National Interest Analysis [2019] ATNIA 14

with attachment on consultation

Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance

(Canberra, 28 March 2019)

[2019] ATNIF 24

NATIONAL INTEREST ANALYSIS: CATEGORY 2 TREATY

SUMMARY PAGE

Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance

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Nature and timing of proposed treaty action

1. The proposed treaty action is to bring into force the *Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance,* and the attached Protocol ('the proposed Convention'), which was signed on 28 March 2019.

2. The proposed treaty action would bring the Convention into force pursuant to **Article 29**, on the date of the last notification through the diplomatic channels of either Australia or Israel to the other country confirming that each country has completed its domestic requirements to bring the proposed Convention into force. Pursuant to Article 29, the provisions of the proposed Convention will take effect in Australia in three stages, namely:

- in respect of withholding tax on income that is derived on or after 1 January next following the date on which the Convention enters into force;

- in respect of fringe benefits tax, in relation to fringe benefits provided on or after 1 April next following the date on which the Convention enters into force; and

- in respect of other Australian tax, in relation to income, profits or gains of any year of income beginning on or after 1 July next following the date on which the Convention enters into force.

Overview and national interest summary

3. The proposed Convention will add to Australia's existing tax treaty network, expanding the international economic framework within which most of Australia's international trade and investment activities occur.

4. The proposed Convention is the first of its kind between Australia and Israel and will provide an avenue to support closer linkages between Australia and Israel, particularly in the areas of commercial trade, investment and innovation.

5. The key objectives of the proposed Convention are to:

a. Promote closer economic cooperation between Australia and Israel by reducing taxation barriers such as the double taxation of income derived by residents of either country; and

b. Improve the integrity of the tax system by providing the framework through which the tax administrations of Australia and Israel can cooperate to prevent tax avoidance and evasion.

6. The proposed Convention is in the national interest because it aims to improve tax certainty for Australian businesses looking to expand into Israel, and for other Australian taxpayers deriving income from Israel, by establishing an internationally accepted framework for the taxation of cross-border transactions which is broadly based upon the Organisation for Economic Cooperation and Development's (OECD) model tax treaty: the *Model Tax Convention on Income and on Capital*.

7. The proposed Convention will encourage cross-border trade and investment by reducing tax barriers to investment and decreasing the cost to Australian business of accessing Israeli capital and technology. The withholding tax rates on cross-border dividends, interest and royalties will be reduced in both Australia and Israel under the treaty.

8. Australia's implementation of the proposed Convention will be without prejudice to Australia's support for a two-state solution to the conflict between Israel and the Palestinians, including the resolution of final status issues.

Reasons for Australia to take the proposed treaty action

Reducing barriers to bilateral investment and trade

9. The proposed Convention is expected to reduce taxation barriers to bilateral trade and investment between Australia and Israel, primarily by reducing source country taxes on cross-border payments of dividends, interest and royalties. Rather than taking unilateral action to reduce such taxes (which are imposed as withholding taxes in Australia), under the proposed Convention the Parties have adopted the approach of agreeing to such reductions on a reciprocal bilateral basis. This approach 'locks in' the tax limits in both countries, thus ensuring a stable tax framework for business between Australia and Israel.

10. In particular, the proposed Convention will reduce source country taxation of outbound dividends (from the domestic rate of 30 per cent for unfranked dividends in the case of Australia) to:

a. Zero for dividends derived from shareholdings of less than 10 per cent by governments (including government investment funds), central banks, tax-exempt Israeli pension funds or complying Australian superannuation funds.

b. 5 per cent for intercorporate dividends paid to companies that hold 10 per cent or more of the paying company throughout a 365 day period. This will promote direct

investment and will allow Israeli subsidiaries of Australian companies to repatriate profits back to Australia at a reduced rate of Israeli tax.

c. 15 per cent for all other dividends (**Article 10**).

