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2002-2003

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

INTERNATIONAL TAX AGREEMENTS AMENDMENT BILL 2003

EXPLANATORY MEMORANDUM

(Circulated by authority of the
Treasurer, the Hon Peter Costello, MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
2003 United Kingdom convention	*Convention between the Government of Australia and the Government of United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*
2003 United Kingdom Notes	Exchange of Notes associated with the *Convention between the Government of Australia and the Government of United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains*
A Tax System Redesigned	Review of Business Taxation: *A Tax System Redesigned*
A$	Australian dollars
Agreements Act	*International Tax Agreements Act 1953*
ATO	Australian Taxation Office
Commissioner	Commissioner of Taxation
FBT	fringe benefits tax
GATS	General Agreement on Trade in Services
GDP	gross domestic product
GST	goods and services tax
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
Mexican agreement	*Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*

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Abbreviation	***Definition***
OECD	Organisation for Economic Co-operation and Development
OECD Model	OECD *Model Tax Convention on Income and on Capital*
tax treaty	includes double tax agreement and double tax convention
Treasury	The Commonwealth Department of the Treasury
UN Model	United Nations *Model Double Taxation Convention between Developed and Developing Countries*

General outline and financial impact

What will the bill do?

This bill will amend the Agreements Act to give the force of law in Australia to the following tax treaties:

- a *Convention between the Government of Australia and the Government of United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains* (2003 United Kingdom convention), and the associated Exchange of Notes (2003 United Kingdom notes); and

- an *Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and the Protocol thereto (Mexican agreement).

The 2003 United Kingdom convention is Australia's third comprehensive tax treaty with the United Kingdom. The existing agreement, which was concluded in 1967 and partially revised by an amending Protocol in 1980, is not well aligned with modern business practices, the respective tax systems and modern tax treaty practice. The new tax treaty will rectify this situation and serves to facilitate trade and investment between Australia and the United Kingdom.

The Mexican agreement will expand trade and investment links between Australia and Mexico by preventing double taxation and reducing tax avoidance and evasion in respect of all forms of income flows between the two countries.

This bill will also clarify within the Agreements Act that references in Australian tax treaties to income from shares, or to income from other rights participating in profits, shall not be taken to include a return on a debt interest.

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This bill will also make consequential amendments to:

- the ITAA 1936 to substitute a new paragraph (a) into the definition for 'relevant provision' under subsection 170(14) to ensure that the definition remains current; and
- the *Taxation (Interest on Overpayments and Early Payments) Act 1983* to update cross-references to the Agreements Act.

How do tax treaties work?

Tax treaties allocate to the country of source, sometimes at limited rates, a taxing right over certain income, profits or gains derived by residents of the treaty partner country. It is accepted that both countries possess the right to tax the income of their own residents under their own domestic laws and as such, the tax treaty wording will not always explicitly restate this rule.

However, where the country of residence is to be given the sole taxing right over particular categories of income, profits or gains, this sole right is usually represented by the words *shall be taxable only in that country*. Tax treaties generally also provide that where income, profits or gains *may be taxed* in both countries, the country of residence (if it taxes) is to allow double tax relief against its own tax for the tax imposed by the country of source. In the case of Australia, effect is given to the relief obligations arising under the tax treaty by application of the general foreign tax credit system provisions of Australia's domestic law, or relevant exemption provisions of the law where applicable.

What is the purpose of Australia's tax treaties?

Australia's tax treaties are primarily concerned with relieving juridical double taxation, which can be described broadly as subjecting the same income of a taxpayer to comparable taxes under the taxation laws of two different countries.

Relief from double taxation is desirable because of the harmful effects that double taxation can have on the expansion of trade and the movement of capital, technology and people between countries. A tax treaty supplements the unilateral double tax relief provisions in the respective treaty partner countries' domestic law and clarifies the taxation position of income flows between the parties.

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Australia's tax treaties are designed to:

- avoid double taxation and provide a level of security about the tax rules that will apply to particular international transactions by:
  - allocating taxing rights between the countries over different categories of income;
  - specifying rules to resolve dual claims in relation to the residential status of a taxpayer and the source of income; and
  - providing a taxpayer with an avenue to present a case for determination by the relevant taxation authorities where the taxpayer considers there has been taxation treatment contrary to the terms of a tax treaty; and
- prevent avoidance and evasion of taxes on various forms of income flows between the treaty partners by:
  - providing for the allocation of profits between related parties on an *arm's length* basis;
  - generally preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices; and
  - providing for exchanges of information between the respective taxation authorities.

Who will be affected by the measures in this bill?

Persons who:

- are residents of Australia or the United Kingdom for the purposes of the 2003 United Kingdom convention and who derive income, profits or gains from the United Kingdom or Australia;
- are residents of Australia or Mexico for the purposes of the Mexican agreement and who derive income, profits or gains from Mexico or Australia; or

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- residents of a treaty partner country who derive certain amounts treated as returns on debt-interests under Australia's debt/equity rules.

How is the legislation structured?

The Agreements Act gives the force of law in Australia to Australia's tax treaties which appear as Schedules to that Act. The provisions of the ITAA 1936, the ITAA 1997 and the *Fringe Benefits Tax Assessment Act 1986* are incorporated into and read as one with the Agreements Act. The provisions of the Agreements Act (including the terms of the tax treaties) take precedence over provisions of the:

- ITAA 1936 (other than section 160AO which determines maximum foreign tax credits and the general anti-avoidance rules under Part IVA);
- ITAA 1997; and
- *Fringe Benefits Tax Assessment Act 1986* (other than section 67 which is an anti-avoidance rule).

In what way does this bill change the Agreements Act?

This bill will make changes to the Agreements Act by:

- repealing the following definitions in subsection 3(1):
  - United Kingdom tax ***[Schedule 1, item 6]***;
  - the United Kingdom ***[Schedule 1, item 3]***;
  - the United Kingdom agreement ***[Schedule 1, item 4]***;
  - the United Kingdom protocol ***[Schedule 1, item 5]***; and
  - the previous United Kingdom agreement ***[Schedule 1, item 2]***;
- inserting the following new definitions into subsection 3(1):
  - the 1946 United Kingdom agreement ***[Schedule 1, item 7]***;

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- the 1967 United Kingdom agreement ***[Schedule 1, item 8]***;
- the 1980 Protocol to the 1967 United Kingdom agreement ***[Schedule 1, item 9]***;
- the 2003 United Kingdom convention ***[Schedule 1, item 10]***;
- the 2003 United Kingdom notes ***[Schedule 1, item 11]***; and
- the Mexican agreement ***[Schedule 2, item 1]***;

- repealing paragraph (b) under the defined term 'agreement' in subsection 3(1) and substituting paragraphs (b), (ba) and (bb) in its place ***[Schedule 1, item 1]***;
- repealing Schedules 1 and 1A and inserting the text of:
  - the 2003 United Kingdom convention (including the text of the 2003 United Kingdom notes) as Schedule 1 ***[Schedule 1, item 14]***; and
  - the Mexican agreement (and Protocol) as Schedule 47 ***[Schedule 2, item 3]***;
- repealing sections 5 and 5A and substituting new sections 5 and 5A that ***[Schedule 1, item 12]***;
  - provide for the entry into force of the provisions of the 2003 United Kingdom convention according to their tenor; and
  - preserve the operation of the 1946 United Kingdom agreement, the 1967 United Kingdom agreement, and the 1980 Protocol to the 1967 United Kingdom agreement so far as the provisions that affect Australian tax continue to have the force of law in relation to tax in respect of income in relation to which the treaties remain effective;
- inserting a new section 11ZL to provide for the entry into force of the provisions of the Mexican agreement and protocol according to their tenor ***[Schedule 2, item 2]***;
- repealing section 17B ***[Schedule 1, item 13]***; and

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- inserting a new subsection (2A) after subsection 3(2) clarifying that any reference in Australian tax treaties to income from shares, or to income from other rights participating in profits, does not include a reference to a return on debt interest ***[Schedule 3, item 3]***.

This bill will also make consequential amendments to:

- subsection 170(14) of the ITAA 1936 to:
  - substitute a replacement paragraph (a) that does not reference any specific tax treaty into the definition of 'relevant provision' (the existing paragraph (a) of the definition references paragraph 3 of Article 5 and paragraph 1 of Article 7 of the 1967 United Kingdom agreement) ***[Schedule 3, item 1]***; and
  - repeal the definition of the United Kingdom agreement ***[Schedule 3, item 2]***; and
- update references to the Agreements Act that occur within subsection 3(1) of the *Taxation (Interest on Overpayments and Early Payments) Act 1983* ***[Schedule 3, items 4 and 5]***.

When will these changes take place?

The 2003 United Kingdom convention will enter into force on the last of the dates on which the treaty partners exchange notes through the diplomatic channel advising each other that all domestic requirements necessary to give the tax treaty the force of law in the respective countries have been completed.

The Mexican agreement will enter into force on the last of the dates on which the treaty partners exchange notes through the diplomatic channel advising each other that all domestic requirements necessary to give the Agreement the force of law in the respective countries have been completed.

The other amendments effected by this bill will commence on the day on which this bill receives Royal Assent.

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When the treaties enter into force, from what date will they have effect?

The 2003 United Kingdom convention will have effect:

***In Australia*:**

- for withholding taxes on income derived:
  - on or after 1 July next following the date on which the tax treaty enters into force;
- in respect of fringe benefits provided:
  - on or after 1 April next following the date on which the tax treaty enters into force; and
- for other Australian taxes on income or gains:
  - the Australian year of income beginning on or after 1 July next following the date on which the tax treaty enters into force.

***In the United Kingdom*:**

- for taxes withheld at source for amounts paid or credited:
  - on or after 1 July next following the date on which the tax treaty enters into force;
- in relation to capital gains tax and income tax (excluding taxes withheld at source for which the date of effect is 1 July next following the date on which the tax treaty enters into force):
  - for any United Kingdom year of assessment commencing on or after 6 April next following the date on which the tax treaty enters into force; and
- in relation to the corporation tax:
  - for any financial year commencing on or after 1 April next following the date on which the tax treaty enters into force.

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The Mexican agreement will have effect:

***In Australia*:**

- for withholding taxes for amounts paid or credited:
  - on or after the first day of the second month next following the date on which the agreement enters into force if the tax treaty enters into force prior to 1 July of that year; or
  - on 1 January of the year following the year in which the tax treaty enters into force in other cases; and
- for other Australian taxes, in relation to income, profits or gains:
  - any year of income beginning on or after 1 July in the calendar year next following that in which the tax treaty enters into force.

***In Mexico*:**

- for withholding taxes for amounts paid or credited:
  - on or after the first day of the second month next following the date on which the tax treaty enters into force if the agreement enters into force prior to 1 July of that year; or
  - on 1 January of the year following the year in which the tax treaty enters into force in other cases; and
- for other Mexican taxes:
  - on or after 1 July in the calendar year next following that in which this tax treaty enters into force.

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The financial impact of this bill

The 2003 United Kingdom convention

The direct cost to revenue from the proposed tax treaty is estimated to be approximately A$100 million per annum. The estimated distribution of this first round cost in future years is shown in the table below:

2003-2004	*2004-2005*	*2005-2006*	*2006-2007*	*2007-2008*
0	-A$90 million	-A$90 million	-A$100 million	-A$100 million

Treasury has estimated that the cost to revenue will be partially offset by a number of second round gains from implementation of the new treaty. There is an expected increase in revenue of around A$70 million per annum as a result of the boost to economic activity sourced in the proposed treaty's downward pressure on interest rates. Other offsets include a reduction in Australian tax credits claimed for United Kingdom withholding taxes (perhaps A$5 million – A$10 million per annum), an increase in GDP as a result of the more efficient allocation of resources flowing from a reduction in pricing distortions, and a small increase in Australia's growth rate as a result of the more open and competitive environment encouraged by the new treaty. Overall, it is anticipated that the new treaty will produce a positive economic outcome for Australia.

The Mexican agreement

The Mexican agreement contained in this bill generally accords with Australia's other modern comprehensive tax treaties and is not expected to have a significant effect on revenue. Although the cost of this measure cannot be precisely defined, it is expected to be approximately A$2 million per annum over the forward estimate period. That is:

2003-2004	*2004-2005*	*2005-2006*	*2006-2007*	*2007-2008*
-A$2 million	-A$2 million	-A$2 million	-A$2 million	-A$2 million

The benefits are widely spread in the economy. Indirect revenue benefits may arise from increased trade and investment between Australia and Mexico and reduced tax credit obligations to Mexico.

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Compliance costs

No significant compliance costs will result from the entry into force of the respective tax treaties and legislative changes.

Summary of regulation impact statements

The 2003 United Kingdom convention

Impact: High.

Main points:

- The United Kingdom tax treaty is expected to have an impact on Australian residents doing business with the United Kingdom and includes Australian investors, banks, suppliers of technology, consultants, exporters, Australian employees working in the United Kingdom, and Australian residents receiving pensions from the United Kingdom. The treaty will also impact on the Australian Government and the ATO.

- While source country tax on interest will continue to be limited to 10%, there will be no withholding tax charged on interest derived by a financial institution resident in the other country, or on interest derived by a government body of the other country. No tax is payable on dividends in the source country where the dividend recipient is a company that holds directly at least 80% of the voting power of the company paying the dividend, subject to certain conditions. A 5% rate limit applies to other dividends where the dividend recipient is a company that holds directly at least 10% of the voting power of the company paying the dividend. A 15% limitation applies to other dividends. These limits apply to both franked and unfranked dividends. The general limit for royalties will be reduced from 10% to 5%.

- Article 13 (*Alienation of property*) preserves Australia's source country taxing rights over capital gains. The Article also addresses widespread business concerns about the potential for double taxation arising from the application of Australia's capital gains tax to expatriates departing Australia.

- The revised tax treaty will assist the bilateral relationship by updating an important treaty in the network of commercial treaties between the countries and provides for greater cooperation between tax authorities to prevent fiscal evasion and tax avoidance.

- The direct annual cost to revenue of the proposed treaty is estimated to be around A$100 million, which is likely to be offset by estimated second round revenue gains from increased investment, GDP, and growth. No material costs to taxpayers have been identified as likely to arise from the proposed treaty but there is likely to be a small, unquantifiable administration cost. It is expected that overall, the new treaty will produce a positive economic outcome for Australia.

The Mexican agreement

Impact: Low.

Main points:

- The Mexican agreement is likely to have an impact on Australian residents with business, investment or employment interests in Mexico.

- Dividends, interest and royalties may generally be taxed in both countries, but there are limits on the tax that the country in which the dividend, interest or royalty is sourced may charge on such income flowing to residents of the other country who are beneficially entitled to that income. These limits are 10% for royalties and 10% or 15% for interest depending on the nature of the interest. No tax is payable on dividends which have been fully taxed at the corporate level and where the dividend recipient is a company that holds directly at least 10% of the voting power of the company paying the dividend. A 15% limitation applies to other dividends.

- Article 13 (*Alienation of property*) covers real property owned through corporate or other entities. A provision will also help to avoid double taxation when a resident of one of the countries departs to become a resident of the other.

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- The Mexican agreement will also assist in making clear the taxation arrangements for pensions and annuities and for individual Australians working in Mexico, either independently as consultants, or as employees.

The Mexican agreement will also assist the bilateral relationship by adding to the existing network of commercial treaties between the two countries.

Chapter 1
The 2003 United Kingdom convention

What is the 2003 United Kingdom convention?

1.1 The 2003 United Kingdom convention is a Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains signed in Canberra on 21 August 2003 (referred to as 'tax treaty' or 'treaty' for the purposes of this chapter). An Exchange of Notes associated with this tax treaty was carried out at the time of signature of the treaty (referred to as 'Notes' for the purposes of this chapter).

1.2 Once in force, the tax treaty will replace:

- the *Agreement between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains* signed on 7 December 1967 (referred to as 'the existing treaty' for the purposes of this chapter); and

- the Protocol to the existing treaty as signed on 29 January 1980 (referred to as 'the 1980 protocol' or 'protocol' for the purposes of this chapter).

Why is the tax treaty necessary?

1.3 The new tax treaty and Notes are required to reflect modern business practice and changes to both countries' tax law and tax treaty practice since the existing treaty and its later amending protocol were negotiated.

1.4 In terms of comparison with the existing treaty, the new tax treaty will serve to facilitate trade and investment between Australia and the United Kingdom by:

- extending the coverage of the new treaty to Australian tax on capital gains and the Australian FBT;
- clarifying in light of the United Kingdom decision in *Padmore v Inland Revenue Commissioners* (1989) Simon's Tax Cases 493, that partnerships, other than Australian limited partnerships, are not persons covered by the treaty;
- providing residency rules for dual listed company arrangements;
- extending the coverage of Article 7 (*Business profits*) in the new treaty to:
  - business trusts; and
  - spectrum licence payments;
- taxing payments for leasing of industrial, commercial, or scientific equipment that are subject to royalty withholding tax on the gross amount under the existing treaty, on a net basis under the new treaty, as either business profits, or profits from international transport operations;
- specifying nil or 5% source country taxation for certain cross-border intercorporate dividends;
- exempting from source country taxation interest payments to government bodies and financial institutions;
- reducing the withholding tax rate on royalties from a maximum of 10% to 5% of the gross royalty payment;
- providing distributive rules for taxation of capital gains including providing for source country taxation where capital gains are not otherwise dealt with in the new treaty and dealing with capital gains derived by departing residents;
- clarifying the tax treatment of income or gains from employee share option schemes;

- providing that fringe benefits will only be taxable in the country which would have the primary taxing right if the benefit had been paid as ordinary employment income;
- including an *Other income* Article (Article 20) and a *Source of income* Article (Article 21);
- including Article 23 (*Limitation of relief*) that will ensure that double non-taxation will not arise where either the United Kingdom or Australia exempts certain income from residence country taxation;
- including Article 25 (*Non-discrimination*) that ensures that nationals of one country are generally subject to no less favourable tax treatment than nationals of that other country;
- modifying the *Exchange of information* Article (Article 27) to remove United Kingdom impediments to the exchange of relevant information; and
- updating all the Articles, having regard to Australian, United Kingdom and OECD tax treaty developments since the existing treaty was entered into and later revised in 1980.

Main features of the new tax treaty

1.5 The new tax treaty between Australia and the United Kingdom, and the Notes, accords with the directions in Australia's treaty policy announced by Government in Treasurer's Press Release No. 032 of 13 May 2003. The treaty and Notes include additional provisions on employee share option schemes, partnerships, dual listed companies and a *Non-discrimination* Article. The Notes contain a number of operative provisions which apply to the tax treaty, as well as an explanatory clause.

1.6 The main features of the tax treaty and the Notes are as follows:

- Dual resident persons (i.e. persons who are residents of both Australia and United Kingdom according to the domestic law of each country) are, in accordance with specified criteria, to be treated for the purposes of the tax treaty as being residents of only one country. Where a non-individual such as a company is resident in both countries for their domestic tax purposes, the entity will be deemed to be a resident of the country in which its place of effective management is

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situated. A special provision has been included to deem a participant in a 'dual listed company arrangement' to be resident only in the country of incorporation, provided that the participant has its primary stock exchange listing in the same country ***[Article 4, paragraphs 3 to 5]***.

- Income from real property may be taxed in full by the country in which the property is situated. Income from real property for these purposes includes natural resource royalties ***[Article 6]***.
- Business profits (including income derived from professional services or other activities of an independent nature) are generally to be taxed only in the country of residence of the recipient unless they are derived by a resident of one country through a branch or other prescribed permanent establishment in the other country, in which case that other country may tax the profits. These rules also apply to:
  - business trusts; and
  - payments for spectrum licences.

[Article 7; Exchange of Notes, Item 7(a)]

- Profits from the operations of ships and aircraft are generally to be taxed only in the country of residence of the operator ***[Article 8]***.
- Profits of associated enterprises may be taxed on the basis of dealings at arm's length ***[Article 9]***.
- Dividends, interest and royalties may generally be taxed in both countries, but there are limits on the tax that the country in which the dividend, interest, or royalty is sourced may charge, on such income flowing to residents of the other country who are the beneficial owners of the income ***[Articles 10 to 12]***.
- In the case of dividends:
  - no source country tax is payable on intercorporate dividends where the dividend recipient is a company that holds directly at least 80% of the voting power of the company paying the dividend, subject to certain conditions ***[Article 10, paragraph 3]***;

- a 5% rate limit applies to other intercorporate dividends where the dividend recipient is a company that holds directly at least 10% of the voting power of the company paying the dividend ***[Article 10, subparagraph 2(a)]***; and

- a 15% limitation applies to all other dividends ***[Article 10, subparagraph 2(b)].***

- The dividend rate limits apply to both franked and unfranked dividends.

