered capital in the FIE, or uses the same as capital investment for the establishment of another FIE, the investor shall obtain a refund of 40 percent of the income tax already paid on the reinvested amount, provided that the term of operation is not shorter than five years. If the reinvestment is withdrawn within five years, the refunded tax shall be paid back. (Income Tax Law on FIEs and FEs, Article 10). The after-tax profits derived from an FIE are not subject to withholding tax upon remittance to the shareholders thereof (Income Tax Law on FIEs and FEs, Article 19 and Implementing Regulations, Article 63).

37. The "local income tax" is referenced at Article 2(1)(b)(iv) of the Canada-China Income Tax Agreement. Prior to July 1, 1991, a "local income tax" of 10% of the income tax otherwise payable was imposed under Article 3 of the Income Tax Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures and Article 4 of Income Tax Law of the People's Republic of China on Foreign Enterprises. Effective July 1, 1991, a "local income tax" is imposed on FIEs and FEs under the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises at a rate of 3% of taxable income (Article 5), subject to reduction by the local authorities (Article 9).

38. Effective January 1, 1994, an "enterprise income tax" is imposed on all enterprises other than foreign investment enterprises and foreign enterprises under the Provisional Regulations on Enterprise Income Tax (adopted at the 12th Executive Meeting of the State Council on November 26, 1993, promulgated by Decree No. 137 of the State Council of the PRC on December 13, 1993). This tax applies specifically to state-owned enterprises, collective enterprises, private enterprises, joint venture enterprises and joint stock enterprises. The enterprise income tax is imposed at a rate of 33% of taxable income, which is world-wide income (Article 1). No "local income tax" is imposed under the Provisional Regulations on Enterprise Income Tax.

39. The Provisional Regulations on Enterprise Income Tax replaced as of January 1, 1994 the "state enterprise income tax", "state enterprise income regulatory tax", "collective enterprise income tax", "private enterprise income tax" and "household income tax" which had been imposed under the Draft Regulations of the People's Republic of China on State-Owned Enterprise Income Tax and Measures of Collection of State Owned Enterprise Adjustment Tax published by the State Council on September 1, 1984, the Provisional Regulations of the PRC on Collective Enterprise Income Tax published April 11, 1985 and the Provisional Regulations of the People's Republic of China on Private Enterprise Income Tax published on June 25, 1988.

40. In addition to the individual income tax, the income tax for FIEs and FEs, the local income tax and the enterprise income tax, there are several other taxes imposed in the Mainland of the PRC, including a "value added tax" on the sale or import of goods or taxable services, a "consumption tax" on luxury items, a "business tax" on the provision of certain services and the transfer of immovable and intangible property, a "land value added tax", a "deed tax", a "stamp tax", a "vehicle and vessel license tax" and a "resource tax".

F. Facts about the Tax Law of the HKSAR of the PRC

41. In the HKSAR of the PRC, there is no general system of taxing income or capital by reference to the residence of the taxpayer. For the purpose of determining taxable income, residents and non-residents are treated alike. Source of income, rather than residence status, is the single most important factor in determining a person's liability for taxation. A taxable person includes any person who has derived income in or from the HKSAR of the PRC. The following are chargeable income or profits: income from an office or employment, assessable profits from a trade, business or profession, and the assessable value of land and buildings. Income derived in or from the HKSAR of the PRC which falls under one of these three heads of taxation in the Inland Revenue Ordinance, Ordinance 112 is generally subject to tax in the HKSAR of the PRC.

42. Taxes in the HKSAR of the PRC are administered by the Department of Inland Revenue. None of the taxes described in this Section F apply to the Mainland of the PRC.

43. Article 73 of the Basic Law provides:
The Legislative Council of the Hong Kong Special Administrative Region shall exercise the following powers and functions: ...
(3) To approve taxation and public expenditure.

44. Article 106 of the Basic Law provides:
The Hong Kong Special Administrative Region shall have independent finances.
The Hong Kong Special Administrative Region shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government.
The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.

45. Article 108 of the Basic Law provides:
The Hong Kong Special Administrative Region shall practice an independent taxation system.
The Hong Kong Special Administrative Region shall, taking the low tax policy previously pursued in Hong Kong as a reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.

46. The Hong Kong Tax Law that was the Inland Revenue Ordinance of May 3, 1947 was adopted as Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC effective July 1, 1997, according to the process described in paragraphs 20-24 hereof. The text of the Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC on July 1, 1997 was identical to the text of the Inland Revenue Ordinance of May 3, 1947 on June 30, 1997.

47. The Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC imposes a "salaries tax" in Part III thereof. The salaries tax is imposed upon individuals in respect of income arising in or derived from the HKSAR of the PRC from any office or employment or profit or any pension, pursuant to section 8(1). Section 8(1) will apply where an individual's employment is sourced in the HKSAR of the PRC and in such a case, all his income from that employment will be subject to the salaries tax even if only part of the services are performed in the HKSAR of the PRC. Section 8(1A) applies the salaries tax to employment which is not

sourced in the HKSAR of the PRC but where the services are performed in the HKSAR of the PRC (CIR v. Geopfert (1987) HKTC 2, 210). The salaries tax is imposed at graduated rates from 2% to 17%.

48. The Inland Revenue department of the HKSAR of the PRC has indicated that an employment will be sourced in the HKSAR of the PRC where the contract of employment is negotiated or entered into in the HKSAR of the PRC, the employer is resident in the HKSAR of the PRC, or the employee's remuneration is paid to the employee in the HKSAR of the PRC.

49. The Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC imposes a "profits tax" in Part IV thereof. Persons, (including corporations, partnerships, trustees and bodies of persons), both resident and non-resident, carrying on or deemed to be carrying on a trade, business or profession in the HKSAR of the PRC are liable to the profits tax on chargeable profits sourced to the HKSAR of the PRC. Certain income from sources outside the HKSAR of the PRC is deemed to arise from a source in the HKSAR of the PRC. Both actual receipts and amounts credited but not paid (i.e. accruals) are considered to be income liable to profits tax. The rate of profits tax is 15% for individuals and 16% for corporate entities.

50. Specific rules for the application of the profits tax to an aircraft owner resident in the HKSAR of the PRC are set out in section 23C of the Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC. Section 23C deems a corporation resident in the HKSAR of the PRC that carries on a business as an owner of an aircraft to be carrying on that business in the HKSAR of the PRC. Section 23C of the Inland Revenue Ordinance, Ordinance 112 prescribes what proportion of the aircraft owner's worldwide income from carrying on business as an owner of an aircraft is to be apportioned to the HKSAR of the PRC for tax purposes.

51. Part VII of the Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC provides for the charging of tax under personal assessment. This Part provides for an effective merging of the heads of taxation under the Inland Revenue Ordinance, Ordinance 112 of the HKSAR of the PRC into a single assessment for an individual who is a permanent or temporary resident of the HKSAR of the PRC and who elects for personal assessment. The total income of the individual for the purposes of personal assessment consists of the net assessable value of land and buildings owned by the individual, the net assessable income from an office or employment of profit of the individual and assessable profits. Total income is reduced by approved charitable donations, business losses and certain interest in order to arrive at the individual's taxable amount.

52. The parties hereto agree, for the purpose of this appeal, to the facts as set out herein. Each party reserves the right to object to the relevance of any of the facts set out herein.

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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