11. The proposed Convention will reduce source country taxation of outbound interest payments (from the domestic rate of 10 per cent in the case of Australia) to:

a. Zero for interest derived by government bodies (including government investment funds) and central banks.

b. 5 per cent for interest derived by recognised Israeli pension funds, complying Australian superannuation funds and financial institutions that are unrelated to the borrower. Reducing Australian withholding tax on interest paid to Israeli financial institutions will lower borrowing costs for Australian firms, the economic burden of which is typically borne by the Australian payer of the interest.

c. 10 per cent for all other interest (**Article 11**).

12. The proposed Convention will also reduce source taxation of outbound royalties (from the domestic rate of 30 per cent in the case of Australia) to 5 per cent of the gross amount of the royalties (**Article 12**). Limiting source country taxation on royalties is likely to encourage Australian businesses to source intellectual property from Israel and vice versa. While Australian withholding taxes on royalties effectively seek to tax the foreign recipients of the royalties, contracts often include provisions (known as 'gross-up' clauses) which effectively transfer the economic burden of the tax onto the payer of the royalties. Reducing these rates is expected to reduce the costs for Australian businesses accessing Israeli intellectual property.

13. More generally, the proposed Convention will establish an internationally accepted framework for the taxation of cross-border transactions thus reducing investor risk and providing greater legal and fiscal certainty. It also includes rules to prevent tax discrimination against Australian and Israeli nationals by the other Party to the proposed Convention.

Increased certainty and reduced compliance costs for taxpayers

14. The proposed Convention provides an agreed basis for determining the allocation of profits within a multinational enterprise and whether the profits derived from related party dealings by members of such an enterprise operating in both countries reflect the pricing that would be adopted by independent parties (**Articles 7 and 9**). Where the revenue authority of one country adjusts the profits of a resident enterprise, to reflect the arm's length price of goods or services provided to an associated enterprise in the other country, the proposed Convention requires the revenue authority of the other country to make an appropriate adjustment to the amount of tax charged in its jurisdiction in respect of those profits. This helps remove double taxation of the same profits in the hands of two associated enterprises. A 10 year time limit generally applies for initiating the first adjustment to profits. The proposed Convention will therefore act as an important tool in dealing with international profit shifting through transfer pricing.

15. The proposed Convention allocates taxing rights over fringe benefits provided by employers to their employees to the country that has the primary taxing right over the employment income to which the benefits relate (**Article 14**). This prevents the double taxation of fringe benefits that can otherwise arise, and remain unrelieved, because Australia taxes the provider of the benefit (the employer) as opposed to the recipient (the employee).

16. The proposed Convention also provides a dispute resolution mechanism that enables taxpayers to present a case to the revenue authority of their country of tax residence (or their country of nationality in some circumstances) if they believe they are not or will not be taxed in accordance with the treaty. Taxpayers will have three years from the first notification of the relevant action to seek such assistance (**Article 25**).

Establishing a more effective framework to prevent international fiscal evasion and avoidance

17. The proposed Convention includes provisions reflecting OECD/G20 tax treaty recommendations intended to address base erosion and profit shifting ('BEPS') practices. These include:

a. noting that the proposed Convention is intended to eliminate double taxation with respect to taxes on income without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements) (**Preamble**);

b. ensuring the benefits of the proposed Convention will be denied if one of the principal purposes of a person in seeking to obtain a benefit is to take advantage of the treaty, unless it is established that granting the benefit is in accordance with the proposed Convention's object and purpose (**Article 22**); and

c. stating that the benefits of the proposed Convention will be available for income derived through fiscally transparent entities (such as partnerships and trusts) but only to the extent that the relevant income is treated as the income of a resident of Australia or Israel under domestic law (**Article 1**(2)).

Collectively, these integrity provisions will better ensure that the benefits of the proposed Convention are only granted in appropriate circumstances.

18. The definition of 'permanent establishment' (PE) in the proposed Convention applies to the taxation of business profits. A PE is a taxable presence threshold for determining whether a country can tax local business profits derived by a foreign resident. Under the proposed Convention, a country can only tax such profits to the extent they are attributable to a PE of the foreign resident located in that country. The definition includes an important integrity rule (included in the OECD/G20 BEPS recommendations) that prevents related parties from circumventing PE time thresholds, by splitting contracts, or from fragmenting their activities to avoid having a PE (**Article 5**).