- Source country taxation on interest is limited to 10% ***[Article 11, paragraph 2].*** However, exemptions from source country taxation have been provided for interest paid to:

  - certain government bodies ***[Article 11, subparagraph 3(a)]***; and

  - financial institutions ***[Article 11, subparagraph 3(b)].***

- The rate limit on source country taxation of royalties is 5% ***[Article 12, paragraph 2].***

- Income or gains from the alienation of real property may be taxed in full by the country in which the property is situated. Subject to that rule and other specific rules in relation to business assets and some shares, capital gains remain taxable in accordance with the domestic law of each country. A specific provision deals with the alienation of property by departing residents ***[Article 13].***

- Income from employment, that is, employee's remuneration, will generally be taxable in the country where the services are performed. However, where the services are performed during certain short visits to one country by a resident of the other country, the income will be exempt in the country visited ***[Article 14].*** The same principles apply to:

  - the taxation of directors' remuneration;

  - teaching income derived by visiting professors or teachers, (although transitional arrangements allow such professors or teachers to continue to access the special rules that applied under the existing treaty) ***[Article 29, paragraph 3]***; and

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   – certain income or gains derived by employees from share option schemes ***[Exchange of Notes, Item 8].***

- Fringe benefits that would otherwise be subject to tax in both countries, will be taxable only in the country which would have the primary taxing right if the benefit had been paid as ordinary employment income ***[Article 15].***

- Income derived by entertainers and sportspersons may be taxed by the country in which the activities are performed ***[Article 16].***

- Pensions and annuities (including for public service) may be taxed only in the country of residence of the recipient ***[Article 17].***

- Income from government service will generally be taxed only in the country that pays the remuneration. However, the remuneration may be taxed in the other country in certain circumstances where the services are rendered in that other country by a resident of that other country ***[Article 18].***

- Payments made from abroad to visiting students for the purposes of their maintenance or education will be exempt from tax in the country visited ***[Article 19].***

- Other income (i.e. income not dealt with by other Articles) may generally be taxed in both countries, with the country of residence of the recipient providing double tax relief ***[Article 20].***

- Source rules are prescribed in the new treaty to the effect that income or gains derived by a resident of the United Kingdom which, under provisions of the treaty, may be taxed in Australia, shall be treated as having an Australian source for Australian tax law purposes ***[Article 21].***

- Double taxation relief for income which, under the tax treaty, may be taxed by both countries, is required to be provided by the country of which the taxpayer is a resident under the terms of the tax treaty as follows:

   – in Australia, by allowing a credit for the United Kingdom tax against Australian tax payable on

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income derived by a resident of Australia from sources in the United Kingdom ***[Article 22, subparagraph 1(a)]***;

- in the United Kingdom, by allowing a credit against United Kingdom tax for the Australian tax paid on income or chargeable gains derived by a resident of the United Kingdom from sources in Australia ***[Article 22, subparagraph 2(a)]***; and
- both Australia and the United Kingdom are required to give credit for underlying taxes on incoming non-portfolio intercorporate dividends should they tax such dividends ***[Article 22, subparagraphs 1(b) and 2(b)].***

- In the case of Australia, effect will be given to the double tax relief obligations arising under the tax treaty by application of the general foreign tax credit provisions of Australia's domestic law, or the relevant exemption provisions of that law where applicable.
- Limitations on the benefits that a country is obliged to provide, apply where income or gains are taxed in the other country on a remittance basis or where income or gains of temporary residents are exempted from tax ***[Article 23].***
- Partnerships (other than Australian limited partnerships) are not persons covered by the treaty and neither country is prevented from taxing their resident partners on the partners' share of income or gains ***[Article 3, subparagraph 1(f) and paragraph 2; Article 24].***
- A *Non-discrimination* Article has been included that protects nationals from tax discrimination in the other country and gives them private rights of appeal. However, the Article does not preclude either country from applying its anti-avoidance rules (including thin capitalisation measures), research and development concessions, consolidation rules or capital gains deferral rules ***[Article 25; Exchange of Notes, Items 1(d) and 9].***

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- Consultation and exchange of information between the two taxation authorities is authorised by the tax treaty. The treaty clarifies that information can be exchanged in relation to relevant transactions or chargeable periods, which predate the date that the treaty entered into force ***[Articles 26 and 27; Exchange of Notes, Item 10]***.

1.7 To ensure that the treaty continues to serve its purpose and remains aligned with current practice, the Governments of Australia and the United Kingdom have committed to consult at regular intervals of not more than five years regarding the treaty's terms, operation and application. ***[Exchange of Notes, Item 12]***

Article 1 – Persons covered

Scope

1.8 This Article establishes the scope of the application of the tax treaty by providing for it to apply to persons (defined to include individuals, companies and any other body of persons but generally not including a partnership other than an Australian limited partnership) who are residents of one or both of the countries. It generally precludes extra-territorial application of the treaty.

1.9 The application of the tax treaty to persons who are dual residents (i.e. residents of both countries) is dealt with in Article 4 (*Residence*).

Article 2 – Taxes covered

Taxes covered

1.10 This Article specifies the existing taxes of each country to which the tax treaty applies. These are, in the case of Australia:

- the Australian income tax (including that imposed on capital gains);

- the resource rent tax in respect of offshore petroleum projects; and

- the FBT.

1.11 The new treaty extends the operation of the treaty to Australian tax on capital gains, which are not covered in the existing treaty. Its operation is also extended to cover Australia's FBT. Australia's tax treaty with New Zealand is the only other tax treaty at this time that covers Australian FBT. ***[Article 2, subparagraph 1(b)]***

1.12 Although Australia considers the resource rent tax to be encompassed by the term 'Australian income tax', a specific reference to this has been included in the tax treaty to put beyond doubt that it is a tax covered. ***[Article 2, subparagraph 1(b)]***

1.13 As with the existing treaty, the new treaty does not cover Australia's GST, wool tax and levies, customs duties, State taxes and duties and estate tax and duties.

1.14 It is specifically stated in both paragraphs of this Article that the tax treaty applies only to taxes imposed under the federal law of Australia. This is to ensure that the tax treaty does not bind Australian States and Territories and applies only to federal taxes. ***[Article 2, subparagraph 1(b) and paragraph 2]***

1.15 For the United Kingdom, the tax treaty applies to:

- the income tax;
- the corporation tax; and
- the capital gains tax.

[Article 2, subparagraph 1(a)]

1.16 The United Kingdom surtax that is included in the taxes covered by the existing treaty was abolished in 1973 and therefore has not been retained as a tax covered under the new tax treaty.

Identical or substantially similar taxes

1.17 The application of the tax treaty will be automatically extended to any identical or substantially similar taxes which are subsequently imposed by either country in addition to, or in place of, the existing taxes. The competent authorities (i.e. the Commissioner in Australia and the Commissioners of Inland Revenue in the United Kingdom, or their authorised representatives) are required to notify each other in the event of a significant change in the taxation law of the respective countries, within a reasonable period of time after those changes. ***[Article 2, paragraph 2]***

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Article 3 – General definitions

Definition of Australia

1.18 As with Australia's other modern tax treaties, ***Australia*** is defined to include certain external territories and areas of the continental shelf. By reason of this definition, Australia preserves its taxing rights, for example, over mineral exploration and mining activities carried on by non-residents on the seabed and subsoil of the relevant continental shelf areas (under section 6AA of the ITAA 1936, certain sea installations and offshore areas are to be treated as part of Australia). The definition is also relevant to the taxation by Australia and the United Kingdom of shipping profits in accordance with Article 8 (*Shipping and air transport*) of the tax treaty. ***[Article 3, subparagraph 1(b)]***

Definition of United Kingdom

1.19 The definition remains unchanged from that in the existing treaty. The defined term ***United Kingdom*** covers Great Britain and Northern Ireland (including areas of the continental shelf). As United Kingdom domestic law excludes British possessions (e.g. the Channel Islands of Alderney, Guernsey, Jersey and Sark, and the Isle of Man) from the domestic law definition of Great Britain and Northern Ireland, such possessions are implicitly also excluded from the definition of United Kingdom for treaty purposes. ***[Article 3, subparagraph 1(a)]***

Definition of person

1.20 The definition of ***person*** includes individuals, companies and any other body of persons. This would normally include a partnership (as a body of persons). However, the treaty with the United Kingdom specifically excludes partnerships, other than limited liability partnerships, from the definition of person. ***[Article 3, subparagraph 1(f)]***

1.21 The exclusion of partnerships, other than limited liability partnerships, from the definition of person is aimed at removing any difficulties that might exist as a result of the decision of the United Kingdom courts in *Padmore v Inland Revenue Commissioners* (1989) Simon's Tax Cases 493. The treaty ensures that, as a partnership is not a person for treaty purposes, the partnership cannot be a resident of either country. Accordingly, such a partnership cannot be an 'enterprise of a Contracting State' or an 'enterprise of the other Contracting State'. However, the treaty will apply to the partners of such a partnership. The partners in a partnership, other than a limited liability partnership, may, to the extent they are persons and residents of a country, constitute an 'enterprise of a Contracting State' and may be taxed on their share of the partnership profits in accordance with the terms of the treaty.

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1.22 Under Australian law, a general law partnership is treated as a resident of Australia for the purpose of calculating the partner's share of partnership income but is not itself a taxable unit. Accordingly, the partnership (as distinct from the partners) is not considered to be a resident of Australia for the purposes of Australian tax. It follows that, even without the specific exclusion of partnerships from the definition of person, a partnership would not be regarded as a resident of Australia for treaty purposes.

1.23 A limited liability partnership is treated as a company for Australian tax purposes where it is a resident of Australia. A limited liability partnership is a resident of Australia where it carries on business in Australia. As a taxable unit, a limited liability partnership will continue to be a 'person', a resident and an 'enterprise of a Contracting State' for the purposes of the treaty. ***[Article 3, paragraph 2]***

Definition of company

1.24 The definition of company in the tax treaty accords with Australia's tax treaty practice.

1.25 The Australian tax law treats certain trusts (public unit trusts and public trading trusts) and corporate limited partnerships (limited liability partnerships) as companies for income tax purposes. These trusts and partnerships are included as companies for the purposes of the tax treaty. ***[Article 3, subparagraph 1(g)]***

Definition of international traffic

1.26 In this tax treaty, this term is of relevance for taxation of profits from shipping and air transport operations (Article 8 (*Shipping and air transport*)), income or gains from the alienation of ships and aircraft (paragraph 4 of Article 13 (*Alienation of property*)) and wages of crew (paragraph 3 of Article 14 (*Income from employment*)).

1.27 ***International traffic***, as defined, covers international transport by a ship or aircraft operated by an enterprise of one country, as well as domestic transport within that country. However, it does not include transport where the ship or aircraft is operated solely between places in the other country, that is, where the place of departure and the place of arrival of the ship or aircraft are both in that other country, irrespective of whether any part of the transport takes place outside that country. For example, a 'voyage to nowhere' which begins and ends in Sydney on a ship operated by a United Kingdom enterprise would not come within the definition of international traffic, even if the ship travels through international waters in the course of the cruise. ***[Article 3, subparagraph 1(j)]***

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Definition of tax

1.28 For the purposes of the tax treaty, the term ***tax*** does not include any amount of penalty or interest imposed under the respective domestic tax law of the two countries. This is important in determining a taxpayer's entitlement to a foreign tax credit under the double tax relief provisions of Article 22 (*Elimination of double taxation*) of the tax treaty.

1.29 In the case of a resident of Australia, any penalty or interest component of a liability determined under the domestic taxation law of the United Kingdom with respect to income that the United Kingdom is entitled to tax under the tax treaty, would not be a creditable 'United Kingdom tax' for the purposes of paragraph 1 of Article 22 (*Elimination of double taxation*). This is in keeping with the meaning of 'foreign tax' in subsection 6AB(2) of the ITAA 1936. Accordingly, such a penalty or interest liability would be excluded from calculations when determining the Australian resident taxpayer's foreign tax credit entitlement under paragraph 1 of Article 22 (pursuant to Division 18 of Part III of the ITAA 1936 – Credits in respect of Foreign Tax). ***[Article 3, subparagraph 1(n)]***

Clarification of other terms and phrases

1.30 Item 1 of the Notes clarifies the meaning of certain terms used in the treaty.

1.31 Australia and the United Kingdom agreed that for the purposes of applying the treaty, the terms (or phrases):

- ***income or gains*** includes profits;
- ***laws*** includes the full body of law (e.g. the common or general law) and is not limited to statutory law provisions; ***[Exchange of Notes, Items 1(a) and (b)]***;
- ***paid or credited*** and ***payments or credits*** do not include the recording of any internal transactions between a permanent establishment and another part of the same enterprise. This is consistent with Australia's reservation to Article 7 (*Business profits*) of the OECD Model that Australia does not recognise intra-entity transfers for tax purposes ***[Exchange of Notes, Item 1(c)]***; and

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- ***any provision of the laws of a Contracting State which is designed to prevent the avoidance or evasion of taxes*** is taken to include:
  - measures designed to address thin capitalisation, dividend stripping and transfer pricing;
  - controlled foreign company, transferor trust and foreign investment fund rules; and,
  - measures designed to ensure that taxes can be effectively recovered.

[Exchange of Notes, Item 1(d)]

Terms not specifically defined

1.32 Where a term is not specifically defined within this tax treaty, or clarified in the Notes, that term (unless used in a context that requires otherwise) is to be taken to have the same interpretative meaning as it has under the domestic taxation law of the country applying the tax treaty at the time of its application, with the meaning it has under the taxation law of the country having precedence over the meaning it may have under other domestic laws.

1.33 It is recognised by both Australia and the United Kingdom that the same term may have a differing meaning and a varied scope within different Acts relating to specific taxation measures. For example, GST definitions are sometimes broader than income tax definitions. The definition more specific to the type of tax should be applied in such cases. For example, where the matter subject to interpretation is an income tax matter, but definitions exist in either the ITAA 1936 or the ITAA 1997 and the *A New Tax System (Goods and Services Tax) Act 1999*, the income tax definition would be the relevant definition to be applied.

1.34 If a term is not defined in the tax treaty, but has an internationally understood meaning in tax treaties and a meaning under the domestic law, the context would normally require that the international meaning be applied. ***[Article 3, paragraph 2]***

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Article 4 – Residence

Residential status

1.35 This Article sets out the basis by which the residential status of a person is to be determined for the purposes of the tax treaty. Residential status is one of the criteria for determining each country's taxing rights and is a necessary condition for the provision of relief under the tax treaty. The concept of who is a resident according to each country's taxation law provides the basic test. ***[Article 4, paragraph 1]***

Residency of Governments

1.36 The Article specifically provides that a country, a political subdivision or a local authority of the country are residents for the purposes of the treaty. This means that the Federal Government, the State Governments and local councils will be residents for the purpose of the treaty. This does not necessarily mean that income, profits or gains derived by these bodies from sources in the United Kingdom will be subject to tax in the United Kingdom as sovereign immunity principles may apply. ***[Article 4, paragraph 1]***

1.37 The OECD Model commentary makes it clear that it has always been the understanding of member countries that the OECD Model applied to treat governments as residents even in the absence of an express reference to that effect.

1.38 The formulation for paragraph 1 (which incorporates the residency rules of the tax laws of each country) ensures that, even in the absence of a specific inclusion, Australian governments and tax-exempt entities are treated as residents for the purposes of the Agreement. This is because a government or tax-exempt entity is a resident of Australia for tax law purposes – even though it may be exempt from tax.

Special residency rules

1.39 Paragraph 2 specifies that a person is not a resident of a country (for purposes of the tax treaty) if that person is liable to tax in that State in respect only of income from sources in that State. This paragraph deals with a person who may be considered to be a resident of a State according to its domestic laws but is only subject to taxation on income from sources in that State, for example, foreign diplomatic and consular staff. In the Australian context, this means that Norfolk Island residents who are generally subject to Australian tax on Australian source income only, will not be residents of Australia for the purposes of the tax treaty.

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Accordingly, the United Kingdom will not have to forgo tax in accordance with the tax treaty on income derived by residents of Norfolk Island from sources in the United Kingdom (which will not be subject to Australian tax). ***[Article 4, paragraph 2]***

Dual residents

1.40 This Article also includes a set of *tie-breaker* rules for determining how residency is to be allocated to one or other of the countries for the purposes of the tax treaty if a taxpayer, whether an individual, a company or other taxable unit, qualifies as a dual resident, that is, as a resident under the domestic law of both countries.

1.41 The tie-breaker rules for individuals apply certain tests, in a descending hierarchy, for determining the residential status (for the purposes of the tax treaty) of an individual who is a resident of both countries under their respective domestic laws.

1.42 These rules, in order of application, are:

- If the individual has a permanent home in only one of the countries, the person is deemed to be a resident solely of that country for the purposes of the tax treaty.
- If the individual has a permanent home available in both countries or in neither, then the person's residential status takes into account the person's personal or economic relations with Australia and the United Kingdom, and the person is deemed for the purposes of the tax treaty to be a resident only of the country with which the person has the closer personal and economic relations.
- Residency will be determined on the basis of an individual's citizenship or nationality where the foregoing test is not determinative.
- If the individual is a national (as defined) of both countries or of neither, the competent authority will endeavour to resolve the question by mutual agreement.

[Article 4, paragraph 3]

1.43 Dual residents remain, however, in relation to Australia, a resident for the purposes of Australian domestic law, and liable to tax as such in Australia, insofar as the tax treaty allows.

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1.44 Where a non-individual (such as a body corporate) is a resident of both countries for their domestic tax purposes, the entity will be deemed to be a resident of the country in which its place of effective management is situated. ***[Article 4, paragraph 4]***

Dual listed companies

1.45 Special rules are included in the treaty to deal with public companies where two such companies enter into a *dual listed company arrangement*. Where, as a consequence of entering into such an arrangement, a company becomes a dual resident then it will be deemed to be resident in the State in which the company is incorporated and has its primary stock exchange listing. ***[Article 4, paragraph 5]***

1.46 The term ***dual listed company arrangement*** is defined exhaustively to refer to an arrangement consisting of two public companies which, while retaining their status as separate legal entities, seek to broadly operate as one company. While the companies retain separate shareholdings and stock exchange listings the arrangement provides for alignment of the strategic directions of the two companies involved and the economic interests of their respective shareholders. The treaty sets out various, cumulative criteria by which such an arrangement may be identified.

1.47 The criteria are:

- common (or almost identical) boards of directors for both companies;
- unified management;
- provision for the payment of equalised distributions as determined by an equalisation ratio (though this ratio may change over time) and applying to distributions on winding up of either company to this contractual arrangement;
- voting in effect as a single electorate on substantial issues; and
- cross-guarantees or similar financial arrangements to support each company's material ongoing financial obligations under the dual listing arrangement.

The final criterion does not apply to dual listed company arrangements where the companies which are a party to the arrangement are prevented from providing such guarantees or financial support under a regulatory

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framework applicable to one or both companies, for example, if providing such cross-guarantees would breach the Australian Prudential Regulation Authority's capital adequacy standards for approved deposit institutions. This definition closely aligns with that used in subsection 125-60(4) of the ITAA 1997. ***[Article 4, paragraph 6]***

Article 5 – Permanent establishment

Role and definition

1.48 The application of various provisions of the tax treaty (principally Article 7 (*Business profits*)) is dependent upon whether a person who is a resident of one country carries on business through a permanent establishment in the other country, and if so, whether income derived by that person is attributable to, or assets of that person are effectively connected with, that permanent establishment.

1.49 The definition of the term ***permanent establishment*** in this Article corresponds generally with definitions of the term in Australia's more recent tax treaties. The term also fully encompasses the concept of 'fixed base', which is used in the existing treaty in a separate Article dealing with independent personal services. As such services will now be dealt with under Article 7 (*Business profits*), it is intended that places that constitute a *fixed base* for purposes of the existing treaty would come within the meaning of permanent establishment for purposes of the new treaty. ***[Exchange of Notes, Item 2]***

Meaning of permanent establishment

1.50 The primary meaning of ***permanent establishment*** is expressed as being a fixed place of business through which the business of an enterprise is wholly or partly carried on. To be a permanent establishment within the primary meaning of that term, the following requirements must be met:

- there must be a place of business;
- the place of business must be fixed (both in terms of physical location and in terms of time); and
- the business of the enterprise must be carried on through this fixed place.

