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Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance

Introduction

4.1 This chapter examines the *Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance*, tabled in the Parliament on 3 December 2015.

Overview and national interest summary

4.2 The Agreement aims to update the existing bilateral tax arrangements in the 1975 Agreement between Australia and Germany, and align them with current Australian and international tax policy settings.[1] The Agreement includes new integrity provisions to minimise tax avoidance opportunities. It enables exchange of information and mutual assistance in the collection of outstanding debts.[2]

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1 National Interest Analysis [2016] ATNIA 2 with attachment on consultation *Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance*, done at Berlin on 12 November 2015 [2015] ATNIF 31 (hereafter the NIA) para 4.

2 NIA, para 5.

4.3 The Treasury explained that the existing treaty with Germany which was signed in 1972 (and came into force in 1975) is Australia's 'oldest unamended tax treaty'.[3] The new treaty updates and modernises the arrangements between the two countries:

> [The existing treaty] is well out of date. We needed to not only include the base erosion and profit-shifting measure … but also generally bring it up to date. It is actually a real refresh for the treaty. It takes it into the modern economy and the modern times. We are confident that it will have a really positive effect.[4]

4.4 The Australian Taxation Office (ATO) and the Treasury saw the need to negotiate a new Agreement with Germany as an opportunity to incorporate the OECD/G20 recommendations to prevent base erosion and profit shifting:

> There is a current process going on in the OECD to try and make sure there is a process for incorporating those sorts of provisions into all of the current treaties to which member states are involved. That, obviously, is … an expedited process to put those provisions in a range of treaties between various partners. We took the opportunity, given we were negotiating with Germany at this time, to really be ahead of the pack. This was an opportunity to put those provisions in now, in a way which is really unprecedented. Both Germany and, obviously, ourselves are very excited to be at the leading edge of making those new provisions a reality.[5]

4.5 By incorporating the OECD/G20 recommendations, the new Agreement will provide a precedent for future such treaties:

> … it is good to have a precedent now in this treaty with Germany, which will help us progress the OECD work. Part of the ongoing work in the OECD is getting a lot of these changes in a multilateral instrument and also part of that, moving forward, is to do it bilaterally to make sure not just Germany but the countries that we do want to have these sorts of provisions in a treaty with, also come on board.[6]

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3 Mr Greg Wood, Senior Adviser, Corporate and International Tax Division, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 12.

4 Ms Caroline Edwards, Chief Adviser, Corporate and International Tax Division, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 12.

5 Ms Edwards, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 11.

6 Mr Stephen Knipler, Assistant Commissioner, Tax Counsel Network, Australian Taxation Office (ATO), *Committee Hansard*, Canberra, 29 February 2016, p. 11.

Reasons for Australia to take the proposed treaty action

Reducing barriers to bilateral trade and investment

4.6 The Agreement is expected to reduce taxation barriers to bilateral trade and investment between Australia and Germany, primarily by reducing source country taxes on cross-border payments of dividends, interest and royalties.[7]

4.7 The treaty will reduce taxation barriers in three ways:

- reducing the dividend withholding tax rate limit from 15 per cent to either zero per cent or five per cent, depending on the inter-corporate relationships. The NIA states that this will promote direct investment and allow Australian companies to repatriate profits made by certain German subsidiaries back to Australia without facing any further tax;[8]
- reducing the interest withholding tax rate limit from 10 per cent to zero for interest paid to financial institutions that are unrelated to, and dealing wholly independently with, the payer. The NIA states that this will lower borrowing costs for Australian firms;[9] and
- reduce the royalty withholding tax rate limit from 10 per cent to five per cent. The NIA states that reduced source country taxation on royalties is expected to reduce the costs for Australian businesses of accessing German intellectual property, and is likely to encourage Australian businesses to source intellectual property from Germany and vice versa.[10]

Increased certainty and reduced compliance costs for taxpayers

4.8 The Agreement allocates taxing rights over income flowing between the two countries. It clarifies that treaty benefits will be available for income received by Australian managed investment trusts and certain German collective investment vehicles.