19. The proposed Convention also enhances tax system integrity through the inclusion of rules to allow the revenue authorities of Australia and Israel to cooperate to detect and prevent tax avoidance

and evasion. In particular, it will allow the exchange of relevant taxpayer information between the two revenue agencies in respect of taxes covered by the treaty (**Article 26**).

20. The proposed Convention also maintains the integrity of Australia's existing laws by providing that nothing in the treaty will prevent either country from applying its own domestic laws to prevent the evasion or avoidance of taxes (**Protocol** paragraph 1).

21. In addition, the proposed Convention provides an agreed basis for determining the allocation of profits within multinational enterprises, and whether the profits derived from related party dealings undertaken by members of such enterprises operating in both countries reflect the profits that would be derived by independent parties (**Articles 7** and **9**). This assists the Australian Taxation Office ('ATO') in responding to international profit shifting through its administration of transfer pricing laws (that is, laws that seek to ensure that the prices charged for goods and services transferred between associated entities reflect market prices).

Obligations

22. The scope of the proposed Convention is set out in Articles 1 and 2. Article 1 notes which persons shall be covered by the proposed Convention, that is, persons who are residents of one or both of the Contracting States. **Article 2** describes the taxes to which the proposed Convention shall apply. Article 2(3) (Taxes Covered) clarifies that Australia's fringe benefits tax and resource rent taxes are included within the scope of the proposed Convention (in addition to income tax).

23. **Article 4** (Resident) sets out how and the factors on the basis of which a person's country of residence shall be determined for the purpose of the proposed Convention. The proposed Convention generally applies to persons (defined to include individuals and companies) that are Australian or Israeli residents for tax purposes. Individuals who are residents of Australia or Israel for the purposes of the proposed Convention are subject to the same treatment irrespective of their nationality or citizenship (whether Australian, Israeli or otherwise).

24. Article 4(3) provides that a mutual agreement procedure will apply to determine the deemed residence of dual-resident entities (persons other than individuals), having regard to a number of factors (e.g. place of effective management and place of incorporation). In the absence of agreement between the competent authorities regarding residence, the dual-resident entity will not be entitled to the benefits of the proposed Convention.

25. **Article 5** (Permanent Establishment) defines the term 'permanent establishment' (PE), which is relevant to determining when a business, which is a resident of one country, will have a taxable presence in the other country. This definition provides for a range of circumstances in which Australia can tax business profits derived by Israeli residents from mining and other natural resource activities, building, installation and construction activities, and the operation of substantial equipment, in Australia. Additionally, a PE will be deemed to exist where a person (an agent) acts on behalf an enterprise, unless that agent is acting in a truly independent capacity.

26. **Article 6** (Income from Immovable Property) provides that income derived by a resident of one of the parties to the proposed Convention from immovable property located in the other party may be taxed by the party where the property is located. Immovable property will include, for example, leases or other interests in or over land, property accessory to immovable property and

rights to explore for mineral, oil or gas deposits or other natural resources. Any interest or right in immovable property will be considered to be in the country in which the immovable property is situated or, in the case of natural resources, where the exploration takes place.

27. **Article 7** (Business Profits) clarifies that an enterprise of a party to the proposed Convention (including beneficiaries of trusts) that derives business profits in the other party will be taxable in that other party only to the extent that the profits are attributable to a PE located in that other party. Article 7(8) sets out how taxing rights over business profits derived by residents of one party through one or more interposed trusts with PEs located in the other party (Article 7(8)). A 7 year time limit will apply for the adjustment of profits, except where an audit has been initiated within that period or in cases of fraud, wilful default or gross negligence (Article 7(9)). Different rules apply to profits derived by insurance businesses (Article 7(7)); such profits are excluded from the operation of Article 7 and may be taxed in accordance with the respective taxation laws of Australia or Israel.

28. **Article 8** (Shipping and Air Transport) provides that profits from international shipping or air transport activities, including from leased containers used in such activities, will be taxable only in the country of residence of the operator, but may also be taxed in the other country where the transport is between places in that other country.