[Article 5, paragraph 1]

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1.51 Other paragraphs of this Article elaborate on the meaning of the term by giving examples (by no means intended to be exhaustive) of what may constitute a permanent establishment – for example:

- an office;
- a factory; or
- an agricultural property.

1.52 Consistent with Australia's modern treaty practice, the definition also extends to places relating to the exploitation of and exploration for natural resources.

1.53 As paragraph 2 of this Article is subordinate to paragraph 1 of this Article, the examples listed will only constitute a permanent establishment if the primary definition in paragraph 1 is satisfied.
[Article 5, paragraph 2]

Agricultural, pastoral or forestry activities

1.54 Most of Australia's tax treaties include as a permanent establishment an agricultural, pastoral or forestry property. This reflects Australia's policy of retaining taxing rights over exploitation of Australian land for the purposes of primary production. This approach ensures that the *arm's length* profits test provided for in Article 7 (*Business profits*) applies to the determination of profits derived from these activities. This position is also reflected in this tax treaty.
[Article 5, subparagraph 2(g)]

Deemed permanent establishment

Building site or construction or installation project

1.55 Under paragraph 3, an enterprise is deemed to have a permanent establishment and to be carrying on business through that permanent establishment in a country if it has a building site or construction or installation project in that country which exists for more than 12 months.
[Article 5, subparagraph 3(a)]

Supervisory and consultancy activities

1.56 Supervisory and consultancy activities carried on for more than 12 months in connection with a building site or a construction or installation project are deemed to constitute a permanent establishment. This provision broadly aligns with Australia's reservation to Article 5 (*Permanent establishment*) of the OECD Model.

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1.57 The term 'building site or construction or installation project' includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. Planning and supervision are considered part of the building site if carried out by the construction contractor. However, planning and supervision carried out by another unassociated enterprise will not be taken into account in determining whether the construction contractor has a permanent establishment in Australia. ***[Article 5, subparagraph 3(a)]***

Anti-avoidance provision

1.58 Given that this Article contains certain time frames, an anti-avoidance rule is included to ensure that where associated enterprises carry on connected activities the periods will be aggregated in determining whether the enterprises have a permanent establishment in the country in which the activities are being carried on. Activities will be regarded as connected where, for example, different stages of a single project are carried out by different subsidiaries within a group of companies.

1.59 This provision is an anti-avoidance measure aimed at counteracting contract splitting for the purposes of avoiding the application of the permanent establishment rules.

1.60 The treaty provides that an enterprise shall be deemed to be associated with another enterprise if one enterprise is controlled directly or indirectly by the other or if both are controlled directly or indirectly by a third person or persons. It also provides that a period of concurrent activities by such associated enterprises is only counted as one period for aggregation purposes. ***[Article 5, paragraph 4]***

Substantial equipment

1.61 Under subparagraph 3(b), an enterprise shall be deemed to have a permanent establishment if it has substantial equipment in a country for rental or other purposes for longer than 12 months, unless the equipment is leased under a 'hire-purchase' agreement. Under Australian law, the lessee under a 'hire-purchase' agreement (a lease accompanied by certain lessee purchase options or rights) is broadly treated for tax purposes as the owner of the leased property.

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1.62 This provision reflects Australia's reservation to the OECD Model concerning the use of substantial equipment and is designed to further protect Australia's right to tax income from natural resources. Australia's experience is that the permanent establishment provision in the OECD Model may be inadequate to deal with high value activities involved in the development of natural resources, particularly in offshore regions.

1.63 The meaning of the term 'substantial' depends on the relevant facts and circumstances of each individual case. However, some examples of substantial equipment would include:

- large industrial earthmoving equipment or construction equipment used in road building, dam building or powerhouse construction;
- manufacturing or processing equipment used in a factory;
- oil and drilling rigs, platforms and other structures used in the petroleum/mining industry; and
- grain harvesters and other large agricultural machinery.

1.64 For the purposes of the tax treaty the enterprise is deemed to carry on business through the substantial equipment permanent establishment. ***[Article 5, subparagraph 3(b)]***

Cost-toll operations

1.65 The inclusion of subparagraph 3(c) is consistent with another of Australia's reservations to the OECD Model. It deals with so-called 'cost-toll' situations, under which a mineral plant, for example, refines minerals at cost, so that the plant operations produce no Australian profits. Title to the refined product remains with the mining consortium and profits on sale are realised mainly outside of Australia.

1.66 Subparagraph 3(c) deems such a plant to be a permanent establishment because the manufacturing or processing activity (which gives the processed minerals their real value) is conducted in Australia, and therefore Australia should have taxing rights over the business profits arising from the sale of the processed minerals to the extent that they are attributable to the processing activity carried on in Australia. This subparagraph prevents an enterprise which carries on very substantial manufacturing or processing activities in a country through an intermediary from claiming that it does not have a permanent establishment in that country.

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1.67 The inclusion of this subparagraph is insisted upon by Australia in its tax treaties and is consistent with Australia's policy of retaining taxing rights over profits from the exploitation of its mineral resources. ***[Article 5, subparagraph 3(c)]***

Preparatory and auxiliary activities

1.68 Certain activities do not generally give rise to a permanent establishment (e.g. the use of facilities solely for storage, display or delivery).

1.69 Generally these activities are of a preparatory or auxiliary character and are unlikely to give rise to substantial profits. The necessary economic link between the activities of the enterprise and the country in which the activities are carried on does not exist in these circumstances.

1.70 Unlike the OECD Model, which provides that the listed activities are deemed not to constitute a permanent establishment, the tax treaty incorporates the Australian tax treaty approach of stating that an enterprise will not be deemed to have a permanent establishment *merely by reason of* such activities. This is to prevent the situation where enterprises structure their business so that most of their activities fall within the exceptions when – viewed as a whole – the activities ought to be regarded as a permanent establishment.

1.71 Another feature consistent with Australia's tax treaty practice is that subparagraph 4(f) of Article 5 (*Permanent establishment*) of the OECD Model – dealing with combinations of the activities of the kind referred to in subparagraphs 5(a) to 5(e) of this treaty – is not included. Australia does not consider that an enterprise undertaking multiple functions of the kind indicated in subparagraphs 5(a) to 5(e) could reasonably be regarded as only engaged in preparatory or auxiliary activities. ***[Article 5, paragraph 5]***

Dependent agents

1.72 Paragraph 6 reflects Australia's tax treaty practice in relation to a person who acts on behalf of an enterprise of another country of deeming that person to constitute a permanent establishment if that person has and habitually exercises an authority to conclude contracts on behalf of the enterprise.

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1.73 A person who substantially negotiates all essential parts of a contract on behalf of an enterprise will be regarded as exercising an authority to conclude contracts on behalf of that enterprise within the meaning of this provision, even if the contract is subject to final approval or formal signature by another person.

1.74 Consistent with the OECD Model and the United Kingdom's treaty practice, this paragraph excludes the excepted activities of paragraph 5 from the scope of dependent agency. Activities of a dependent agent will not give rise to a permanent establishment where that agent's activities are limited to the preparatory and auxiliary activities mentioned in paragraph 5. ***[Article 5, paragraph 6]***

Independent agents

1.75 Business carried on through an independent agent will not, of itself, give rise to a permanent establishment, provided that the independent agent is acting in the ordinary course of that agent's business as such an agent. ***[Article 5, paragraph 7]***

Subsidiary companies

1.76 Generally, a subsidiary company will not be a permanent establishment of its parent company. A subsidiary, being a separate legal entity, would not usually be carrying on the business of the parent company but rather its own business activities. However, a subsidiary company gives rise to a permanent establishment if the subsidiary permits the parent company to operate from its premises such that the tests in paragraph 1 of Article 5 are met, or acts as an agent such that a dependent agent permanent establishment is constituted. ***[Article 5, paragraph 8]***

Article 6 – Income from real property

Where income from real property is taxable

1.77 This Article provides that the income of a resident of one country from real property situated in the other country may be taxed by that other country. Thus, income from real property in Australia will be subject to Australian tax laws. ***[Article 6, paragraph 1]***

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Definition

1.78 Income from ***real property*** (which is primarily defined as having the meaning which it has under the domestic law of the country where the property is situated) also extends to income from the direct use, letting or use in any form of real property including:

- any other interest in or over land (including exploration and mining rights);
- property accessory to real property;
- livestock and equipment used in agriculture and forestry; and
- usufruct of real property (generally, a right to use property without degrading it and to retain any profits derived from it).

1.79 Royalties and other payments relating to the exploration for, or exploitation of mines or quarries or other natural resources, or rights in relation thereto are also covered by the Article. However, ships and aircraft are excluded from the definition of real property, so this Article does cover income from their use. ***[Article 6, paragraph 2]***

Deemed situs

1.80 Under Australian law the situation (situs) of an interest in land, such as a lease, is not necessarily where the underlying property is situated – there may not necessarily be a situs. This paragraph puts the situation of the interest or right beyond doubt by deeming the situs to be where the real property is situated or where any exploration may take place. ***[Article 6, paragraph 3]***

Real property of an enterprise

1.81 Paragraph 5 extends the application of this Article to income derived from the use or exploitation of real property of an enterprise.

1.82 Accordingly, this Article (when read with Article 7 (*Business profits*)) ensures that the country in which the real property is situated may impose tax on the income derived from that property by an enterprise of the other country, irrespective of whether or not that income is attributable to a permanent establishment of such an enterprise situated in the first-mentioned country. ***[Article 6, paragraph 5]***

Article 7 – Business profits

1.83 This Article is concerned with the taxation of business profits derived by an enterprise that is a resident of one country from sources in the other country.

1.84 The taxing of these profits depends on whether they are attributable to the carrying on of a business through a permanent establishment in the other country. If a resident of one country carries on business through a permanent establishment (as defined in Article 5) in the other country, the country in which the permanent establishment is situated may tax the profits of the enterprise that are attributable to that permanent establishment. ***[Article 7, paragraph 1]***

1.85 If an enterprise which is a resident of one country derives business profits in the other country other than profits attributable to a permanent establishment in that other country, the general principle of this Article is that the enterprise will not be liable to tax in the other country on its business profits (except where paragraph 6 of this Article applies – see the explanation in paragraphs 1.90 and 1.91).

Determination of business profits

1.86 Profits of a permanent establishment are to be determined for the purposes of this Article on the basis of *arm's length* dealing. The provisions in the tax treaty correspond to international practice and the comparable provisions in Australia's other tax treaties.
[Article 7, paragraphs 2 and 3]

1.87 In respect of paragraph 3, no deductions are allowed in respect of expenses which would not be deductible if the permanent establishment were an independent enterprise which incurred the expense. ***[Exchange of Notes, Item 3(a)]***

1.88 No profits are to be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise. Accordingly, profits of a permanent establishment will not be increased by adding to them any profits attributable to the purchasing activities undertaken for the head office. It follows, of course, that any expenses incurred by the permanent establishment in respect of those purchasing activities will not be deductible in determining the taxable profits of the permanent establishment. ***[Article 7, paragraph 5]***

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Inadequate information

1.89 The domestic law of the country in which the profits are sourced (e.g. Australia's Division 13 of the ITAA 1936) may be applied to determine the tax liability of a person, consistently with the principles of the Article. This is of particular relevance where, due to inadequate information, the correct amount of profits attributable on the *arm's length* principle basis to a permanent establishment cannot be determined, or can only be ascertained with extreme difficulty. Paragraph 4 explicitly recognises the right of each country to apply its domestic law in these circumstances. This is consistent with Australia's reservation to Article 7 (*Business profits*) of the OECD Model. ***[Article 7, paragraph 4]***

Profits dealt with under other Articles

1.90 Where income or gains are specifically dealt with under other Articles of the tax treaty, the effect of those particular Articles is not overridden by this Article.

1.91 This provision lays down the general rule of interpretation that categories of income or gains which are the subject of other Articles of the tax treaty (e.g. Article 8 (*Shipping and air transport)*, Article 10 (*Dividends)*, Article 11 (*Interest)*, Article 12 (*Royalties)* and Article 13 (*Alienation of property)*) are to be treated in accordance with the terms of those Articles (except where otherwise provided e.g. by paragraph 6 of Article 10 (*Dividends*) where the asset in respect of which the income is paid is effectively connected with a permanent establishment). ***[Article 7, paragraph 6]***

Insurance with non–residents

1.92 Each country has the right to continue to apply any provisions in its domestic law relating to the taxation of income from insurance. However, if the relevant law in force in either country at the date of signature of the treaty is subsequently varied (otherwise than in minor respects so as not to affect its general character), the countries must consult with each other with a view to agreeing to any amendment of this paragraph that may be appropriate. An effect of this paragraph is to preserve, in the case of Australia, the application of Division 15 of Part III of the ITAA 1936 (Insurance with Non-residents). ***[Article 7, paragraph 7]***

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Trust beneficiaries

1.93 The principles of this Article will apply to business profits derived by a resident of one of the countries (directly or through one or more interposed trust estates) as a beneficiary of a trust estate other than a trust estate which is treated as a company for tax purposes. ***[Exchange of Notes, Item 3(b)]***

1.94 In accordance with this Article, Australia has the right to tax a share of business profits, originally derived by a trustee of a trust estate (other than a trust estate that is treated as a company for tax purposes) from the carrying on of a business through a permanent establishment in Australia, to which a resident of the United Kingdom is beneficially entitled under the trust estate. Item 3(b) of the Notes ensures that such business profits will be subject to tax in Australia where, in accordance with the principles set out in Article 5 (*Permanent establishment*), the trustee of the relevant trust estate has a permanent establishment in Australia in relation to that business.

Article 8 – Profits from the operation of ships and aircraft

1.95 The main effect of this Article is that the right to tax profits from the operation of ships or aircraft in international traffic, including a share of profits attributable to participation in a pool, a joint business or an international operating agency, is generally reserved to the country in which the operator is a resident for tax purposes. ***[Article 8, paragraphs 1 and 4]***

1.96 However, this Article reflects Australian treaty policy of reserving to the source country the right to tax profits from internal traffic and profits from other coastal and continental shelf activities, including non-transport shipping and aircraft activities, within its own waters and airspace. Profits derived by a United Kingdom enterprise from the operation of ships or aircraft, to the extent that they relate to operations confined solely to places in Australia, may thus be taxed in Australia. ***[Article 8, paragraph 2]***

1.97 Australia's taxing rights are specifically preserved over profits from the carriage by ships or aircraft of passengers or cargo (including mail) where the passenger or cargo is shipped and discharged in Australia. ***[Article 8, subparagraph 5(a)]***

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Example 1.1

> A ship operated by a United Kingdom enterprise, in the course of an international voyage from Southampton to Melbourne, makes a stop in Perth to pick up cargo. Profits derived from the transport of the goods loaded in Perth and discharged in Melbourne would be profits from operations confined solely to places in Australia. Australia would therefore have the right to tax the profits relating to such transport. Accordingly, 5% of the amount paid in respect of the transport of those goods would be deemed to be taxable income of the operator for Australian tax purposes pursuant to Division 12 of Part III of the ITAA 1936.

Example 1.2

> A United Kingdom enterprise operates sightseeing flights to observe whales in the Southern Ocean. Passengers board the aircraft in Hobart and disembark at the same airport later on the same day. These operations would be regarded as operations confined solely to places in Australia, notwithstanding that the aircraft passes through international airspace. Australia would therefore have the right to tax the profits relating to the carriage of these passengers.

1.98 Operations involving the use of ships or aircraft, such as haulage, survey or dredging activities, or other activities relating to exploration or extraction of natural resources, that are undertaken in Australia (including coastal waters, the continental shelf areas and external territories) are also regarded as operations confined solely to places in Australia. ***[Article 8, subparagraph 5(b)]***

1.99 Profits from leasing a ship or aircraft on a full basis (i.e. fully equipped, crewed and supplied) are treated in the same way as profits from the carriage of passengers and cargo. Such profits will generally be taxable only in the country of residence of the lessor, unless the ship or aircraft is used for operations confined solely to places in the other country. The Article extends exclusive residence country taxation to profits from bare-boat leases of ships or aircraft, and profits from the use, maintenance and rental of containers used for the transport of goods or merchandise, provided the rental or use is directly connected or ancillary to the operation by the enterprise of ships or aircraft in international traffic. ***[Article 8, paragraph 3]***

1.100 Profits from the lease of ships, aircraft or containers, or from the use or maintenance of containers, that are not covered by Article 8 (*Shipping and air transport*) will come within the scope of Article 7 (*Business profits*). Source country taxation is only permitted under Article 7 (*Business profits*) to the extent that the profits are attributable to a permanent establishment in that country.

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Article 9 – Adjustments to profits of associated enterprises

Reallocation of profits

1.101 This Article deals with associated enterprises (parent and subsidiary companies and companies under common control). It authorises the reallocation of profits between related enterprises in Australia and the United Kingdom on an *arm's length* basis where the commercial or financial arrangements between the enterprises differ from those that might be expected to operate between unrelated enterprises dealing wholly independently with one another.

1.102 This Article would not generally authorise the rewriting of accounts of associated enterprises where it can be satisfactorily demonstrated that the transactions between such enterprises have taken place on normal, open market commercial terms. Consistent with Australia's modern treaty practice, the inclusion of the expression 'dealing wholly independently with one another' in paragraph 1 recognises dealings on a truly independent basis as the appropriate benchmark for determining whether the transactions have taken place on normal, open market commercial terms. ***[Article 9, paragraph 1; Exchange of Notes, Item 4]***

1.103 Australia's domestic law provisions relating to international profit shifting arrangements were revised in 1981 in order to deal more comprehensively with arrangements under which profits are shifted out of Australia, whether by transfer pricing or other means. The broad scheme of the revised domestic law provisions is to impose arm's length standards in relation to international dealings, but where the Commissioner cannot ascertain the arm's length consideration, it is deemed to be such an amount as the Commissioner determines.

1.104 Paragraph 2 of this Article specifically recognises the right of each country to apply its domestic law relating to the determination of the tax liability of a person (e.g. Australia's Division 13 of the ITAA 1936) to its own enterprises in cases where the available information is inadequate, provided that such provisions are applied, so far as it is practicable to do so, consistently with the principles of the Article. This reflects Australia's reservation to Article 9 (*Associated enterprises*) of the OECD Model. ***[Article 9, paragraph 2]***

Correlative adjustments

1.105 Where a reallocation of profits is made (either under this Article or, by virtue of paragraph 2, under domestic law) so that the profits of an enterprise of one country are adjusted upwards, a form of double taxation would arise if the profits so reallocated continued to be subject to tax in the hands of an associated enterprise in the other country. To avoid this result, the other country is required to make an appropriate compensatory adjustment to the amount of tax charged on the profits involved to relieve any such double taxation.

1.106 It would generally be necessary for the affected enterprise to apply to the competent authority of the country not initiating the reallocation of profits for an appropriate compensatory adjustment to reflect the reallocation of profits made by the other treaty partner country. If necessary, the competent authorities of Australia and the United Kingdom will consult with each other to determine the appropriate adjustment. ***[Article 9, paragraph 3]***

Article 10 – Dividends

1.107 This Article allocates taxing rights in respect of dividends flowing between Australia and the United Kingdom. The Article, in conjunction with the Notes, provides that:

- certain cross-border intercorporate dividends will be either exempt or subject to a maximum 5% rate of source country tax;
- a maximum 15% rate of source country tax may be applied on all other dividends;
- dividends paid in respect of a holding which is effectively connected with a permanent establishment are dealt with under Article 7 (*Business profits*); and
- the extra-territorial application by either country of taxing rights over dividend income is not permitted.

1.108 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

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Permissible rate of source country taxation

Exemption for certain cross-border intercorporate dividends

1.109 No tax will be payable in the source country on dividends where a company that is the beneficial owner and is resident in the other country:

- holds 80% or more of the voting power of the company paying the dividend; and
- satisfies a 12 month holding requirement at the time of the declaration of the dividend in relation to the shares on which the dividend is payable.

[Article 10, paragraph 3]

1.110 To qualify for the exemption, the company that is the beneficial owner of the dividends must either be:

- a company that has its principal class of shares;
  - listed on specified Australian or United Kingdom stock exchanges; and
  - regularly traded on one or more recognised stock exchanges (as defined under Article 3 (*General definitions*) of the treaty); or
- a company that is owned either directly or indirectly by such a company.