4.9 The NIA advises that the Agreement will help remove double taxation on the same profits of two associated enterprises. In cases where the revenue authority of one country adjusts the taxable income of a resident of the other country, to reflect the arm's-length price of goods or services provided to an associated enterprise, the Agreement will require the

7 NIA, para 6.

8 NIA, para 7.

9 NIA, para 8.

10 NIA, para 9.

revenue authority of the other country to make an appropriate adjustment to the amount of tax charged in its jurisdiction in respect of the same profits (**Article 9**).[11]

4.10 The Agreement will prevent the double taxation of fringe benefits, by allocating taxing rights over fringe benefits to the country that has the primary taxing right over the relevant employment income.[12]

4.11 The NIA advises that the Agreement will protect taxpayers from one country from tax discrimination in the other country (**Article 24**). Australian nationals and businesses will not be subject to more burdensome taxation and connected requirements in Germany than German nationals and businesses in the same circumstances, and vice versa.[13]

4.12 Taxpayers will have an avenue for resolving tax disputes arising from the application of the treaty. Taxpayers will be able to seek the revenue authorities' assistance by presenting their case to the competent authority in either country. Taxpayers will be able to seek independent and binding arbitration where a tax dispute remains unresolved after two years.[14]

4.13 Overall, although the benefits cannot be quantified, the Treasury expects the Agreement to have a positive impact on both countries:

> … our experience with tax treaties is that they do enhance business relationships and they certainly are sought after by many businesses around the world. We certainly expect it to have a very positive effect on our relationship with German companies and with the German government and also be an opportunity for Australian companies to do business in Germany in a more efficient and effective way.[15]

Establishing a more effective framework to address international fiscal evasion

4.14 The Agreement includes OECD/G20 tax treaty recommendations from the *Base Erosion and Profit Shifting* (BEPS) Reports, including:

- a new Preamble clarifying the purpose of the treaty;[16]

11 NIA, para 13.
12 NIA, para 14.
13 NIA, para 15.
14 NIA, para 16.
15 Ms Edwards, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 11.
16 NIA, para 17.

- ensuring the benefits of the proposed treaty will be denied if a principal purpose of a person is to take advantage of the treaty;[17]
- clarifying that treaty benefits will be available for income derived through fiscally transparent entities but only to the extent that the income is treated as the income of a resident of Australia or Germany under domestic law;[18]
- individuals who change their tax residence after at least 5 years will remain taxable in their former country of residence on certain capital gains from the alienation of property;[19]
- the source country is not obliged to provide treaty benefits for income derived by a temporary resident of the other country if that other country exempts that income because of the individual's status as a temporary resident;[20] and
- strengthening the definition of 'permanent establishment' in the proposed treaty to broaden the range of circumstances in which both countries can tax business profits.[21]

4.15 The Treasury provided practical examples of the way the OECD/G20 measures will strengthen tax evasion provisions in the Agreement:

> A particular feature that the OECD recommended was a new preamble, which makes it very clear that the treaty is not intended to create instances of non-taxation—where income is not taxed in either jurisdiction—and it specifically refers to treaty shopping. The preamble with treaty interpretation laws sets the scene. It makes it very clear that this is not an intended purpose. Then there are a range of provisions throughout the treaty. There is a general rule in there, which we call the 'principal purpose test', that allows the tax administrations to deny treaty benefits if the main purpose was to take advantage of the treaty and the particular arrangement is contrary to the intended objective of the treaty.[22]

4.16 To further strengthen tax avoidance, integrity rules throughout the Agreement have been improved. One example is with regard to the definition of 'permanent establishment':

17 NIA, para 17.

18 NIA, para 17.

19 NIA, para 18.

20 NIA, para 18.

21 NIA, para 19.

22 Ms Lyn Redman, Senior Adviser, Corporate and International Tax Division, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 11.

> We have strengthened the definition of 'permanent establishment', which is the principle that is used to determine whether you have a taxable presence in a jurisdiction. It is much more difficult to avoid having a taxable presence now.[23]

4.17 Nothing in the Agreement will prevent either country from applying their own domestic laws to prevent the evasion or avoidance of taxes.[24] The Agreement also establishes a framework to address international tax evasion through allowing the exchange of relevant information and enabling mutual assistance in the collection of outstanding tax debts. There are also strict rules governing the privacy of tax information exchanged between Australia and Germany in relation to individuals.[25]

Obligations

4.18 Paragraphs 24 to 52 of the NIA set out the specific obligations contained in Articles 2 to 31 of the treaty. These obligations relate to:

Article	Subject matter
Article 2	Includes fringe benefits tax and resource rent tax within the treaty.
Article 4	How an individual's State of residence shall be determined.
Article 5	Defines the term 'permanent establishment'.
Article 6	Income from immoveable property (e.g. mining rights).
Article 7	Clarifies taxing rights over profits derived through a permanent establishment in the source country.
Article 8	International shipping or air transport profits may be taxed where the transport is between places in the other country (e.g. Australian coastal shipping).
Article 9	Removes double taxation for transactions between related enterprises.
Articles 10, 11, 12	Allows for dividends interest and royalties, arising in one country and paid to a resident of the other country, to be taxed in the country of residence (noting the reduced rate of tax in the first country mentioned above).
Article 13	Allows for source country taxation of income or profits from the alienation of immoveable property within that country, and for the taxing of former residents on moveable property.
Article 14	Prevents the double taxation of salaries, wages and fringe benefits subject to certain conditions.
Article 15	Allows for directors' fees to be taxed by the resident state where the fees derive from a company of the other state.
Article 16	Allows for visiting sportspersons and entertainers to be exempt from tax in the country visited if funded by public funds from the home country.
Article 17	Allows for pensions and annuities to be taxed only in the recipient's country of

23 Ms Redman, The Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 11.

24 NIA, para 20.

25 NIA, para 21.

	residence.
Article 18	Provides that government service income and pensions will be taxable only in the source country.
Article 19	Visiting teachers and professors will be exempt for up to two years if supported by public funds or a tax exempt charity.
Article 20	Income not expressly dealt with in the treaty may be taxed only in the country of residence, except for income arising from the other country.
Article 21	Covers the circumstances where Germany may apply its capital tax to capital owned by Australian residents.

Implementation

4.19 The implementation of the Agreement will take place in three stages:

- in respect of withholding tax, on income derived on or after 1 January next following the date of entry into force;
- in respect of fringe benefits tax, in relation to fringe benefits provided on or after 1 April next following the date of entry into force; and
- in respect of other Australian tax, on income, profits or gains of any year of income beginning on or after 1 July next following the date of entry into force.[26]

4.20 Amendments to the *International Tax Agreements Act* (1953) will be made to implement the obligations contained in the treaty. These amendments will be made before the Agreement enters into force.[27]

Costs

4.21 The NIA advises that the reciprocal nature of tax treaties means that both countries can expect direct costs and benefits to their revenue bases as a result of changes to their taxing rights and increased taxpayer compliance.[28]

26 NIA, para 2.
27 NIA, para 53.
28 NIA, para 54.

First-round impact of the Agreement

4.22 The Treasury estimates that the first round impact will be a revenue loss of $85 million, mainly attributable to reduced dividend, interest and royalty withholding tax collections.[29]

4.23 Administration costs for the ATO will be managed within existing agency resources.[30]

4.24 The NIA advises that the Agreement is expected to reduce compliance costs for those taxpayers with cross-border dealings between the two countries, because it brings the bi-lateral tax relationship within international norms.[31]

Second-round impact of the Agreement

4.25 The NIA does not provide any detail of the second round costs and benefits, only noting that 'the estimated revenue costs and benefits do not take account of any additional revenues that may flow from the second round impacts generated by the treaty'.[32]

4.26 According to the NIA, it is possible that there will be revenue gains from changes in cross-border investment levels, improved access to technology, reduced capital costs, economic growth and job creation.[33]

4.27 Asked to clarify the lack of detail regarding the second round costs, the Treasury acknowledged that, consistent with normal practice, no modelling had been done:

> Consistent with normal rules, we can only look at the first- round effects but, with tax treaties, it is generally acknowledged that they are about removing or reducing tax impediments. It is about facilitating greater trade and investment and growing the pie. Beyond that, there is not very much that we can add.[34]

Conclusion

4.28 The Committee acknowledges the significance of incorporating the OECD/G20 recommendations to combat base erosion and profit shifting into the new Agreement with Germany. The Committee commends the

29 NIA, para 55.

30 NIA, para 56.

31 NIA, para 58.

32 NIA, para 59.

33 NIA, para 59.

34 Ms Redman, the Treasury, *Committee Hansard*, Canberra, 29 February 2016, p. 11.

Treasury and the ATO for taking advantage of the opportunity to set a precedent for future taxation treaties in this regard thus furthering worldwide efforts to minimise tax avoidance.

4.29 The Committee supports the ratification of the Agreement.

Recommendation 4

The Committee supports the *Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with Respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance* and recommends that binding treaty action be taken.