29. **Article 9** (Associated Enterprises) requires the revenue authorities to make appropriate adjustments to the amount of tax charged on profits from transactions between related enterprises in certain circumstances, to remove double taxation. This will ensure that transactions between associated entities are not double-taxed and reflect the pricing that would be adopted by independent parties. A 7 year time limit will apply for the adjustment of profits, except where an audit has been initiated within that period or in cases of fraud, wilful default or gross negligence (Article 9(4)).

30. **Articles 10** (Dividends), **11** (Interest) and **12** (Royalties) provide that dividends, interest and royalties that arise in one country and are paid to a resident of the other country may be taxed in the other country. They may also be taxed in the originating country, although limits are placed on this depending on certain circumstances.

31. **Article 13** (Alienation of Property) enables a country to tax income or gains derived by a resident of the other country from the alienation of immovable property located within its jurisdiction, including from the disposal of interests in land-rich entities. Income or gains derived from the alienation of moveable property forming part of the business property of a PE may be taxed in the country where the PE is located (Article 13(3)). Income or gains derived by an enterprise of one country that operates ships or aircraft in international traffic from the alienation of such ships or aircraft, or from movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that country (Article 13(4)). Residual capital gains will also be taxable only in the country of residence of the alienator (Article 13(5)). Article 13(6) provides that the other provisions of Article 13 will not affect the right of a party to the proposed Convention from taxing in accordance with its domestic laws former resident individuals on capital gains if they have been a resident at any time during the 5 years immediately preceding the year of alienation.

32. **Article 14** (Income from Employment) prevents the double taxation of salaries, wages and similar remuneration. It also prevents the double taxation of fringe benefits by allocating relevant taxing rights to the country that has the primary taxing right over the underlying employment income to which the benefits relate (Article 14(5)). Article 14 contains certain conditions and exceptions and

expressly defers to the more specific rules contained in Articles 15, 17, 18 and 19 in relation to salaries, wages and other similar remuneration.

33. **Article 15** (Directors' Fees) provides that directors' fees and other similar payments derived by a resident of one country as a member of the board of directors of a company that is a resident of the other country may be taxed in that other country.

34. **Article 16** (Artistes and Sportspersons) provides that income derived by an entertainer or sportsperson from their personal activities may be taxed in the country where the activities take place. However, such income is exempt from tax in the country visited if the visit is wholly or mainly supported by public funds of the individual's country of residence, and is taxable only in the country of residence (Article 16(3)). This will foster publicly-funded cultural visits between the two countries.

35. **Article 17** (Pensions) provides for pensions and similar periodic remuneration to be taxed only in the recipient's country of residence. However, the source (paying) country may tax lump sums paid to the recipient from a recognised pension fund, under a retirement benefit scheme, or in consequence of retirement, invalidity, disability or death, or by way of compensation for injuries (Article 17(2)).

36. **Article 18** (Government Service) provides that government service income (salaries, wages and other similar remuneration) will be taxable only in the country that paid the remuneration. However, if the services are performed in the other country, such income may be taxed in that country if the individual is a tax resident and a national of that country, or is a tax resident of that country who did not become a resident solely for the purpose of rendering the services. Government pensions will be taxable only in the country that paid the pension, unless the person is both a resident and a national of the other country, in which case the pension will be taxable only in that other country (Article 18(2)).

37. **Article 19** (Professors, Teachers and Researchers) provides for the exemption from taxation in the country visited for remuneration derived by visiting teachers, professors, and researchers for up to two years, to the extent that the remuneration is subject to tax in the other country (Article 19(1)). No exemption shall be granted with respect to any remuneration for research undertaken primarily for the private benefit of a specific person or persons (that is, if the research is not undertaken in the public interest) (Article 19(2)).

38. **Article 20 (**Students) deals with certain payments received by students or business apprentices. Payments made to such individuals for their maintenance, education or training are exempt in the country where they are present provided the payments arose from outside that country, and the individual is, or was immediately before the visit, a resident of the other country.