1.111 Dividends which are beneficially owned by a company that does not meet the conditions in the previous paragraph will also be exempt from tax in the source country if the competent authority determines, in accordance with its domestic law, that the recipient company was established, acquired, or maintained for reasons other than obtaining benefits under the treaty. Before concluding that a company is not entitled to benefits under this subparagraph (e.g. because the arrangements had a principal purpose of obtaining such benefits), the competent authority is required to consult with the other competent authority. ***[Article 10, subparagraphs 3(a) to (c)]***

1.112 For the purpose of the above tests, a ***recognised stock exchange*** includes:

- in Australia's case, the Australian Stock Exchange or any other Australian stock exchange recognised under Australian domestic law; and
- in the United Kingdom, the London Stock Exchange or any other investment exchange recognised under United Kingdom domestic law.

1.113 Under sub-subparagraph 1(o)(iii) of Article 3 (*General definitions*), provision has been made to allow the competent authorities to reach agreement that other exchanges constitute a recognised stock exchange for the purpose of the treaty. ***[Article 3, sub-subparagraph 1(o)(iii)]***

1.114 The principal class of shares will generally be the ordinary or common shares of the company where such shares constitute the majority of both the voting power and value of the company. ***[Article 10, paragraph 8]***

5% rate limit on source country tax of certain cross-border intercorporate dividends

1.115 This Article allows both countries to tax other dividends flowing between them but limits the rate of tax that the country of source may impose on dividends payable by companies that are residents of that country under its domestic law to residents in the other country who are the beneficial owners of the dividends. ***[Article 10, paragraphs 1 and 2]***

1.116 A rate limit of 5% will apply for dividends paid in respect of company shareholdings that do not qualify for the intercorporate dividend exemption under paragraph 3 of this Article, but constitute a direct voting interest of at least 10%. ***[Article 10, subparagraph 2(a)]***

15% rate limit for all other dividends

1.117 In all other cases, the treaty provides that the source country will generally limit its tax to 15% of the gross amount of the dividend. In the case of Australia, this will mean that the domestic rate of withholding tax imposed on unfranked dividends will be reduced from 30% to 15%. ***[Article 10, subparagraph 2(b)]***

1.118 The above limits do not distinguish between franked and unfranked dividends. However, the dividend withholding tax exemption provided by Australia under its domestic law for franked dividends paid to non-residents will continue to apply.

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Future changes to either country's domestic tax treatment of dividend

1.119 If there is a material change to either country's general approach to taxing dividends (e.g. a change to Australia's domestic law arrangements for franked dividends flowing overseas), the two countries are obliged to consult to consider whether any amendment to paragraphs 2 and 3 of this Article would be appropriate as a consequence of the change to domestic law. ***[Exchange of Notes, Item 5]***

Dividends effectively treated as business profits

1.120 The limitation on the tax of the country in which the dividend is sourced does not apply to dividends derived by a resident of the other country who has a permanent establishment in the country from which the dividends are derived, if the holding giving rise to the dividends is effectively connected with that permanent establishment.

1.121 Where the holding is so effectively connected, the dividends are to be treated as business profits and therefore subject to the full rate of tax applicable in the country in which the dividend is sourced in accordance with the provisions of Article 7 (*Business profits*). In practice, however, under the full imputation system of company taxation in Australia's domestic law, such dividends, to the extent that they are franked dividends, remain exempt from Australian tax. Unfranked dividends that have the relevant connection with a permanent establishment in Australia will be subject to withholding tax at the rate of 15% instead of being taxed by assessment. ***[Article 10, paragraph 5]***

Extra–territorial application precluded

1.122 The extra-territorial application by either country of taxing rights over both dividend income and undistributed profits is precluded. Broadly, one country (the first country) will not tax dividends paid by a company resident solely in the other country, unless:

- the person deriving the dividends is a resident of the first country; or
- the shareholding giving rise to the dividends is effectively connected with a permanent establishment in the first country.

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1.123 For example, Australia may not tax dividends paid by a United Kingdom company to a resident of the United Kingdom out of profits derived from Australian sources, unless the United Kingdom shareholder has a permanent establishment in Australia with which the holding is effectively connected. Similarly, a country is precluded from imposing an undistributed profits tax on a company which is a resident of the other country, even if those undistributed profits arose in the first country. Australia does not impose an undistributed profits tax.

1.124 These preclusions do not apply when the company is a resident of both Australia and the United Kingdom for Australian tax purposes. ***[Article 10, paragraph 6]***

Definition of dividends

1.125 The term ***dividends*** in this Article means income from:

- shares or other rights which participate in profits and are not debt-claims;
- corporate rights which are subject to the same taxation treatment as income from shares in the country of which the distributing company is resident; and
- any other item that is treated as a dividend or company distribution by the laws of the country of which the paying company is a resident.

The inclusion of 'any other item which, ... , is treated as a dividend or distribution of a company' within the definition is consistent with the observation lodged by the United Kingdom to Article 10 (*Dividends*) of the OECD Model, which indicates that certain interest payments are treated as distributions under its domestic law and are therefore subject to the *Dividends* Article in preference to the *Interest* Article. ***[Article 10, paragraph 4]***

Limitation of benefits

1.126 The source country rate limits and exemptions available under this Article will not apply where a creation or assignment of shares or other rights in respect of which dividends are paid, has been made with the main objective of, or one of the main objectives of accessing the relief otherwise available under this Article. ***[Article 10, paragraph 7]***

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Article 11 – Interest

1.127 This Article allocates taxing rights in respect of interest flows between Australia and the United Kingdom. The Article, in conjunction with the Notes, provides that:

- an exemption from source country tax applies to cross-border interest flows to:
  - government bodies; and
  - financial institutions;
- a maximum 10% rate of source country tax may be applied on all other interest income;
- interest paid on an indebtedness which is effectively connected with a permanent establishment shall be subject to Article 7 (*Business profits*);
- interest payments are deemed to have an Australian source (and may therefore be taxed in Australia) where:
  - the interest is paid by an Australian resident to a United Kingdom resident;
  - the interest is paid by a non-resident to a United Kingdom resident and it is an expense of the payer in carrying on business in Australia through a permanent establishment; and
- relief will be restricted to the gross amount of interest which would be expected to be paid on an arm's length dealing between independent parties.

1.128 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

Permissible rate of source country taxation

10% rate limit

1.129 This Article provides for interest income to be taxed by both countries but requires the country in which the interest arises to generally limit its tax to 10% of the gross amount of the interest where a resident of the other country is the beneficial owner of the interest. ***[Article 11, paragraphs 1 and 2]***

Exemptions for interest paid to government bodies

1.130 The exemption for interest paid to government bodies reflects the principle of sovereign immunity and will apply to interest derived in the course of exercising governmental functions. It will not extend to interest derived by a government body from the conduct of a trade or business. Similar exemptions apply in a number of Australia's tax treaties. ***[Article 11, subparagraph 3(a)]***

Exemptions for interest paid to financial institutions

1.131 The exemption for interest paid to financial institutions recognises that the agreed 10% withholding tax rate on gross interest can be excessive given their cost of funds. The exemption will also broadly align the treatment of interest paid to United Kingdom financial institutions with the Australian domestic law exemption for interest paid on widely distributed arm's length corporate debenture issues (section 128F of the ITAA 1936). ***[Article 11, subparagraph 3(b)]***

1.132 The term ***financial institution*** means a bank or other enterprise substantially raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on the business of providing finance. It does not include a corporate treasury or a member of a group that performs the financing services of the group. ***[Article 11, subparagraph 3(b); Exchange of Notes, Item 6(b)]***

1.133 The exemption will not be available for interest paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and structured to have a similar effect. The denial of the exemption for these back-to-back loan type arrangements is directed at preventing related party and other debt from being structured through financial institutions to gain access to a withholding tax exemption. The exemption will only be denied for interest paid on the component of a loan that is considered to be back-to-back. ***[Article 11, paragraph 4]***

1.134 A back-to-back arrangement would include, for instance, a transaction or series of transactions structured in such a way that:

- a United Kingdom financial institution receives or is credited with an item of interest arising in Australia; and,

- the financial institution pays or credits, directly or indirectly, all or substantially all of that interest (at any time or in any form, including commensurate benefits) to another person who, if it received the interest directly from Australia, would not be entitled to similar benefits with respect to that interest.

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1.135 However, a back-to-back arrangement would generally not include a loan guarantee provided by a related party to a United Kingdom financial institution.

Definition of interest

1.136 The term ***interest*** is defined for the purposes of this Article to include income from debt-claims of every kind, including:

- income from government securities;
- income from bonds and debentures;
- income from any other forms of indebtedness; and
- any income that is subject to the same taxation treatment as income from monies lent in the country in which the interest arises.

1.137 The use of the term *debt-claims* in this Article of the treaty rather than the more commonly used 'indebtedness' in Australia's other treaties reflects the preferred tax treaty practice of the United Kingdom and is of no practical consequence for the purposes of Australian law. The two terms are intended to encompass the same kinds of debt.

1.138 Consistent with the United Kingdom's observation on Article 11 (*Interest*) of the OECD Model, the definition of 'interest' excludes any amount that satisfies the definition of 'dividend' under paragraph 4 of Article 10 (*Dividends*). Under United Kingdom domestic law, certain interest payments are treated as distributions and would therefore be dealt with under Article 10. ***[Article 11, paragraph 5]***

Interest effectively treated as business profits

1.139 Interest derived by a resident of one country which is paid in respect of an indebtedness which is effectively connected with a permanent establishment of that person in the other country, will form part of the business profits of that permanent establishment and be subject to the provisions of Article 7 (*Business profits*). Accordingly, the rate limitation of 10% and the exemption for financial institutions do not apply to such interest in the country in which the interest is sourced. ***[Article 11, paragraph 6]***

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Deemed source rules

1.140 Interest source rules are set out in paragraph 7. Those rules operate to allow Australia to tax interest of which a resident of the United Kingdom is beneficial owner where the interest is paid by a resident of Australia. Australia may also tax interest paid by a non-resident, being interest which is beneficially owned by a United Kingdom resident, if it is an expense incurred by the payer of the interest in carrying on a business in Australia through a permanent establishment.

1.141 However, consistent with Australia's interest withholding tax provisions, an Australian source is not deemed in respect of interest that is an expense incurred by an Australian resident in carrying on a business through a permanent establishment outside both Australia and the United Kingdom (i.e. the permanent establishment is in a third country). ***[Article 11, paragraph 7; Exchange of Notes, Item 6(b)]***

1.142 In determining whether a permanent establishment exists in a third country, the principles set out in Article 5 (*Permanent establishment*) apply.

Related persons

1.143 This Article includes a general safeguard against payments or credits of excessive interest where a special relationship exists between the persons associated with a loan transaction – by restricting the 10% source country tax rate limitation to an amount of interest which might have been expected to have been agreed upon if the parties to the loan agreement were dealing with one another at arm's length. Any excess part of the interest remains taxable according to the domestic law of each country but subject to the other Articles of the tax treaty. ***[Article 11, paragraph 8]***

1.144 Examples of cases where a special relationship might exist include payments to a person (either individual or legal):

- who controls the payer (whether directly or indirectly);
- who is controlled by the payer; or
- who is subordinate to a group having common interests with the payer.

1.145 It also covers relationships of blood or marriage and, in general, any community of interests.

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'For whatever reason'

1.146 The words 'for whatever reason' in paragraph 8 of Article 11 were the subject of a former reservation by the United Kingdom to Article 11 (*Interest*) of the OECD Model. The inclusion of these additional words permits interest and other payments in respect of certain loans to be dealt with as distributions in a range of circumstances provided for in its domestic law, including those where the amount of the loan, or the rate of interest, or other terms relating to it are not what would have been agreed in the absence of a special relationship.

1.147 The addition of these words clarifies that this paragraph permits not only the adjustment of the rate at which interest is charged but also the reclassification of the excess interest in such a way as to give it the character of a distribution. The current OECD Model commentary to Article 11 (*Interest*) recognises that this addition is appropriate to enable recharacterisation of the excess interest. ***[Article 11, paragraph 8]***

Limitation of benefits

1.148 The source country rate limit and exemptions available under this Article will not apply where a creation or assignment of the debt-claim in respect of which interest paid has been made with the main objective, or one of the main objectives, of accessing the relief otherwise available under this Article. ***[Article 11, paragraph 9]***

Article 12 – Royalties

1.149 This Article allocates taxing rights in respect of royalties paid or credited between Australia and the United Kingdom. The Article, in conjunction with the Notes, provides that:

- a maximum 5% rate of source country tax may be levied on the gross amount of the royalties;
- royalties paid in respect of a right or property which is effectively connected with a permanent establishment are subject to Article 7 (*Business profits*);
- equipment royalties are not included within the definition of royalties and are subject to either Article 7 (*Business profits*) or Article 8 (*Shipping and air transport*);
- payments for spectrum licences are subject to Article 7 (*Business profits*);

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- royalties are deemed to have an Australian source (and may therefore be taxed in Australia) where:
  - the royalties are paid by an Australian resident to a United Kingdom resident;
  - the royalties are paid by a non-resident to a United Kingdom resident and are an expense of the payer in carrying on business in Australia through a permanent establishment; and
- relief will be restricted to the gross amount of royalties which would be expected to be paid on an arm's length dealing between independent parties.

1.150 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

Permissible rate of source country taxation

1.151 This Article in general allows both countries to tax royalty flows but limits the tax of the country of source to 5% of the gross amount of royalties beneficially owned by residents of the other country. ***[Article 12, paragraphs 1 and 2]***

1.152 In the absence of a tax treaty, Australia taxes royalties paid to non-residents at 30% of the gross royalty.

1.153 The 5% rate limitation does not apply to natural resource royalties, which, in accordance with Article 6 (*Income from real property*), remain taxable in the country of source without limitation of the tax that may be imposed.

Definition of royalties

1.154 The definition of ***royalties*** in the tax treaty reflects most elements of the definition in Australia's domestic income tax law. It includes payments for the supply of scientific, technical, industrial or commercial know-how but not payments for services rendered, except as provided for in subparagraph 3(c). The definition also includes payments for the use of video or audio disks or any other means of image or sound reproduction or for transmission for use in connection with television, radio or other broadcasting (e.g. satellite and Internet broadcasting). ***[Article 12, paragraph 3]***

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1.155 Payments for the use of, or the right to use industrial, commercial or scientific equipment have been removed from the definition under the new treaty. Such amounts will either be treated as business profits under Article 7 (*Business profits*) or as profits from international transport operations (for certain leases of ships, aircraft and containers) under Article 8 (*Shipping and air transport*). The exclusion of payments for the use of equipment from the *Royalties* Article reflects common international tax treaty practice and recognises that source country taxation on a gross basis may be excessive given low profit margins.

1.156 The definition does not include payments made for the use of spectrum licences: Article 7 (*Business profits*) applies to such payments. ***[Exchange of Notes, Item 7(a)]***

Payments for the supply of know-how versus payments for services rendered

1.157 It is considered that a German Supreme Court decision (*Bundesfinanzhof (No. IR 44/67)* of 16 December 1970) provides a definitive test to distinguish between a know-how contract and a contract for services. A know-how contract, it was held, involved the supply by a person of their know-how to the paying entity (e.g. teaching a personal expertise), whereas in a contract for services, although it may involve the use of know-how, that know-how is applied by the person in the performance of their services.

1.158 Payments for design, engineering or construction of plant or building, feasibility studies, component design and engineering services may generally be regarded as being in respect of a contract for services, unless there is some provision in the contract for imparting techniques and skills to the buyer.

1.159 In cases where both know-how and services are supplied under the same contract, if the contract does not separately provide for payments in respect of know-how and services, an apportionment of the two elements of the contract may be appropriate.

1.160 Payments for services rendered are to be treated under Article 7 (*Business profits*).

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Forbearance

1.161 Consistent with Australian tax treaty practice, subparagraph 3(e) expressly treats as a royalty, amounts paid or credited in respect of forbearance to grant to third persons, rights to use property covered by this Article. This is designed to address arrangements along the lines of those contained in *Aktiebolaget Volvo v Federal Commissioner of Taxation (1978)* 8 ATR 747; 78 ATC 4316, where instead of amounts being payable for the exclusive right to use the property they were made for the undertaking that the right to use the property will not be granted to anyone else. This provision ensures that such payments are subject to tax as a royalty payment under the terms of the *Royalties* Article. ***[Article 12, subparagraph 3(e)]***

Other royalties effectively treated as business profits

1.162 As in the case of interest income, it is specified that the withholding tax rate limitation does not apply to royalties paid in respect of property or rights which are effectively connected with a permanent establishment in the country in which the income is sourced – such income being subject to full taxation under Article 7 (*Business profits*). ***[Article 12, paragraph 4]***

Deemed source rules

1.163 The royalties source rules provided for in the new treaty and the Notes effectively correspond, in the case of Australia, with the deemed source rule contained in section 6C (Source of royalty income derived by a non-resident) of the ITAA 1936 for royalties paid to non-residents of Australia. They broadly mirrors the source rule for interest income contained in paragraph 7 of Article 11 (*Interest*).

1.164 Consistent with Australia's royalty withholding tax provisions, royalty payments that are an expense incurred by an Australian resident in carrying on a business through a permanent establishment outside both Australia and the United Kingdom (i.e. the permanent establishment is in a third country) will not be subject to tax in Australia. ***[Article 12, paragraph 6; Exchange of Notes, Item 7(b)]***

1.165 In determining whether a permanent establishment exists in a third country, the principles set out in Article 5 (*Permanent establishment*) apply.

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Related persons

1.166 Where a special relationship exists between the payer and the beneficial owner of the royalties, the 5% source country tax rate limitation will apply only to the extent that the royalties are not excessive. Any excess part of the royalty remains taxable according to the domestic law of each country but subject to the other Articles of this tax treaty.

1.167 Examples of special relationships have been provided in respect of the corresponding paragraph in Article 11. ***[Article 12, paragraph 6]***

Limitation of benefits

1.168 The source country rate limit available under this Article will not apply where a creation or assignment of the rights in respect of which royalties paid has been made with the main objective, or one of the main objectives of accessing the relief available under this Article. ***[Article 12, paragraph 7]***

Article 13 – Alienation of property

Taxing rights

1.169 This Article, in conjunction with the Notes, allocates between the respective countries taxing rights in relation to income or gains arising from the alienation of real property and other items of property. ***[Article 13, paragraph 1]***

1.170 The reference to ‘income or gains’ (which is specified in Item 1(a) of the Notes to include profits) in this Article is designed to put beyond doubt that a gain from the alienation of property which in Australia is income or a profit under ordinary concepts, will be taxed in accordance with this Article, rather than Article 7 (*Business profits*), together with relevant capital gains.

Real property

1.171 Income or gains from the alienation of real property may be taxed by the country in which the property is situated. For the purpose of this Article, the term real property has the same meaning as it has under paragraph 2 of Article 6. Where the property is situated is determined in accordance with paragraph 3 of Article 6. ***[Article 13, paragraphs 1, 7 and 8]***

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Permanent establishment

1.172 Paragraph 2 deals with income or gains arising from the alienation of property (other than real property covered by paragraph 1) forming part of the business assets of a permanent establishment of an enterprise. It also applies where the permanent establishment itself (alone or with the whole enterprise) is alienated. Such income or gains may be taxed in the country in which the permanent establishment is situated. This corresponds to the rules for taxation of business profits contained in Article 7 (*Business profits*). ***[Article 13, paragraph 2]***

Disposal of ships or aircraft

1.173 Income or gains derived by a resident of a country from the disposal of ships or aircraft operated in international traffic, or of associated property (other than real property covered by paragraph 1), are taxable only in that country. This rule corresponds to the operation of Article 8 (*Shipping and air transport*) in relation to profits from the international operation of ships or aircraft. ***[Article 13, paragraph 3]***

1.174 For the purposes of this Article, the term 'international traffic' does not include any transportation which commences at a place in a country and returns to that place or another place in that country, after travelling through international airspace or waters (e.g. so-called 'voyages to nowhere' by cruise ships). ***[Article 3, subparagraph 1(j)]***

Shares and other interests in land-rich entities

1.175 Paragraph 4 applies to situations involving the alienation of shares or other interests in companies, and other entities, where the value of the assets is principally attributable to the real property situated in the other country. Income or gains from alienation of such shares or interests may be taxed by the country in which the real property is situated. This paragraph complements paragraph 1 of this Article and is designed to cover arrangements involving the effective alienation of *incorporated real property*, or like arrangements.

1.176 Such treatment applies whether the real property is held directly or indirectly through a chain of interposed entities. While not limited to chains of companies, or even chains of entities, only some of which are companies, the example of chains of companies is used to make clear that the *corporate veil* should be lifted in examining direct or indirect ownership.

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1.177 This provision responds to the tax planning opportunities exposed by the decision of the Full Federal Court in the *Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597. It is designed to protect Australian taxing rights over income or gains on the alienation or effective alienation of Australian real property (as defined) despite the presence of interposed bodies corporate or other entities. ***[Article 13, paragraph 4]***

Exemption from former residence country taxation

1.178 Australia's law provides for taxation of individuals who cease to be a resident of Australia on gains arising from the deemed disposal of assets (other than those having the necessary connection with Australia) (subsections 104-165(2) and (3) of the ITAA 1997).

1.179 The taxation of unrealised gains can give rise to cash flow problems because proceeds from the gains are not available to pay the tax. Australia's domestic law provides relief by allowing departing individuals to defer tax on unrealised gains if they elect to treat assets to which the gains relate as having the necessary connection with Australia (subsections 104-165(2) and (3) of the ITAA 1997). The effect of the election is that a gain on the subsequent disposal of the property will be taxable in Australia even though the individual is not an Australian resident.

1.180 Paragraph 5 of this Article will provide an exemption from taxation in the former country of residence on gains in respect of which an individual has elected to defer taxation on ceasing to be a resident of that country, if the individual is a resident of the other country when the gains are crystallised. ***[Article 13, paragraph 5]***

1.181 An individual departing Australia who defers tax by electing for an asset to have the necessary connection with Australia will, for instance, be exempt in Australia on a gain arising from a subsequent disposal of that asset if the individual is a resident of the United Kingdom at the time of the disposal. This will reduce compliance difficulties for departing residents, ensure post-residence change gains on foreign assets are not taxable in Australia and precludes the need to relieve double taxation.

1.182 Paragraph 5 will not affect the taxation of gains derived from the disposal of assets that, prior to a residence change, already have the necessary connection with Australia. A requirement of paragraph 5 is that an individual must elect to defer tax on a residence change gain. This requirement will not be satisfied for assets that have the necessary

connection with Australia because there is no deemed disposal of these assets when an individual ceases to be an Australian resident. Australia may therefore continue to tax gains realised on the disposal of these assets.

1.183 Similarly, paragraph 5 will not affect the inclusion in assessable income of a discount on a qualifying share or right that has been deferred under an employee share acquisition scheme. Again, this is because there is no taxation deferred as a result of a residence change. Paragraph 5 could operate, however, to exempt gains accrued on shares after allocation where an individual ceases to be a resident of Australia and elects to defer the residence change gain.

Capital gains

1.184 This Article contains a sweep-up provision in relation to capital gains which enables each country to tax, according to its domestic law, any gains of a capital nature derived by its own residents or by a resident of the other country from the alienation of any property, except where different treatment is provided in the preceding paragraphs of the Article. Thus, except where Australia's right to tax capital gains is limited by the other paragraphs (e.g. paragraphs 3 and 5), the provision preserves the application of Australia's domestic law relating to the taxation of capital gains. Australia will thus continue to be able to tax, for instance, capital gains derived by United Kingdom residents on the disposal of Australian entities. ***[Article 13, paragraph 6]***

United Kingdom residents – residence during a six year period prior to alienation of property

1.185 Paragraph 9 protects the United Kingdom taxing right in respect of income or gains from the alienation of any property of a person who is, or has been, a resident of the United Kingdom during the year in which the property is alienated or during the six years immediately preceding that year. ***[Article 13, paragraph 9]***

Double tax relief

1.186 In the event that the operation of this Article should result in an item of income or gain being subjected to tax in both countries, the country of which the person deriving the income or gain is a resident (as determined in accordance with Article 4 (*Residence*)) would be obliged by Article 22 (*Elimination of double taxation*) to provide double tax relief for the tax imposed by the other country.

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Article 14 – Income from employment

Basis of taxation

1.187 This Article generally provides the basis upon which the remuneration of visiting employees is to be taxed. However this Article does not apply in respect of income that is dealt with separately in:

- Article 15 (*Fringe benefits*);
- Article 16 (*Entertainers*);
- Article 17 (*Pensions and annuities*); and
- Article 18 (*Income from government service*).

1.188 Generally, salaries, wages and similar remuneration derived by a resident of one country from an employment exercised in the other country may be taxed in that other country. However, subject to specified conditions, there is a conventional provision for exemption from tax in the country being visited where visits of only a short-term nature are involved. ***[Article 14, paragraphs 1 and 2]***

Short-term visit exemption

1.189 The conditions for this exemption are that:

- the period of the visit or visits does not exceed, in the aggregate, 183 days in any 12 month period commencing or ending in the fiscal year or year of income of the visited country;
- the remuneration is paid by, or on behalf of, an employer who is not a resident of the country being visited; and
- the remuneration is not deductible in determining taxable profits of a permanent establishment which the employer has in the country being visited.

1.190 Where all of these conditions are met, the remuneration so derived will be liable to tax only in the country of residence of the recipient. ***[Article 14, paragraph 2]***

1.191 Where a short-term visit exemption is not applicable, remuneration derived by a resident of Australia from employment in the United Kingdom may be taxed in the United Kingdom. However, this Article does not allocate sole taxing rights to the United Kingdom in that situation.

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1.192 Accordingly, Australia would also be entitled to tax that remuneration in accordance with the general rule of the ITAA 1997 that a resident of Australia remains subject to tax on worldwide income. However, in accordance with Article 22 (*Elimination of double taxation*) Australia would be required to in this situation relieve the double taxation.

1.193 Although that Article provides for the double tax relief to be provided by Australia to be in the form of the grant of a credit against the Australian tax for the United Kingdom tax paid, the exemption with progression method of providing double tax relief in relation to employment income derived in the situation described would normally be applicable in practice pursuant to the foreign service income provisions of section 23AG of the ITAA 1936. This method exempts the income from foreign employment from tax in Australia, but takes into account the foreign earnings when calculating the Australian tax on other assessable income the person has derived.

Employment on a ship or aircraft

1.194 Income from an employment exercised aboard a ship or aircraft operated in international traffic may be taxed in the country of which the enterprise operating the ship or aircraft is a resident. ***[Article 14, paragraph 3]***

1.195 For the purposes of this Article, the term 'international traffic' does not include any transportation which commences at a place in a country and returns to that place or another place in that country, notwithstanding that the vessel travels through international waters (e.g. so-called 'voyages to nowhere' by cruise ships). ***[Article 3, subparagraph 1(j)]***

Remuneration of company directors

1.196 The treatment provided under the Article for income from employment also applies to remuneration of a director of a company derived from a company. This provision is identical to paragraph 4 of Article 12 of the existing treaty. ***[Article 14, paragraph 4]***

Exchange of Notes – Employee share option schemes

1.197 The Notes specifically address the treatment of income or gains derived by employees in relation to certain employee share option schemes where the options are granted in respect of an employment which is partly or wholly exercised in the other country. ***[Exchange of Notes, Item 8]***

1.198 The Notes make it clear that the income or gains derived under employee share option plans are 'other similar remuneration' for the purposes of Article 14 (*Income from employment*). Such benefits accruing up until the time when the option is exercised will be treated as income from employment, and will therefore be subject to the rules in Article 14 of the treaty. Any increase in the value of any shares acquired as a result of the exercise of the options will fall for consideration under Article 13 (*Alienation of property*). ***[Exchange of Notes, Item 8(a)]***

1.199 There is a rebuttable presumption that the period of employment to which the option relates is the period between the grant of the option and the date on which all the conditions for its exercise have been satisfied (the vesting of the option). It follows that, unless the facts indicate that the option was granted in respect of another period, the income or gains derived under the option – whenever derived – will be treated as remuneration from employment exercised during this period. ***[Exchange of Notes, Item 8(b)]***

1.200 Where certain conditions are met, the Notes provide a rule for determining the part of the income or gain which should be treated as attributable to employment exercised in the other country. The conditions are:

- the relevant period of employment is the period between grant and vesting of the option;
- the employee remains in that employment at the date of alienation or exercise of the option; and
- the employee, being a resident of one country, has exercised the employment in the other country at some time during the period between grant and vesting of the option.

1.201 If these conditions are met, then, for the purposes of Article 14, the amount of the income or gain that will be treated as attributable to employment exercised in one country (the employment country) by a resident of the other country (the residence country) will be calculated in accordance with the following formula:

$$\text{amount of benefit} \times \frac{\text{number of days of employment exercise in the employment country}}{\text{total number of days between grant and vesting of the option}}$$

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1.202 The amount so calculated may be taxed in the employment country, regardless of when the benefit is treated as derived for purposes of the domestic law of that country and regardless of whether the benefit is characterised under that law as income or a capital gain. Thus, for example, if Australia is the employment country, Australia may tax the proportion of income or gain derived under an option attributable to employment exercised in Australia, irrespective of whether the relevant amount is included in the taxpayer's assessable income in the year in which the option is acquired, or is deferred until a later year in accordance with Division 13A of ITAA 1936. Where any benefit accruing prior to exercise of the option is taxed as a capital gain under Australia's domestic law (e.g. where the employee disposes of the option), then that part of the capital gain which is attributable to employment exercised in Australia may be taxed in Australia in accordance with the provisions of Article 14. ***[Exchange of Notes, Item 8(c)]***

1.203 The option benefit may also be taxed in the residence country. Consistent with Article 22 (*Elimination of double taxation*), the tax on the proportion of the income or gain attributable to the employment country will be eligible for double tax relief in the residence country.

1.204 Where the above conditions are not satisfied, Article 14 continues to apply to the taxation of the option benefits. However, no method of apportionment is prescribed. In such cases, the matter could be resolved by the competent authorities of the two countries in accordance with Article 26 (*Mutual agreement procedure*).

Article 15 – Fringe benefits

1.205 This Article deals with fringe benefits which, in the absence of the Article, would be taxable in both Australia and the United Kingdom. Under this Article, the country which would have the *primary taxing right* if the benefit were ordinary employment income will have the sole taxing right in relation to the fringe benefit. This would generally be determined in accordance with Article 14 (*Income from employment*) or Article 18 (*Government service*). ***[Article 15, paragraph 1]***

Definition of primary taxing right

1.206 This Article provides that the ***primary taxing right*** lies with the country that may, in accordance with the treaty, impose tax on the employment remuneration, being tax in respect of which the other country is required to provide relief under Article 22 (*Elimination of double taxation*). ***[Article 15, subparagraph 2(b)]***

Example 1.3

A United Kingdom resident employee of a United Kingdom company is sent to work in Australia. The employee, who is present in Australia for more than 183 days, receives both employment income and fringe benefits. Under paragraph 1 of Article 14 (*Income from employment*), Australia has the right to tax the employment income. The United Kingdom may also tax but, under Article 22 (*Elimination of double taxation*), would be obliged to give credit for the Australian tax paid on the fringe benefit if it was ordinary employment income. Therefore, Australia would have the primary right to tax.

Operation of the provision in respect of fringe benefits tax law

1.207 Both Australia and the United Kingdom impose taxation on certain 'fringe' or employee benefits. In Australia, the relevant law is the *Fringe Benefits Tax Assessment Act 1986*. Under the *Fringe Benefits Tax Assessment Act 1986*, an employer who provides a fringe benefit to an employee or to an associate of an employee (which includes a family member) may have a FBT liability. FBT is separate from income tax and is calculated on the grossed-up taxable value of the fringe benefits provided. In the United Kingdom, many benefits provided to employees are taxed in the hands of the employee under the rules relating to earnings.

1.208 There may be circumstances in both countries where a resident of one country working in the other country would be liable to tax in both countries on the fringe benefit. Regardless of whether the benefit is taxed under the ordinary income tax law or under a separate enactment (as is currently the case in Australia), or whether the tax is liable to be paid by the employer or the employee, this Article will ensure that liability to tax on the fringe benefit will be taxed in only one of the countries.

Example 1.4

An Australian employee is seconded to the United Kingdom to work for the permanent establishment of his Australian resident employer for two months. During that time, the employer continues to pay the salary and provides the employee with a car that is available for the employee's use in the United Kingdom.

The employee remains an Australian resident and as such is taxable on his worldwide income. The employee's United Kingdom sourced remuneration from his employment is not exempt from Australian tax under section 23AG of the ITAA 1936 (because he is not employed in the United Kingdom for a continuous period of 91 days or more).

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Accordingly, the employee is a person who receives (or is entitled to receive) payments subject to *pay as you go withholding* and an employer/employee relationship exists for the purposes of the Australian *Fringe Benefits Tax Assessment Act 1986*. Therefore, the employer will be liable for FBT in Australia on the taxable value of the car fringe benefit.

The employee's United Kingdom sourced remuneration will also be subject to United Kingdom tax as the exemption from United Kingdom tax in respect of short visits provided for under paragraph 2 of Article 14 (*Income from employment*) is not available because the permanent establishment deducts the employee's remuneration in determining the taxable profits of the permanent establishment for the purposes of United Kingdom income tax. In the United Kingdom, the car fringe benefit may be taxed to the employee as ordinary employment income under the income tax system.

The fringe benefit is therefore taxable under the domestic law of both countries. However, under the terms of this Article, the taxing right over the benefit will be allocated solely to the United Kingdom as the United Kingdom has the primary taxing right over the employee's remuneration. Accordingly, no Australian FBT will be payable by the employer but the employee will be subject to tax in respect of the benefit in the United Kingdom under the United Kingdom's income tax system.

Definition of fringe benefit

1.209 ***Fringe benefit*** is given the meaning which it has under the *Fringe Benefits Tax Assessment Act 1986*. A fringe benefit is a benefit that is provided to an employee or an associate of an employee in respect of the employment of the employee. Fringe benefits may include property, rights, privileges or services but payments of salary or wages, eligible termination payments or contributions to complying superannuation funds are excluded. For example, a fringe benefit is provided when an employer allows an employee to use a work motor vehicle for private purposes, gives an employee a subsidised loan, or pays an employee's private health insurance costs. Benefits arising from employee share option schemes are excluded from the treaty definition of fringe benefit. Such option benefits are treated as remuneration from employment for the purposes of Article 14 (*Income from Employment*). ***[Article 15, subparagraph 2(a)]***

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Article 16 – Entertainers and sportspersons

Personal activities

1.210 Under this Article, income derived by visiting entertainers (which has a reasonably wide meaning in international tax treaty usage) and sportspersons from their personal activities as such may be taxed in the country in which the activities are exercised, irrespective of the duration of the visit. The application of this Article extends to income generated from promotional and associated kinds of activities engaged in by the entertainer or sportsperson while present in the visited country. ***[Article 16, paragraph 1]***

Safeguard

1.211 Paragraph 2 is designed to ensure that income in respect of personal activities exercised by an entertainer or sportsperson, where derived by another person (e.g. a separate enterprise which formally provides the entertainer's or sportsperson's services), is taxed in the country in which the entertainer or sportsperson performs, whether or not that other person has a permanent establishment in that country. ***[Article 16, paragraph 2]***

Article 17 – Pensions and annuities

1.212 Pensions (including government pensions) and annuities (the term *annuity* as used in this Article is defined in paragraph 2) are taxable only by the country of which the recipient is a resident. The application of this Article extends to pensions and annuity payments made to dependants, for example, a widow, widower or children of the person in respect of whom the pension or annuity entitlement accrued where, upon that person's death, such entitlement has passed to that person's dependants. ***[Article 17, paragraphs 1 and 2]***

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Article 18 – Government service

Salary and wage income

1.213 Salary and wage type income, other than government service pensions or annuities, paid to an individual for services rendered in the discharge of governmental functions to a government (including a political subdivision or local authority) of one of the countries, is to be taxed only in that country. However, such remuneration will be taxable only in the other country if:

- the services are rendered in that other country; and
- the recipient is a resident of that other country, who is either:
  - a national of that country; or
  - did not become a resident of that other country solely for the purpose of rendering the services.

[Article 18, paragraph 1]

Business income

1.214 Remuneration for services rendered in connection with a trade or business carried on by any governmental authority referred to in paragraph 1 of this Article is excluded from the scope of the Article. Such remuneration will remain subject to the provisions of Article 14 (*Income from employment*), Article 15 (*Fringe benefits*) or Article 16 (*Entertainers and sportspersons*). ***[Article 18, paragraph 2]***

Article 19 – Students

Exemption from tax

1.215 This Article applies to students who are temporarily present in one of the countries solely for the purpose of their education if the students are, or immediately before the visit were, resident in the other country. In these circumstances, payments from abroad received by the students solely for their maintenance or education will be exempt from tax in the country visited. This will apply even though the student may qualify as a resident of the country visited during the period of their visit.

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1.216 The exemption from tax provided by the visited country is treated as extending to maintenance payments received by the student that are made for maintenance of dependent family members who have accompanied the student to the visited country.

Employment income

1.217 Where, however, a student from the United Kingdom who is visiting Australia solely for educational purposes undertakes any employment in Australia, for example:

- some part time work with a local employer; or
- during a semester break undertakes work with a local employer,

the income earned by that student as a consequence of that employment may, as provided for in Article 14 (*Income from employment*), be subject to tax in Australia. In this situation, the payments received from abroad for the student's maintenance or education will not, however, be taken into account in determining the tax payable on the employment income that is subject to tax in Australia. No Australian tax would be payable on the employment income if the student qualifies as a resident of Australia during the visit and the taxable income of the student does not exceed the tax-free threshold applicable to Australian residents for income tax purposes.

Article 20 – Other income

Allocation of taxing rights

1.218 This Article provides rules for the allocation between the two countries of taxing rights with respect to items of income not dealt with in the preceding Articles of the tax treaty. The scope of the Article is not confined to such items of income arising in one of the countries – it extends also to income from sources in a third country.

1.219 Broadly, such income derived by a resident of one country is to be taxed only in the country of residence unless it is from sources in the other country, in which case the income may also be taxed in the other country. This is consistent with Australia's reservation to Article 21 (*Other income*) of the OECD Model. ***[Article 20, paragraphs 1 and 3]***

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1.220 Where the income may be taxed in both countries in accordance with this provision, the country of residence of the recipient of the income is obliged by Article 22 (*Elimination of double taxation*) to provide double taxation relief.

1.221 This Article does not apply to income (other than income from real property as defined in paragraph 2 of Article 6 (*Income from real property*)) where the right or property in respect of which the income is paid is effectively connected with a permanent establishment which a resident of one country has in the other country. In such a case, Article 7 (*Business profits*) will apply. ***[Article 20, paragraph 2]***

Related persons

1.222 The paragraph restricts the operation of this Article in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of other income paid exceeds the amount which would have been agreed upon by parties operating at arm's length. The paragraph generally mirrors paragraph 8 of Article 11 (*Interest*) and paragraph 6 of Article 12 (*Royalties*), and ensures that any excess part of the income remains taxable according to the domestic law of each country. However, other relevant provisions of the treaty, such as Article 22 (*Elimination of double taxation*), Article 23 (*Limitation of relief*), Article 26 (*Mutual agreement procedure*) and Article 27 (*Exchange of information*), will continue to apply to such income. ***[Article 20, paragraph 4]***

Limitation of benefits

1.223 Relief from taxation which would otherwise be available under this Article will not apply where a creation or assignment of rights in respect of which the income is derived has been carried out with the main objective of, or one of the main objectives of, taking advantage of the relief available under this Article. ***[Article 20, paragraph 5]***

Article 21 – Source of income

Deemed source

1.224 This Article effectively deems income or gains derived by a resident of the United Kingdom which, in accordance with the tax treaty, may be taxed in Australia, to have a source in Australia for the purposes of the tax law of Australia. It therefore avoids any difficulties arising under domestic law source rules in respect of the exercise by Australia of the taxing rights allocated to Australia by the tax treaty over income derived by residents of the United Kingdom.

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Article 22 – Elimination of double taxation

1.225 Double taxation does not arise in respect of income flowing between Australia and the United Kingdom:

- where the terms of the tax treaty provide for the income to be taxed only in one country; or
- where the domestic taxation law of one of the countries exempts the income from its tax.

Tax credit

1.226 It is necessary, however, to prescribe a method for relieving double taxation for other classes of income or gains which, under the terms of the tax treaty, remain subject to tax in both countries. In accordance with international practice, Australia's tax treaties provide for double tax relief to be provided by the country of residence of the taxpayer by way of a credit basis of relief against its tax for the tax of the country of source. This Article also reflects that approach.