39. **Article 21** (Other Income) provides that any income derived by a resident of a country that is not expressly dealt with elsewhere in the proposed Convention may be taxed only in that country, unless the income arises in the other country – in which case that other country may tax it (Article 21(1)). In the case of business profits derived through a PE, the provisions of Article 7 (Business Profits) will generally prevail over Article 21 (Article 21(2)). In relation to transactions between related parties, Article 21 will apply to income determined using the arm's-length principle (that is,

by valuing the provision of goods and services between related parties at their market value) (Article 21(3)).

40. **Article 22** (Limitation on Benefits) includes a rule – based on an OECD/G20 BEPS recommendation - denying benefits under the proposed Convention if it is reasonable to conclude having regard to all relevant facts and circumstances that one of the principal purposes of any arrangement or transaction resulting in that benefit is to take advantage of the treaty, unless it is established that granting the benefit is in accordance with the object and purpose of the treaty.

41. **Article 23** (Relief from Double Taxation) includes rules allowing a credit for tax paid in Israel against Australian tax payable on that income, and vice-versa. Profits, income and gains derived by a resident of a country which may be taxed in the other country in accordance with the proposed Convention shall be deemed to arise from sources in that other country (Article 23(3)).

42. **Article 24** (Non-discrimination) contains rules requiring each country to treat nationals (including entities) of the other country no less favourably for tax purposes than it treats its own nationals in the same circumstances.

43. **Article 25** (Mutual Agreement Procedure) provides a dispute resolution procedure, including a mechanism for taxpayers to present complaints within 3 years from the first notification of the action, where they consider that they have not been taxed in accordance with the proposed Convention. A person may use the procedure irrespective of the remedies provided by the domestic laws of either country. Taxpayers may present their case to the competent authority of their country of residence or, if the case comes under paragraph 1 of Article 24 (Non-discrimination), of the country of which the person is a national (Article 25(1)). The competent authority receiving a complaint that appears to be justified shall endeavour to resolve it, either unilaterally or by mutual agreement with the other competent authority (Article 25(2)). More generally, the two competent authorities are required to endeavour to resolve, by mutual agreement, any difficulties or doubts regarding the interpretation or application of the proposed Convention. They may also consult together for the elimination of double taxation in cases not provided for in the proposed Convention (Article 25(3)), and communicate with each other directly for the purpose of reaching an agreement in relation to this article (Article 25(4)).

44. **Article 26** (Exchange of Information) obliges the exchange of taxpayer information between the Australian and Israeli competent authorities that is foreseeably relevant for carrying out the provisions of the proposed Convention or for the administration or enforcement of domestic laws concerning taxes. The exchange of information is not restricted by Article 1 (Persons Covered) (Article 26(1)). Article 26(2) imposes an obligation on the country receiving any such information to treat it as secret in the same manner as information obtained under its domestic laws. Article 26(3) clarifies that in no case shall the provisions of Article 26 be construed so as to impose on either country the obligation to provide assistance that would require it to: (i) carry out administrative measures at variance with either country's domestic law or administrative practice; (ii) supply information that is not obtainable under the laws or in the normal course of administration of either country; or (iii) supply information that would involve the disclosure of a trade or business secret or would be contrary to public policy (for example, the supply of information that would result in a breach of Australia's human rights obligations). Article 26 requires competent authorities to supply information even if they have no domestic interest in such information, or if the information is held by

banks and other financial institutions. This latter feature prevents bank secrecy laws from impeding access to relevant information (Article 26(4) and (5)).

45. **Article 27** (Members of Diplomatic Missions and Consular Posts) provides that nothing in the proposed Convention will change the fiscal privileges under general rules of international law or special international agreements of members of diplomatic missions and consular posts.

46. **Article 28** (Protocol) provides that the Protocol to the proposed Convention is an integral part of the treaty. The Protocol provides further clarification on the operation of particular provisions of the proposed Convention. These clarifications have been incorporated, where relevant, into the preceding discussion of the obligations of the proposed Convention.