Australian method of relief

1.227 This Article requires Australia to provide Australian residents a credit against their Australian tax liability for United Kingdom tax paid in accordance with the tax treaty on income or gains derived from United Kingdom sources which are taxable in Australia. ***[Article 22, subparagraph 1(a)]***

1.228 Where a dividend is paid by a United Kingdom company to an Australian resident company which controls 10% or more of the voting power in the United Kingdom company, this Article requires Australia to allow a credit for the underlying United Kingdom tax paid by the company paying the dividend (i.e. the tax paid on the portion of its profits out of which the dividend is paid). This credit is in addition to any credit allowable for the United Kingdom tax paid in respect of the dividends themselves. ***[Article 22, subparagraph 1(b)]***

1.229 Australia's general foreign tax credit system, together with the terms of this Article and of the tax treaty generally, will form the basis of Australia's arrangements for relieving a resident of the United Kingdom from double taxation on income or gains arising from sources in the United Kingdom.

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1.230 Accordingly, effect is to be given to the tax credit relief obligation imposed on Australia by paragraph 1 of this Article by application of the general foreign tax credit provisions (Division 18 of Part III) of the ITAA 1936.

1.231 This will include the allowance of *underlying* tax credit relief in respect of dividends paid by United Kingdom resident companies that are related to Australian resident companies, where that Australian resident company controls directly or indirectly not less than 10% of the voting power of the United Kingdom company, including for unlimited tiers of related companies, in accordance with the relevant provisions of the ITAA 1936 and the ITAA 1997.

1.232 Notwithstanding the credit basis of relief provided for by paragraph 1 of this Article, the *exemption with progression* method of relief will be applicable, as appropriate, in relation to salary and wages and like remuneration derived by a resident of Australia during a continuous period of foreign service (as defined in subsection 23AG(7) of the ITAA 1936) in the United Kingdom.

1.233 Dividends and branch profits derived in the United Kingdom by an Australian resident company that are exempt from Australian tax under the foreign source income measures (e.g. sections 23AH or 23AJ of the ITAA 1936) will continue to qualify for exemption from Australian tax under those provisions. As double taxation does not arise in these cases, the credit form of relief will not be relevant.

United Kingdom relief

1.234 In the case of a resident of the United Kingdom who is taxable in the United Kingdom on income or chargeable gains which are also taxable in Australia under this tax treaty, this Article requires the United Kingdom to allow the United Kingdom resident a credit for the amount of Australian tax paid on that income or chargeable gains. ***[Article 22, subparagraph 2(a)]***

1.235 Where a dividend is paid by an Australian company to a United Kingdom company which controls 10% or more of the voting power in the Australian company, this Article requires the United Kingdom to allow a credit for the underlying Australian tax paid by the company paying the dividend (i.e. the tax paid on the portion of its profits out of which the dividend is paid). This credit is in addition to any credit allowable for the Australian tax paid in respect of the dividends themselves. ***[Article 22, subparagraph 2(b)]***

Source of income – double taxation relief

1.236 Paragraph 3 of this Article deems income or gains of a resident of one country, to have a source in the other country for the purposes of paragraph 1 and 2 of this Article, where the income or gains may be taxed in that other country under the rules contained in the tax treaty.

1.237 This provision is variously included in Article 21 (*Source of income*) or Article 22 (*Elimination of double taxation*) of Australia's tax treaties and has the operative effect of ensuring that where an item of income or gain is taxable in both countries, double taxation relief will be given by the recipient's country of residence in accordance with paragraphs 1 and 2 of this Article. In this way, income or gains derived by a resident of Australia, which is taxable by the United Kingdom under this treaty, will be treated as being foreign income for the purposes of the ITAA 1936 and the ITAA 1997, including the foreign tax credit provisions of the ITAA 1936. ***[Article 22, paragraph 3]***

Article 23 – Limitation of relief

1.238 The treaty provides that where income or gains derived by a resident of a country are taxed in that country only to the extent that such income or gains are remitted to the country, then any relief (such as exemption from taxation or reduction in tax rates) that the other country may be required to provide under the treaty will only apply to the amount remitted. ***[Article 23, paragraph 1]***

1.239 The United Kingdom operates a remittance-based system in respect of the income of taxpayers who are resident but not ordinarily resident in the United Kingdom. Under the United Kingdom's domestic law, such taxpayers are only subject to tax in the United Kingdom on the amount actually remitted to the United Kingdom. An example of the operation of this Article might be where only half of a dividend is remitted to the United Kingdom. In these circumstances, as the recipient is taxed in the United Kingdom only on that part of the dividend that is remitted to the United Kingdom, Australia would only be called on to limit its tax to the appropriate tax rate limitation specified in the treaty on half the dividend.

1.240 The treaty also provides that where an individual is a temporary resident of a country and is, for that reason, exempt from tax in that country on certain income or gains in that country, then the other country will not be required to provide any relief specified in the treaty in respect of such income or gains. ***[Article 23, paragraph 2]***

Article 24 – Partnerships

1.241 This provision is a complementary measure to the exclusion of a general law partnership from the definition of 'person' (see subparagraph 1(f) of Article 3 (*General definitions*)). It seeks to address possible implications of the decision in *Padmore v Inland Revenue Commissioners* (1989) Simon's Tax Cases 493 by ensuring that a country is not prevented from taxing a partner who is resident in that State on the partner's share of the income or gains of a partnership.

1.242 This Article clarifies that where a partnership is subject to tax as a resident of one country and income or gains derived in the other country are relieved from tax in that country under the treaty, the latter country may nevertheless tax any resident partner on their share of the partnership income or gains. However, the country of residence of the partner is required under Article 22 (*Elimination of double taxation*) to provide relief for tax imposed on that income or those gains in the other country. For this purpose, the income or gains are deemed to have a source in the country of which the partnership is a resident. ***[Article 24]***

Article 25 – Non–discrimination

1.243 Australia has to date only ever agreed to the inclusion of a *Non-discrimination* Article in its tax treaty with the United States (i.e. Article 23 (*Non-discrimination*) of Schedule 2 to the Agreements Act). The *Non-discrimination* Article in the United States treaty has limited operation, not having been given the force of law in Australia. Accordingly, it does not confer on taxpayers private rights of appeal.

1.244 Recommendation 22.22 of *A Tax System Redesigned* proposed that *Non-discrimination* Articles be agreed to in future Australian tax treaties. The new United Kingdom tax treaty gives effect to this recommendation. It will provide private rights of appeal for those coming within its terms.

1.245 The Australian tax system is generally non-discriminatory and as such it has not been seen as necessary in the past to include a *Non-discrimination* Article in Australia's tax treaties. As part of Australia's first such Article which provides taxpayers with private rights of appeal, it was agreed that certain pillars of the tax systems of Australia and the United Kingdom should not be seen as coming within the Article's terms. The measures identified can be characterised as being an integral part of today's administration of a country's economic and tax policy and the collection of its taxes. As such it has been recognised that the measures carved out do not offend the spirit or intendment of a *Non-discrimination* Article based on the OECD Model Article 24 (*Non-discrimination*).

Discrimination based on nationality

1.246 This Article prevents discrimination on the grounds of nationality by providing that nationals of one country may not be less favourably treated than nationals of the other country in the same circumstances. ***[Article 25, paragraph 1]***

1.247 The discrimination that the Article precludes applies to both taxation and any requirement connected therewith. Accordingly, discrimination in the administration of the tax law is also precluded.

1.248 The term ***national*** is defined under Article 3 (*General definitions*) of the tax treaty and covers both individuals who are citizens of one country or the other and companies which 'derive their status as such from the laws in force in a country'. Accordingly, a company that is incorporated in Australia would be a national of Australia while a company that is incorporated or otherwise constituted under a law of the United Kingdom would be a national of the United Kingdom for the purposes of this paragraph. ***[Article 3, subparagraph 1(l)]***

1.249 The term ***national*** also includes in the case of Australia any individual who has been granted permanent residency status. This provision covers those individuals who reside in Australia for extended periods of time without taking out Australian citizenship, for example, the holder of a permanent visa under the *Migration Act 1958*.

In the same circumstances/in particular with respect to residence

1.250 The expression 'in the same circumstances' refers to persons who, from the point of the application of the ordinary taxation laws and regulations, are in substantially similar circumstances both in law and in fact.

1.251 Where a person operates in an industry that is subject to government regulation such as prudential oversight, another person operating in the same industry but not subject to the same oversight, would not be in the same circumstances.

1.252 The inclusion of the further clarification 'in particular with respect to residence' makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. Therefore, different treatment accorded to a United Kingdom resident compared to an Australian resident will not constitute discrimination for purposes of this Article. A potential breach of paragraph 1 of this Article only arises if two persons who are residents of the same country are treated differently solely by reason of one being a national of Australia and the other a national of the United Kingdom.

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Other or more burdensome

1.253 The words 'more burdensome' taxation refer to the quantum of taxation while 'other' taxation may refer to some form of income tax other than the form of income tax to which a national of the country is subject (*Woodend Rubber Co. v Commissioner of Inland Revenue* [1971] A.C. 321 at 332).

1.254 The phrase is also applicable to administrative or compliance requirements that a taxpayer may be called upon to meet where those requirements differ based on nationality grounds.

Non-residents of Australia/United Kingdom

1.255 Unlike paragraph 1 of Article 24 (*Non-discrimination*) of the OECD Model, paragraph 1 of this Article does not apply to persons who are not residents of either Australia or the United Kingdom. It follows that residents of third countries cannot seek the benefits of this provision. The provision also does not extend to residents of either country who are not nationals (as defined in Article 3 (*General definitions*)) of either country.

Non-discrimination and permanent establishments

1.256 Paragraph 2 of this Article provides that the tax on permanent establishments of enterprises of the other country shall not be levied less favourably than on the country's own enterprises carrying on the same activities in similar circumstances. This provision applies to all residents of a treaty country, irrespective of their nationality, who have a permanent establishment in the other country. ***[Article 25, paragraph 2]***

1.257 Unlike paragraph 2 of Article 24 (*Non-discrimination*) of the OECD Model, paragraph 2 of this Article contains the additional proviso that, for this paragraph to apply, the enterprises of both countries must be 'in similar circumstances'. Therefore, the comparison must be made between a permanent establishment and local enterprises which are not only carrying on the same activities but are also carrying on those activities 'in similar circumstances'. This is to address situations where resident and non-resident enterprises may be carrying on the same activities but the circumstances in which they do so are very different. For example, one may be conducting dealings on a non-arm's length basis and the other on an arm's length basis. The provision recognises that appropriate differences in taxation treatment are not precluded because of the differing circumstances.

1.258 Permanent establishments of non-resident enterprises may be treated differently from resident enterprises as long as the treatment does not result in more burdensome taxation for the former than for the latter. That is, a different mode of taxation may be adopted with respect to non-resident enterprises, to take account of the fact that they often operate in different conditions to resident enterprises. The provision would not affect, for example, domestic law provisions that tax a non-resident by withholding, provided that calculation of the tax payable is not greater than that applying to a resident taxpayer.

Deductions paid to non-residents

1.259 Paragraph 3 of this Article requires the treaty partner countries to allow the same deductions for interest, royalties and other disbursements paid to residents of the other country as it does for payments to its own residents. However, the paragraph allows the treaty countries to reallocate profits between related enterprises on an arm's length basis under Article 9 (*Associated enterprises*) and to limit deductions in accordance with paragraph 8 or 9 of Article 11 (*Interest*), paragraph 6 or 7 of Article 12 (*Royalties*) or paragraph 4 or 5 of Article 20 (*Other income*). ***[Article 25, paragraph 3]***

Companies owned or controlled abroad

1.260 Paragraph 4 of this Article prevents a country from giving less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other country. That is, Australian companies owned or controlled by United Kingdom residents may not be given less favourable treatment than locally owned or controlled Australian companies. ***[Article 25, paragraph 4]***

1.261 Differential tax treatment based on residency is not affected by this paragraph. Nor does the paragraph require the same treatment of non-resident shareholders in the company as resident shareholders. Accordingly, there is no obligation under this provision or any other provision of the Article to allow imputation credits to non-resident shareholders. This position is made explicit in the Notes. ***[Exchange of Notes, Item 9(b)]***

1.262 In relation to paragraph 4 of this Article, the Notes provides that a reference to capital being owned or controlled 'directly or indirectly' is to be taken as including cases where the capital is held through a chain of companies or other entities. ***[Exchange of Notes, Item 9(a)]***

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Exclusions

1.263 Non-resident individuals do not have to be granted the personal allowances, reliefs or reductions available to residents of the tax treaty countries. ***[Article 25, paragraph 5]***

1.264 This means that Australia will continue to be able to tax non-resident individuals according to a different tax rate scale to residents.

1.265 Unlike paragraph 3 of Article 24 (*Non-discrimination*) of the OECD Model, paragraph 5 of this Article is not just limited to those benefits conferred by a country relating to civil status or family responsibilities of the individual. For Australian tax purposes, it also extends, for example, to the tax-free threshold which may be considered not to be based either on civil status or family responsibilities.

1.266 Paragraph 6 of this Article excludes from the operation of the Article certain provisions of the law of both countries that are important for purposes of economic regulation and integrity of the tax system. Although most are generally recognised by the international community as not being discriminatory, the specific exclusion of these provisions will ensure that they can continue to operate for their intended purpose. The provisions of the law of Australia and the United Kingdom to be excluded are those that:

- prevent the avoidance or evasion of taxes;
- defer tax where an asset is transferred out of the jurisdiction;
- provide for consolidation of group entities;
- provide for deductions for research and development expenditure;
- are agreed in an Exchange of Notes between the two Governments to be unaffected by the Article.

[Article 25, paragraph 6]

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Avoidance or evasion provisions

1.267 Subparagraph (6)(a) of this Article ensures that the operation of domestic measures to combat avoidance and evasion is not affected by this Article. The Notes provide that the reference to laws designed to prevent avoidance or evasion of taxes includes thin capitalisation, dividend stripping, transfer pricing and controlled foreign company, trust and foreign investment fund provisions. Although it is commonly accepted by most OECD member countries that such provisions do not contravene *Non-discrimination* Articles, this outcome is specifically provided for in this treaty by the exclusion of such rules from the operation of this Article. ***[Exchange of Notes, Item 1(d)]***

1.268 The Notes also provide that references in the treaty to laws of a country 'designed to prevent the avoidance or evasion of taxes' covers measures designed to ensure that taxes can be effectively recovered (conservancy measures). ***[Exchange of Notes, Item 1(d)(iii)]***

1.269 The enforcement and operation of the various aspects of the withholding tax provisions relating to non-residents are preserved by the operation of this provision. For example, section 221YRA (*Recovery of amounts by the Commissioner*) of the ITAA 1936 provides that where interest or royalties are paid to a non-resident and the payer fails to deduct withholding tax that the interest or royalty cannot be claimed as a deduction. No similar measure exists in relation to payments from a resident to another resident.

Capital gains roll-over relief

1.270 This Article will not affect the operation of any provision of domestic tax legislation which does not permit the deferral of tax arising on the transfer of an asset where the transfer of the asset by the transferee would take the asset beyond the taxing jurisdiction of the country. ***[Article 25, subparagraph 6(b)]***

1.271 Under Australia's domestic tax legislation permanent establishments generally enjoy the same tax treatment as resident enterprises. However, roll-over relief is denied to a permanent establishment where an asset with the necessary connection with Australia is transferred to a non-resident if the asset is not an asset with the necessary connection with Australia in the hands of the transferee. Subparagraph 6(b) ensures that Australia will be able to continue to deny roll-over relief in these circumstances.

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Consolidation

1.272 Domestic law rules which provide for single entity treatment of a group of entities are excluded from the operation of this Article, provided that there is no discrimination regarding access to consolidation treatment between Australian resident companies on the basis of ownership of the company.

1.273 The *Business Tax Reform consolidation measures* are restricted to wholly-owned Australian resident groups. The Article will not apply to these measures, with the result that domestic law provisions continue to operate to preclude permanent establishments of non-resident companies from consolidating with resident entities that may be wholly-owned by a non-resident. ***[Article 25, subparagraph 6(c)]***

Research and development expenditure

1.274 The domestic law research and development provisions are excluded from the operation of this Article. It follows that Australia will be able to continue to apply its domestic law rules concerning access to concessions in respect of research and development expenditure. Currently, these concessions are only available to companies that are incorporated in Australia. ***[Article 25, subparagraph 6(d)]***

Power to carry out an Exchange of Notes

1.275 Subparagraph 6(e) of this Article provides a mechanism for the two Governments to exclude other provisions of domestic law from the operation of the Article. The two Governments may agree in an Exchange of Notes that other domestic law provisions will not be affected by the requirements of the Article. ***[Article 25, subparagraph 6(e)]***

Taxes to which the Non-discrimination Article applies

1.276 Paragraph 7 of this Article provides that this Article shall only apply to taxes which are covered by the tax treaty as specified in Article 2 (*Taxes covered*). ***[Article 25, paragraph 7]***

1.277 In the case of Australia, the relevant taxes are the income tax (including the petroleum resource rent tax and tax on capital gains) and the FBT. Other federal taxes, such as the GST, are not affected by this Article. The provisions of this Article also do not apply to taxes imposed by the Australian States and Territories (see also commentary to Article 2 (*Taxes covered*)).

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More favourable treatment

1.278 Nothing in this Article prevents either country from treating residents of the other country more favourably than its own residents.

Article 26 – Mutual agreement procedure

Consultation on specific cases

1.279 This Article provides for consultation between the competent authorities of the two countries with a view to reaching a solution in cases where a person is able to demonstrate actual or potential imposition of taxation contrary to the provisions of the tax treaty. ***[Article 26, paragraph 2]***

1.280 A person wishing to use this procedure may present a case to the competent authority of the country of which the person is a resident. If the case comes under paragraph 1 of Article 25 (*Non-discrimination*) of this tax treaty, the person must present a case to the competent authority of the country of which the person is a national. Presentation of a case by a person to a competent authority does not deprive them of access to, or affect their rights in relation to, other legal remedies available under the domestic laws of the countries. ***[Article 26, paragraph 1]***

1.281 If, after consideration by the competent authorities, a solution is reached, it shall be implemented, subject to the domestic law time limits of each country.

Time limits

Presentation of the case

1.282 Unlike most Australian tax treaties, this Article does not specify a time limit within which a case must be presented to the competent authority. Generally, Australian tax treaties provide that the case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty.

1.283 The omission of this sentence from the paragraph 1 of this Article means that a taxpayer wishing to make use of this procedure must present their case to the competent authority of the country of which the person is a resident, or of which they are a national, within the time period stipulated under the domestic law of the country of residence or nationality. The applicable time limits under domestic law need not specifically refer to the competent authority process. ***[Article 26, paragraph 1; Exchange of Notes, Item 11]***

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1.284 In the case of an Australian resident or national, the objection process under section 175A of the ITAA 1936 and the time limits prescribed under Division 3 of Part IVC of the *Taxation Administration Act 1953* will apply. The time for lodging an objection is generally four years from the date of assessment. An Australian resident or national may also lodge a request for an extension of time to lodge an objection under section 14ZX of the *Taxation Administration Act 1953*. These time limits will also apply for the purpose of presenting a case to the Australian competent authority under this Article.

1.285 The omission of this sentence was agreed to by Australia on the basis of the United Kingdom's consistent treaty practice. The United Kingdom has lodged a reservation to Article 25 (*Mutual Agreement Procedure*) of the OECD Model that reserves the United Kingdom's position on the inclusion of the sentence on the grounds that the three year limit conflicts with the longer six year limit prescribed by its domestic law.

Implementation of a solution

1.286 No time limit is specified for implementation of any solution reached between competent authorities. This is a departure from Australia's usual treaty practice of including at the end of paragraph 2 an additional sentence which provides that the solution so reached shall be implemented notwithstanding any time limits in the domestic laws of the tax treaty countries.

1.287 The omission of this sentence from paragraph 2 of this Article means in Australia's case, that the normal domestic time limits contained in section 170 (*Amendment of assessments*) of the ITAA 1936 would apply to the implementation of any solution reached by the competent authorities.

1.288 In practice, the absence of a specific provision in the Article to override Australian domestic law time limits on amendments has no material effect on the Commissioner's ability to implement a solution reached on a transfer pricing case with a treaty partner (administrative practice for the implementation of a solution in transfer pricing cases is summarised at paragraphs 4.30 to 4.35 of Taxation Ruling TR 2000/16 (Income tax: international transfer pricing – transfer pricing and profit reallocation adjustments, relief from double taxation and the Mutual Agreement Procedure)).

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1.289 The time limits under Australian domestic tax law for implementation of a solution in non-transfer pricing cases are either four years from the date of assessment or two years in the case of a shorter period of review taxpayer as defined in section 6AD of the ITAA 1936 for an amendment to effect a reduction in a taxpayer's liability (subsection 170(3) of the ITAA 1936). However, if the taxpayer lodges an objection to their assessment within the required time, their assessment can be amended at any time to give effect to a successful objection (subsection 170(7) of the ITAA 1936).

1.290 While the lodging of an objection to an assessment in Australia is not a condition for access to the mutual agreement procedure process, by doing so, either within:

- the prescribed time limits for lodgment; or
- such later period as the Commissioner allows,

the person can ensure that, if a solution is reached between competent authorities on their non-transfer pricing case, the solution can be implemented in Australia, notwithstanding the absence of a specific provision in the Article to override Australian domestic law time limits on amendments.

1.291 The omission of the sentence concerning time limits with respect to the implementation of reliefs and refunds following a solution reached under the mutual agreement procedure is consistent with the United Kingdom's treaty practice. The United Kingdom has lodged a reservation to Article 25 (*Mutual Agreement Procedure*) of the OECD Model on the grounds that the implementation of reliefs and refunds should remain linked to the time–limits prescribed under the United Kingdom's domestic law.

Consultation on general problems

1.292 This Article also authorises consultation between the competent authorities of the two countries for the purpose of resolving any difficulties that arise regarding the interpretation or application of the treaty and to give effect to it. They may also consult together regarding elimination of double taxation in cases not provided for in the tax treaty. ***[Article 26, paragraph 3]***

Methods of communication between competent authorities

1.293 The competent authorities are able to communicate directly with each other without having to go through diplomatic channels. This may be done by letter, facsimile transmission, telephone, direct meetings or any other convenient means. ***[Article 26, paragraph 4]***

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Application of Article without regard to the date of the relevant transactions

1.294 The Notes confirm that consultation under this Article may be conducted once the treaty enters into force, irrespective of when the relevant transactions to which the issue relates took place. For example, this allows a case presented by a taxpayer after the date of entry into force of the new treaty, but relating to an income year prior to entry into force, to be the subject of consultation under this Article. ***[Exchange of Notes, Item 10]***

General Agreement on Trade in Services dispute resolution process

1.295 This Article deals with disputes that may be brought before the Council for Trade in Services in accordance with paragraph 3 of Article XXII (*Consultation*) of the World Trade Organisation GATS. ***[Article 26, paragraph 5]***

Background

1.296 Australia and the United Kingdom are both parties to the GATS. Article XVII (*National Treatment*) of this treaty requires a party to accord the same treatment to services and service suppliers of other parties as it accords to its own like services and service suppliers.

1.297 Articles XXII (*Consultation*) and XXIII (*Dispute Settlement and Enforcement*) provide for discussion and resolution of disputes. Paragraph 3 of Article XXII provides that a party may not invoke Article XVII (*National Treatment*) with respect to a measure of another party that falls within the scope of an international agreement between them relating to the avoidance of double taxation. However, if there is a dispute as to whether a measure actually falls within the scope of a tax agreement, either country may take the matter to the Council on Trade in Services for referral to binding arbitration.

1.298 Notwithstanding paragraph 3 of Article XXII, Australia and the United Kingdom have agreed that the consent of both countries is required before a dispute as to whether a measure falls within the scope of this tax treaty may be brought before the Council on Trade in Services. This is seen as the most effective way of dealing with such disputes, and avoids difficult questions as to when a disputed issue falls within the dispute resolution mechanism of this tax treaty or of the GATS dispute.

1.299 This provision is based, in all essential respects, on an OECD Model commentary recommendation, and is common in recent international treaty practice. ***[Article 26, paragraph 5]***

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Article 27 – Exchange of information

Limitations on exchange

1.300 This Article authorises and limits the exchange of information by the two competent authorities to information foreseeably relevant to the administration or enforcement of the provisions of the treaty or of the domestic laws concerning the taxes to which the tax treaty applies. The exchange of information is not limited by Article 1 (*Persons covered*) of this tax treaty, and may therefore cover persons who are not residents of Australia or the United Kingdom. ***[Article 27, paragraph 1]***

1.301 The standard of foreseeable relevance is intended to provide for exchange of information in tax matters to a wide extent. However, competent authorities would not be entitled to request information from the other country which is unlikely to be relevant to the tax affairs of a taxpayer, or to the administration and enforcement of tax laws.

1.302 The limitation placed on the kind of information authorised to be exchanged means that information access requests relating to taxes not within the coverage provided by Article 2 (*Taxes covered*) of the treaty, for example Australia's GST, are not within the scope of the Article.

Purpose

1.303 The purposes for which the exchanged information may be used and the persons to whom it may be disclosed are restricted consistent with Australia's tax treaty practice. Any information received by a country must be treated as secret in the same manner as information obtained under the domestic law of that country. ***[Article 27, paragraph 1]***

1.304 When requested, a country is required to obtain information in the same manner as if it were administering its domestic tax system, notwithstanding that the country may not require the information for its own purposes. There is no requirement that the country receiving the request must require the same information for the purposes of administering its domestic law. ***[Article 27, paragraph 2]***

1.305 This provision was included in accordance with the United Kingdom's observation on Article 26 (*Exchange of information*) of the OECD Model. It is intended to overcome limitations in their domestic law on collection of information in cases where no liability to United Kingdom tax arises. Australia would recognise the obligation to obtain relevant information in these cases for treaty partner countries, even in the absence of an explicit provision to this effect.

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1.306 The country requested to provide information under this Article is not obliged to provide such information where:

- it would be required to carry out administrative procedures incompatible with its own law or the administrative practice in that country or the country requesting the information; or
- such information is not obtainable within the limitations imposed under its domestic law or in the normal course of administration in that country or the country requesting the information.

[Article 27, subparagraphs 3(a) and (b)]

1.307 Also, in no case is the country receiving the request obliged to supply information under this Article that would:

- disclose any trade, business, industrial, commercial or professional secret or trade process; or
- be contrary to public policy.

[Article 27, subparagraph 3(c)]

Application

1.308 This Article applies to all taxes covered by the tax treaty. In the case of Australia these are:

- the income tax (including that imposed on capital gains);
- the petroleum resource rent tax in respect of offshore petroleum projects; and
- the FBT.

Application of Article without regard to the date to which the information on relevant transactions refers

1.309 The Notes confirm that information on relevant transactions, irrespective of the period to which the information relates, may be exchanged under this Article, once the treaty enters into force.

1.310 For example, where a request for information is made in accordance with this Article after the new treaty enters into force, information relating to an earlier period may be exchanged.
[Exchange of Notes, Item 10]

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Article 28 – Members of diplomatic missions or permanent missions and consular posts

1.311 The purpose of this Article is to ensure that the provisions of the tax treaty do not result in members of diplomatic missions, permanent missions and consular posts receiving less favourable treatment than that to which they are entitled in accordance with international conventions. Such persons are entitled, for example, to certain fiscal privileges under the *Diplomatic Privileges and Immunities Act 1967* and the *Consular Privileges and Immunities Act 1972* which reflect Australia's international diplomatic and consular obligations. ***[Article 28]***

Article 29 – Entry into force

Date of entry into force

1.312 This Article provides for the entry into force of the tax treaty. The treaty will enter into force on the last date on which diplomatic notes are exchanged notifying that the domestic processes to give the tax treaty the force of law in the respective countries has been completed. In Australia, enactment of the legislation giving the force of law in Australia to the tax treaty along with tabling the treaty in Parliament are prerequisites to the exchange of diplomatic notes. ***[Article 29, paragraph 1]***

Date of application for Australian taxes

Withholding taxes

1.313 Once it enters into force, the treaty will apply in Australia in respect of withholding tax on income that is derived by a non-resident in relation to income derived on or after 1 July next following the date on which the tax treaty enters into force. ***[Article 29, sub-subparagraph 1(a)(i)]***

Fringe benefits tax

1.314 The treaty will apply in Australia in respect of fringe benefits provided on or after 1 April next following the date on which the tax treaty enters into force. ***[Article 29, sub-subparagraph 1(a)(ii)]***

Other Australian taxes

1.315 The treaty will first apply to other Australian taxes on income or gains of the Australian year of income beginning on or after 1 July next following the date on which the tax treaty enters into force.

1.316 Where a taxpayer has adopted an accounting period ending on a date other than 30 June, the accounting period that has been substituted for the year of income beginning on 1 July next following the date on which the tax treaty enters into force will be the relevant year of income for the purposes of the application of such Australian tax. ***[Article 29, sub-subparagraph 1(a)(iii)]***

Date of application in the United Kingdom

Taxes withheld at source

1.317 In the United Kingdom, the treaty will first have effect, in relation to taxes withheld at source, for amounts paid or credited on or after 1 July next following the date on which the tax treaty enters into force. ***[Article 29, sub-subparagraph 1(b)(i)]***

Capital gains tax and income tax (excluding those taxes withheld at source)

1.318 The treaty will first have effect, in relation to CGT and income tax (excluding those taxes withheld at source for which the date of effect is 1 July next following the date on which the tax treaty enters into force), for any United Kingdom year of assessment commencing on or after 6 April next following the date on which the tax treaty enters into force. ***[Article 29, sub-subparagraph 1(b)(ii)]***

Corporation tax

1.319 In the United Kingdom, the treaty will first have effect, in relation to the corporation tax, for any financial year commencing on or after 1 April next following the date that the tax treaty enters into force. ***[Article 29, sub-subparagraph 1(b)(iii)]***

Termination of the existing treaty as amended by the protocol

Taxes covered under paragraph 1 of Article 29

1.320 The existing treaty shall cease to have effect from the dates on which the new treaty commences application for the respective taxes. ***[Article 29, paragraph 2]***

Tax credits for dividends paid by United Kingdom resident companies to Australian resident beneficial owners

1.321 The existing treaty will cease to have effect in respect of tax credits on dividends paid by United Kingdom resident companies for dividends paid on or after 1 July next following the date on which the new tax treaty enters into force. ***[Article 29, paragraph 2]***

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Transitional arrangements for visiting teachers and professors

1.322 At the date of entry into force of the new treaty, an individual who is entitled to benefits under Article 16 of the existing treaty, as amended by the 1980 protocol, shall continue to have access to the benefit provided for a limited period.

1.323 To qualify for the exemption under Article 16 of the existing treaty for remuneration from specified teaching activities, the visit must be 'for a period not exceeding two years'. This effectively limits these transitional arrangements to a maximum of two years from the date of entry into force of the new treaty. The actual period that a particular individual will qualify for the exemption will depend on their circumstances and the date they became eligible for the exemption under Article 16 of the existing treaty. ***[Article 29, paragraph 3]***

Article 30 – Termination

1.324 The tax treaty is to continue in effect indefinitely. However, either country may give written notice of termination of the tax treaty through the diplomatic channel on or before 30 June in any calendar year beginning after the expiration of 5 years from the date of its entry into force. ***[Article 30]***

Cessation in Australia

1.325 In the event of either country terminating the tax treaty, the tax treaty would cease to be effective in Australia for the purposes of:

- withholding tax on income derived by a non-resident in relation to income derived on or after 1 January in the calendar year next following that in which the notice of termination is given;
- FBT, in respect of fringe benefits provided on or after 1 April in the calendar year next following that in which the notice of termination is given; and
- other Australian taxes in relation to income or gains in the Australian year of income commencing on or after 1 July in the calendar year next following that in which the notice of termination is given.

[Article 30, subparagraph (a)]

Cessation in the United Kingdom

1.326 The tax treaty would correspondingly cease to be effective in the United Kingdom for the purposes of:

- taxes withheld at source, for amounts paid or credited on or after 1 January in the calendar year next following that in which the notice of termination is given;
- CGT and income tax (excluding those taxes withheld at source and subject to clause (i)), for any United Kingdom year of assessment commencing on or after 6 April in the calendar year next following that in which the notice of termination is given; and
- corporation tax, for any financial year commencing on or after 1 April in the calendar year next following that in which the notice of termination is given.

[Article 30, subparagraph (b)]

Item 1(3) of the Exchange of Notes – Tax treaty does not take precedence over domestic provisions designed to prevent the avoidance or evasion of taxes

1.327 Tax treaty provisions generally prevail over inconsistent provisions in the domestic law. In Australia, this principle is recognised in subsections 4(2) and 4AA(2) of the Agreements Act. However,

- subsection 4(2) of the Agreements Act preserves the operation of Part IVA (Schemes to reduce income tax) of the ITAA 1936; and
- subsection 4AA(2) of the Agreements Act preserves the operation of section 67 (Arrangements to reduce or avoid FBT) of the *Fringe Benefits Tax Assessment Act 1986*.

1.328 Item 1(e) of the Notes ensures that nothing in the treaty shall be construed as restricting or limiting in any way the general application of any provisions under Australian or United Kingdom domestic law that are designed for the purpose of preventing the avoidance or evasion of taxes. Such provisions would include, in the case of Australia, the provisions noted in the previous paragraph. ***[Exchange of Notes, Item 1(e)]***

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1.329 Item 1(d) of the Notes further elaborates that the phrase 'any provision of the laws of a country which is designed to prevent the avoidance or evasion of taxes' includes:

- measures designed to address thin capitalisation, dividend stripping and transfer pricing;
- controlled foreign company, transferor trust and foreign investment fund rules; and
- measures designed to ensure that taxes can be effectively recovered.

[Exchange of Notes, Item 1(d)]

Item 12 of the Exchange of Notes – Regular consultation

1.330 To ensure that the treaty continues to achieve its purposes of avoiding double taxation and preventing fiscal evasion, the exchange of Notes provides for regular consultation between the two countries regarding the treaty's terms, operation and application. Such consultations are to take place at intervals of not more than five years, with the first such review occurring no later than the end of the fifth year after the entry into force of the new treaty in accordance with the provisions of Article 29 (*Entry into force*). Such consultations will enable both countries to consider whether any further action – such as resolving matters of interpretation or application of the treaty through agreement between competent authorities, or negotiating amendments to the treaty – are required to ensure that the treaty remains appropriate and effective. Neither country is under a formal obligation to enter into negotiations to amend or replace the treaty. ***[Exchange of Notes, Item 12]***

Chapter 2
The Mexican agreement

What is the Mexican agreement?

2.1 The Mexican agreement is an *Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and the *Protocol* thereto (referred to as 'tax treaty' or 'treaty' for the purposes of this chapter), signed in Mexico City on 9 September 2002.

Why is the treaty necessary?

2.2 The new treaty, which is the first tax treaty between Australia and Mexico, will facilitate trade and investment between the two countries by:

- preventing double taxation and providing a level of security about the tax rules that will apply to particular international transactions by:
  - allocating taxing rights between the two countries over different categories of income;
  - specifying rules to resolve dual claims in relation to the residential status of taxpayers, who are residents of the treaty countries, and their source of income; and
  - providing taxpayers, who are residents of the treaty countries, with an avenue to present a case for determination by the relevant taxation authorities where the taxpayers consider there has been taxation treatment contrary to the terms of the tax treaty; and

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- preventing avoidance and evasion of taxes on various forms of income flows between the two countries by:
  - providing for the allocation of profits between related parties on an *arm's length* basis;
  - generally preserving the application of domestic law rules that are designed to address transfer pricing and other international avoidance practices; and
  - providing for exchanges of information between the Australian and Mexican taxation authorities.

Main features of the tax treaty

2.3 The tax treaty between Australia and Mexico will facilitate trade and investment between the two countries by preventing double taxation and reducing tax obstacles to cross-border movement of capital, technology and people.

2.4 The tax treaty accords substantially with other Australian comprehensive tax treaties concluded prior to the review of Australia's international tax arrangements.

2.5 The features of the tax treaty include:

- Dual resident persons (i.e. persons who are residents of both Australia and Mexico according to the domestic law of each country) are, in accordance with specified criteria, to be treated for the purposes of the tax treaty as being residents of only one country. Where a non-individual such as a company is resident in both countries for their domestic tax purposes, the entity will be deemed to be a resident of the country in which its place of effective management is situated ***[Article 4]***.
- Income from real property may be taxed in full by the country in which the property is situated. Income from real property for these purposes includes natural resource royalties ***[Article 6]***.
- Business profits are generally to be taxed only in the country of residence of the recipient unless they are derived by a resident of one country through a branch or other prescribed permanent establishment in the other country, in which case

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that other country may tax the profits. Sales of similar goods and merchandise not through a permanent establishment may in certain circumstances be subject to Article 7 ***[Article 7].***

- Profits from the operations of ships and aircraft are generally to be taxed only in the country of residence of the operator ***[Article 8].***

- Profits of associated enterprises may be taxed on the basis of dealings at arm's length ***[Article 9].***

- Dividends, interest and royalties may generally be taxed in both countries, but there are limits on the tax that the country in which the dividend, interest or royalty is sourced may charge on such income flowing to residents of the other country who are beneficially entitled to that income. These limits are 10% for royalties and 10% or 15% for interest. No tax is payable on dividends which have been fully taxed at the corporate level and where the dividend recipient is a company that holds directly at least 10% of the voting power of the company paying the dividend. A 15% limitation applies to other dividends ***[Articles 10 to 12].***

- Income or profits from the alienation of real property may be taxed in full by the country in which the property is situated. Subject to that rule and other specific rules in relation to business assets and some shares, capital gains are to be taxed in accordance with the domestic law of each country ***[Article 13].***

- Income from independent personal services provided by an individual will generally be taxed only in the country of residence of the recipient. However, remuneration derived by a resident of one country in respect of professional services rendered in the other country may be taxed in the other country, where derived through a fixed base of the person concerned in that country, or if the person is present for more than 183 days in that country ***[Article 14].***

- Income from employment, that is, employee's remuneration, will generally be taxable in the country where the services are performed. However, where the services are performed during certain short visits to one country by a resident of the other country, the income will be exempt in the country visited ***[Article 15].***

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- Directors' fees and other similar payments may be taxed in the country of residence of the paying company ***[Article 16]***.

- Income derived by entertainers and sportspersons may generally be taxed by the country in which the activities are performed ***[Article 17]***.

- Pensions and annuities (including for public service) may be taxed only in the country of residence of the recipient ***[Article 18]***.

- Income from government service will generally be taxed only in the country that pays the remuneration. However, the remuneration may be taxed in the other country in certain circumstances where the services are rendered in that other country ***[Article 19]***.

- Payments to visiting students will be exempt from tax in the country visited insofar as they consist of payments made from abroad for the purposes of their maintenance or education ***[Article 20]***.

- Other income (i.e. income not dealt with by other Articles) may generally be taxed in both countries, with the country of residence of the recipient providing double tax relief ***[Article 21]***.

- Double taxation relief for income which, under the tax treaty, may be taxed by both countries, is required to be provided by the country in which the taxpayer is resident under the terms of the tax treaty as follows:

  – in Australia by allowing a credit for the Mexican tax against Australian tax payable on income derived by a resident of Australia from sources in Mexico;

  – in Mexico, by allowing a credit against Mexican tax for the Australian tax paid on income derived by a resident of Mexico from sources in Australia; and

  – both Australia and Mexico are required to give credit for underlying taxes on incoming non-portfolio intercorporate dividends should they tax such dividends.

  [Article 23]

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- In the case of Australia, effect will be given to the double tax relief obligations arising under the tax treaty by application of the general foreign tax credit provisions of Australia's domestic law, or the relevant exemption provisions of that law where applicable ***[Article 23]***.

- Consultation and exchange of information between the two taxation authorities is authorised by the tax treaty ***[Articles 24 and 25]***.

Detailed explanation of the provisions

Article 1 – Personal Scope

2.6 This Article establishes the scope of the application of the tax treaty by providing for it to apply to persons (defined to include individuals, companies and any other body of persons) who are residents of one or both of the countries. It generally precludes extra-territorial application of the treaty.

2.7 The application of the tax treaty to persons who are dual residents (i.e. residents of both countries) is dealt with in Article 4 (*Residence*).

Article 2 – Taxes Covered

Taxes covered

2.8 This Article specifies the existing taxes of each country to which the tax treaty applies. These are, in the case of Australia:

- the Australian income tax; and

- the resource rent tax in respect of offshore petroleum projects.