Implementation

47. Amendments to the *International Tax Agreements Act 1953* will be made prior to the proposed Convention entering into force, in order for Australia to comply with the treaty obligations contained in the proposed Convention. These amendments will be effected prior to the proposed Convention entering into force in Australia. No action is required by the States or Territories. The implementation of the proposed Convention will not affect the existing roles of the Commonwealth, or the States and Territories, in tax matters.

48. As noted above, Australia's implementation of the proposed Convention will be without prejudice to Australia's support for a two-state solution to the conflict between Israel and the Palestinians, including the resolution of final status issues. For the purposes of the proposed Convention, Australia will interpret references to "the State of Israel" in accordance with Australia's obligations under international law and United Nations Security Council resolutions. Nothing in Australia's implementation will imply recognition by Australia of any claims to disputed territories.

Costs

49. 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.

Financial impact of the proposed Convention

50. Treasury has estimated the impact of the first round effects of the proposed Convention to have an unquantifiable cost to revenue over the forward estimates.

51. No other material costs have been identified as likely to arise from the implementation of the proposed Convention.

52. As the proposed Convention is broadly based upon the Organisation for Economic Cooperation and Development's (OECD) model tax treaty: the *Model Tax Convention on Income and on Capital*, it is expected to reduce compliance costs for those taxpayers with cross-border dealings between the two countries.

Second-round impact of the proposed Convention

53. 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. Second-round impacts include revenue gains from changes in cross-border investment levels, improved access to technology, reduced capital costs, economic growth and job creation. The revenue cost does not therefore take into account anticipated revenue benefits from expected increases in cross-border trade and investment.

Regulation Impact Statement

54. The Office of Best Practice Regulation has advised Treasury that a Regulation Impact Statement is not required.

Future treaty action

55. The proposed Convention does not provide for the negotiation of future legally binding instruments, nor does it contain specific amendment procedures. Under **Article 39** of the *Vienna Convention on the Law of Treaties*, the proposed Convention may be amended from time to time by mutual consent of both Parties. Any such amendments would be subject to Australia's domestic treaty-making requirements, including tabling in Parliament and consideration by the Joint Standing Committee on Treaties.

Withdrawal or denunciation

56. **Article 30** provides that, following its entry into force, either country may terminate the proposed Convention by giving notice of termination, through diplomatic channels, at least six months prior to the end of any calendar year beginning after the expiration of five years from the date of entry into force of the proposed Convention. The proposed Convention would then cease to have effect in Australia:

a. in respect of withholding tax on income that is derived by a non-resident, in relation to income derived on or after 1 January next following the date on which the notice of termination is given;

b. in respect of fringe benefits tax, in relation to fringe benefits provided on or after 1 April next following the date on which the notice of termination is given; and

c. in respect of other Australian tax, in relation to income, profits or gains of any year of income beginning on or after 1 July next following that date on which the notice of termination is given.

57. Any future termination of the proposed Convention by Australia will be subject to Australia's domestic treaty-making requirements.

Contact details

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ATTACHMENT ON CONSULTATION

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CONSULTATION

58. On 17 September 2015, the then Treasurer announced Australia's intention to commence tax treaty negotiations with Israel. On 18 September 2015, Treasury invited public submissions on negotiating the proposed tax treaty. Six submissions were received from companies and professional bodies. Treasury also sought comments from the business community through the Tax Treaties Advisory Panel, members of which included:

a. Australian airline industry representatives;

b. Australian Bankers' Association;

c. Australian Financial Markets Association;

d. CPA Australia;

e. Corporate Tax Association;

f. Financial Services Council;

g. Institute of Chartered Accountants in Australia;

h. Law Council of Australia;

i. Minerals Council of Australia;

j. Property Council of Australia; and

k. The Tax Institute.

59. In general, business and industry groups endorsed the conclusion of a new double tax treaty as it would likely strengthen Australia's economic ties with Israel and support increased trade and investment particularly, in the areas of science, innovation and technology. In particular, business and industry groups strongly supported reductions in withholding taxes on dividends, interest and royalties.

60. The State and Territory Governments have been consulted through the mechanism of the biannual meetings of the Commonwealth-State Standing Committee on Treaties.