2.9 In the case of Australia, income tax (including that imposed on capital gains) and resource rent tax are covered by the tax treaty. Goods and services tax, fringe benefits tax, wool tax and levies, customs duties, Australian State taxes and duties and estate tax and duties are not covered by the tax treaty. ***[Article 2, subparagraph 1(b)]***

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2.10 It is specifically stated that this Article applies only to taxes imposed under the federal law of Australia. This is to ensure that the tax treaty does not bind Australian States and Territories and applies only to federal taxes. ***[Article 2, subparagraph 1(b) and paragraph 2]***

2.11 For Mexico, the tax treaty applies to the federal income tax (*el impuesto sobre la renta federal*). ***[Article 2, subparagraph 1(a)]***

Identical or substantially similar taxes

2.12 The application of the tax treaty will be automatically extended to any identical or substantially similar taxes which are subsequently imposed by either country in addition to, or in place of, the existing taxes. The two countries are required to notify each other within a reasonable time of any significant changes in their respective laws to which this tax treaty applies. ***[Article 2, paragraph 2]***

Article 3 – General Definitions

Definition of Australia

2.13 As with Australia's other modern taxation agreements, ***Australia*** is defined to include certain external territories and areas of the continental shelf. By reason of this definition, Australia preserves its taxing rights, for example, over mineral exploration and mining activities carried on by non-residents on the seabed and subsoil of the relevant continental shelf areas (under section 6AA of the ITAA 1936, certain sea installations and offshore areas are to be treated as part of Australia). ***[Article 3, subparagraph 1(b)]***

Definition of company

2.14 The definition of ***company*** in the tax treaty accords with Australia's tax treaty practice. It reflects the fact that Australia's domestic tax law does not specifically use the expression body corporate for tax purposes.

2.15 The Australian tax law treats certain trusts (public unit trusts and public trading trusts) and corporate limited partnerships as companies for income tax purposes. These entities are included as companies for the purposes of the tax treaty. ***[Article 3, subparagraph 1(e)]***

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Definition of international traffic

2.16 In this tax treaty, this term is only relevant in relation to the alienation of ships and aircraft (paragraph 4 of Article 13 (*Alienation of Property*)) and wages of crew (paragraph 3 of Article 15 (*Dependent Personal Services*)). ***[Article 3, subparagraph 1(i)]***

Definition of tax

2.17 For the purposes of the tax treaty, the term ***tax*** does not include any amount of penalty or interest imposed under the respective domestic law of the two countries. This is important in determining a taxpayer's entitlement to a foreign tax credit under the double tax relief provisions of Article 23 (*Methods of Elimination of Double Taxation*) of the tax treaty.

2.18 In the case of a resident of Australia, any penalty or interest component of a liability determined under the domestic taxation law of Mexico with respect to income that Mexico is entitled to tax under the tax treaty, would not be a creditable 'Mexican tax' for the purposes of paragraph 2 of Article 23 (*Methods of Elimination of Double Taxation*) of the tax treaty. This is in keeping with the meaning of foreign tax in the ITAA 1936 (subsection 6AB(2)). Accordingly, such a penalty or interest liability would be excluded from calculations when determining the Australian resident taxpayer's foreign tax credit entitlement under paragraph 2 of Article 23 (pursuant to Division 18 of Part III of the ITAA 1936 – Credits in Respect of Foreign Tax). ***[Article 3, subparagraph 1(k)]***

Terms not specifically defined

2.19 Where a term is not specifically defined within this tax treaty, that term (unless used in a context that requires otherwise) is to be taken to have the same interpretative meaning as it has under the domestic taxation law of the country applying the tax treaty at the time of its application, with the meaning it has under the taxation law of the country having precedence over the meaning it may have under other domestic laws.

2.20 If a term is not defined in the tax treaty, but has an internationally understood meaning in tax treaties and a meaning under the domestic law, the context would normally require that the international meaning be applied. ***[Article 3, paragraph 2]***

Article 4 – Residence

Residential status

2.21 This Article sets out the basis by which the residential status of a person is to be determined for the purposes of the tax treaty. Residential status is one of the criteria for determining each country's taxing rights and is a necessary condition for the provision of relief under the tax treaty. The concept of who is a resident according to each country's taxation law provides the basic test. ***[Article 4, paragraph 1; Protocol, Item 1]***

Special residency rules

2.22 Paragraph 2 specifies that a person is not a resident of a country (for purposes of the tax treaty) if that person is liable to tax in that country in respect only of income from sources in that country. This paragraph deals with a person who may not be domiciled in a country, but who may be considered to be a resident according to its domestic laws and may only be subject to taxation on income from sources in that country, for example, foreign diplomatic and consular staff. In the Australian context this means that Norfolk Island residents who are generally subject to Australian tax on Australian source income only, will not be residents of Australia for the purposes of the tax treaty. Accordingly, Mexico will not have to forgo tax in accordance with the tax treaty on income derived by residents of Norfolk Island from sources in Mexico (which will not be subject to Australian tax). ***[Article 4, paragraph 2]***

Residency of Governments

2.23 Item 1 of the Protocol clarifies the residential status of the Government and a political subdivision or a local authority thereof.

2.24 The commentary to the OECD Model was amended in September 1995 to add wording similar to item 1 of this Protocol to the OECD Model. The OECD Model commentary makes it clear that it has always been the understanding of OECD member countries that the OECD Model nevertheless applied to treat governments as residents and the addition of these words merely confirmed that understanding.

2.25 In the case of Australia, the formulation for paragraph 1 of this Article (which incorporates the residency rules of the tax laws of each country) would in any event ensure that Australian governments and tax-exempt entities are treated as residents for the purposes of the tax treaty. This is because a government or tax-exempt entity is a resident of Australia for tax law purposes – even though it may be exempt from tax. ***[Protocol, Item 1]***

Dual residents

2.26 This Article also includes a set of *tie-breaker* rules for determining how residency is to be allocated to one or other of the countries for the purposes of the tax treaty if a taxpayer, whether an individual, a company or other entity, qualifies as a dual resident, that is, as a resident under the domestic law of both countries.

2.27 The tie-breaker rules for individuals apply certain tests, in a descending hierarchy, for determining the residential status (for the purposes of the tax treaty) of an individual who is a resident of both countries under their respective domestic laws.

2.28 These rules, in order of application, are:

- if the individual has a permanent home in only one of the countries, the person is deemed to be a resident solely of that country for the purposes of the tax treaty; or
- if the individual has a permanent home available in both countries or in neither, then the person’s residential status takes into account the person’s personal or economic relations (including habitual abode) with Australia and Mexico, and the person is deemed to be a resident only of the country for the purposes of the tax treaty with which the person has the closer personal and economic relations. An individual’s citizenship or nationality is a factor in determining the degree of the person’s personal and economic relations with that country.

[Article 4, paragraph 4]

2.29 Dual residents remain, however, a resident for the purposes of Australian domestic law, and subject to Australian tax as such, insofar as the tax treaty allows.

2.30 Where a non-individual (such as a company) is a resident of both countries for their domestic tax purposes, the entity will be deemed to be a resident of the country in which its place of effective management is situated. ***[Article 4, paragraph 5]***

2.31 Three categories of persons – partnerships, estates of deceased individuals and trusts – are treated as residents of a country only to the extent that the entity’s income is subject to that country’s tax as the income of a resident, either in that entity’s hands or in the hands of its partners or beneficiaries. Where income is not subject to tax in that

country (either in the entity's hands or the hands of a resident partner or beneficiary), the partnership, estate or trust may also be treated a resident of that country to the extent that the entity's income is exempt from tax in that country only because it is subject to tax in the other country. Paragraph 3 of this Article is consistent with Mexico's observations to Article 4 (*Residence*) of the OECD Model. Trusts whose income is always exempted from tax in a country under the tax laws of that country (e.g. a public charitable trust) are unaffected by this provision. ***[Article 4, paragraph 3]***

Article 5 – Permanent Establishment

Role and definition

2.32 The application of various provisions of the tax treaty (principally Article 7 (*Business Profits*)) is dependent upon whether a person who is a resident of one country carries on business through a permanent establishment in the other country, and if so, whether income derived by that person is attributable to, or effectively connected with, that permanent establishment. The definition of the term permanent establishment which this Article embodies, corresponds generally with definitions of the term in Australia's more recent tax treaties.

Meaning of permanent establishment

2.33 The primary meaning of the term ***permanent establishment*** is expressed as being a fixed place of business through which the business of an enterprise is wholly or partly carried on. To be a permanent establishment within the primary meaning of that term, the following requirements must be met:

- there must be a place of business;
- the place of business must be fixed (both in terms of physical location and in terms of time); and
- the business of the enterprise must be carried on through this fixed place.

[Article 5, paragraph 1]

2.34 Other paragraphs of this Article elaborate on the meaning of the term by giving examples (by no means intended to be exhaustive) of what may constitute a permanent establishment – for example:

- an office;
- a workshop; or
- a mine.

As paragraph 2 of this Article is subordinate to paragraph 1, the examples listed will only constitute a permanent establishment if the primary definition in paragraph 1 is satisfied. ***[Article 5, paragraph 2]***

Agricultural, pastoral or forestry activities

2.35 Most of Australia's comprehensive tax treaties include as a permanent establishment an agricultural, pastoral or forestry property. This reflects Australia's policy of retaining taxing rights over exploitation of Australian land for the purposes of primary production. This approach ensures that the *arm's length* profits test provided for in Article 7 (*Business Profits*) applies to the determination of profits derived from these activities. This position is also reflected in this tax treaty. ***[Article 5, subparagraph 2(g)]***

Deemed permanent establishment

Building site or construction or installation project

2.36 Under paragraph 3, an enterprise is deemed to have a permanent establishment and to be carrying on business through that permanent establishment in a country if it has a building site or construction or installation project in that country which exist for more than six months. Building sites and construction and installation projects lasting less than six months, which nevertheless meet the requirements of a fixed place of business, will also be permanent establishments.

2.37 It is consistent with Mexico's and Australia's preferred treaty practice to treat any building site, construction or installation project that lasts more than six months as a permanent establishment. ***[Article 5, paragraph 3]***

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Supervisory and consultancy activities

2.38 Supervisory and consultancy activities carried on for more than six months in connection with a building site, a construction or installation project are deemed to constitute a permanent establishment. This accords with Mexico's treaty practice and broadly aligns with Australia's reservation to Article 5 (*Permanent establishment*) of the OECD Model.

2.39 The term 'building site or construction or installation project' includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. Planning and supervision are considered part of the building site if carried out by the construction contractor. However, planning and supervision carried out by another unassociated enterprise will not be taken into account in determining whether the construction contractor has a permanent establishment in Australia. ***[Article 5, paragraph 3]***

Heavy equipment

2.40 Under subparagraph 4(a), an enterprise is deemed to have a permanent establishment in a country if heavy equipment is being used in that country by, for or under contract with the enterprise.

2.41 This provision reflects Australia's reservation to the OECD Model concerning the use of substantial equipment and is designed to further protect Australia's right to tax income from natural resources. Australia's experience is that the permanent establishment provision in the OECD Model may be inadequate to deal with high value activities involved in the development of natural resources, particularly in offshore regions.

2.42 Some examples of heavy equipment are:

- large industrial earthmoving equipment or construction equipment used in road building, dam building or powerhouse construction;
- manufacturing or processing equipment used in a factory;
- oil and drilling rigs, platforms and other structures used in the petroleum or mining industry; and
- grain harvesters and other large agricultural machinery.

2.43 For the purposes of the tax treaty the enterprise is deemed to carry on business through the heavy equipment permanent establishment. ***[Article 5, subparagraph 4(a)]***

Cost-toll operations

2.44 The inclusion of subparagraph 4(b) is consistent with another of Australia's reservations to the OECD Model. It deals with so-called 'cost-toll' situations, under which a mineral plant, for example, refines minerals at cost, so that the plant operations produce no Australian profits. Title to the refined product remains with the mining consortium and profits on sale are realised mainly outside of Australia.

2.45 Subparagraph 4(b) deems such a plant to be a permanent establishment because the manufacturing or processing activity (which gives the processed minerals their real value) is conducted in Australia, and therefore Australia should have taxing rights over the business profits arising from the sale of the processed minerals to the extent that they are attributable to the processing activity carried on in Australia. This subparagraph prevents an enterprise which carries on very substantial manufacturing or processing activities in a country through an intermediary from claiming that it does not have a permanent establishment in that country.

2.46 The inclusion of this subparagraph is insisted upon by Australia in its tax treaties and is consistent with Australia's policy of retaining taxing rights over profits from the exploitation of its mineral resources. ***[Article 5, subparagraph 4(b)]***

Preparatory and auxiliary activities

2.47 Certain activities do not generally give rise to a permanent establishment (e.g. the use of facilities solely for storage, display or delivery).

2.48 These activities would ordinarily be of a preparatory or auxiliary character and not likely to give rise to substantial profits. Where this is the case, the necessary economic link between the activities of the enterprise and the country in which the activities are carried on does not exist.

2.49 Unlike the OECD Model, which provides that the listed activities are deemed not to constitute a permanent establishment, the tax treaty incorporates the Australian tax treaty approach of stating that an enterprise will not be deemed to have a permanent establishment *merely by reason of* such activities. This is to prevent the situation where

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enterprises structure their business so that most of their activities fall within the exceptions when – viewed as a whole – the activities ought to be regarded as a permanent establishment.

2.50 Another feature consistent with Australia's tax treaty practice is that subparagraph 4(f) of Article 5 of the OECD Model – dealing with combinations of the activities in subparagraphs 5(a) to (f) of this treaty – is not included. Australia does not consider that an enterprise undertaking multiple functions of the kind indicated in subparagraphs 5(a) to (f) could reasonably be regarded as only engaged in preparatory or auxiliary activities. ***[Article 5, paragraph 5]***

2.51 Australian banks which maintain a 'representative office' in Mexico, where that office only undertakes preparatory or auxiliary work, will not give rise to a permanent establishment. Under current Mexican banking law, representative offices are not allowed to accept deposits or otherwise conduct a banking business in Mexico. These banks are only permitted to conduct 'preparatory or auxiliary' activities. ***[Article 5, subparagraph 5(f)]***

Dependent agents

2.52 Paragraph 6 reflects Australia's tax treaty practice in relation to a person who acts on behalf of an enterprise of another country of deeming that person to constitute a permanent establishment if that person has and habitually exercises an authority to conclude contracts on behalf of the enterprise.

2.53 A person who substantially negotiates all essential parts of a contract on behalf of an enterprise will be regarded as exercising an authority to conclude contracts on behalf of that enterprise within the meaning of this provision, even if the contract is subject to final approval or formal signature by another person.

2.54 Consistent with the OECD Model and Mexico's treaty practice, this paragraph excludes the excepted activities of paragraph 5 from the scope of dependent agency. A dependent agent will not constitute a permanent establishment where that agent's activities are limited to the preparatory and auxiliary activities mentioned in paragraph 5. ***[Article 5, paragraph 6]***

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Independent agents

2.55 Business carried on through an independent agent does not, of itself, constitute a permanent establishment, provided that the independent agent is acting in the ordinary course of that agent's business as such an agent.

2.56 While this paragraph generally follows the OECD Model and Australia's usual treaty practice, it contains the additional requirement that the person act at arm's length. While Australia would normally take this approach in any event, this provision was included to reflect Mexico's observation to the OECD Model commentary. ***[Article 5, paragraph 7]***

Subsidiary companies

2.57 Generally, a subsidiary company will not be a permanent establishment of its parent company. A subsidiary, being a separate legal entity, would not usually be carrying on the business of the parent company but rather its own business activities. However, a subsidiary company gives rise to a permanent establishment if the subsidiary permits the parent company to operate from its premises such that the tests in paragraph 1 of this Article are met, or acts as an agent such that a dependent agent permanent establishment is constituted. ***[Article 5, paragraph 8]***

Other Articles

2.58 The principles set down in this Article are also to be applied in determining whether a permanent establishment exists in a third country or whether an enterprise of a third country has a permanent establishment in Australia (or in Mexico) when applying the source rule contained in:

- paragraph 6 of Article 11 (*Interest*); and
- paragraph 6 of Article 12 (*Royalties*).

[Article 5, paragraph 9]

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Article 6 – Income from Immovable (Real) Property

Where income from immovable (real) property is taxable

2.59 This Article provides that the income of a resident of one country from real ('immovable') property situated in the other country may be taxed by that other country. Thus, income from real property in Australia will be subject to Australian tax laws. ***[Article 6, paragraph 1]***

Definition

2.60 Income from ***immovable (real) property*** is effectively defined as extending, in the case of Australia, to income from:

- the direct use, letting or use in any other form of real property, a lease of land and any other interest in or over land (including exploration and mining rights); and
- royalties and other payments relating to the exploration for or exploitation of mines or quarries or other natural resources or rights in relation thereto.

2.61 In the case of Mexico, the definition of ***immovable (real) property*** generally follows the OECD Model definition of immovable property and includes:

- property accessory to immovable property;
- livestock and equipment used in agriculture and forestry;
- rights to which the provisions of the general law respecting landed property apply including direct use, letting or use in any other form of such property;
- usufruct of immovable property (generally, a right to use property without degrading it and to retain any profits derived from it); and
- rights to variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral deposits, oil or gas wells, quarries or other places of extraction or exploitation of natural resources.

[Article 6, paragraphs 2 and 4]

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Deemed situs

2.62 Under Australian law the situation (situs) of an interest in land, such as a lease, is not necessarily where the underlying property is situated – there may not necessarily be a situs. This paragraph puts the situation of the interest or right beyond doubt. ***[Article 6, paragraph 3]***

Real property of an enterprise and of persons performing independent personal services

2.63 The operation of this Article extends to income derived from the use or exploitation of real property of an enterprise and income derived from real property that is used for the performance of independent personal services.

2.64 Accordingly, application of this Article (when read with Articles 7 (*Business Profits*) and 14 (*Independent Personal Services*)) to such income ensures that the country in which the real property is situated may impose tax on the income derived from that property by:

- an enterprise of the other country; or
- an independent professional person resident in that other country,

irrespective of whether or not that income is attributable to a permanent establishment of such an enterprise, or fixed base of such a person, situated in the firstmentioned country. ***[Article 6, paragraph 5]***

Article 7 – Business Profits

2.65 This Article is concerned with the taxation of business profits derived by an enterprise that is a resident of one country from sources in the other country.

2.66 The taxing of these profits depends on whether they are attributable to the carrying on of a business through a permanent establishment in the other country or to sales of similar goods to those sold through such a permanent establishment.

2.67 If a resident of one country carries on a business through a permanent establishment (as defined in Article 5 (*Permanent Establishment*)) in the other country, the country in which the permanent establishment is situated may tax the profits of the enterprise that are attributable to that permanent establishment. ***[Article 7, paragraph 1]***

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2.68 According to Item 2 of the Protocol, this Article applies to business profits derived by an enterprise that are attributable to a permanent establishment, notwithstanding that the enterprise has ceased to carry on a business through that permanent establishment in the other country. This provision was included at Mexico's suggestion to confirm the countries' understanding that this Article does not prevent source country taxation of attributable profits after a permanent establishment has ceased business. Australia's domestic law allows such attribution of business profits irrespective of this specific provision because the essential requirement under this Article is that income should be attributable to a permanent establishment. Therefore, a temporal nexus is not required. ***[Protocol, Item 2]***

2.69 Consistent with Mexico's reservation to the OECD Model, a 'limited force of attraction' rule is included in the treaty to ensure, where a permanent establishment exists in one country, business profits derived by an enterprise of the other country from the sale of goods or merchandise carried out directly by its head or home office situated in that other country may be taxed in the first country, provided that those goods and merchandise are of the same or similar kind as the ones sold through that permanent establishment.

2.70 Mexico has explained to the OECD that this is a safeguard against abuse and not a broad 'force of attraction' rule. Subparagraph 1(b) makes it clear that the rule will not apply when the enterprise proves that the sales have been carried out in that manner for bona fide commercial reasons and not merely to obtain a benefit under the treaty. ***[Article 7, subparagraph 1(b)]***

2.71 If an enterprise which is a resident of one country derives business profits in the other country other than profits attributable to a permanent establishment in that other country or to sales of similar goods, the general principle of this Article is that the enterprise will not be liable to tax in the other country on its business profits (except where paragraph 5 of this Article applies – see the explanation in paragraphs 2.75 and 2.76). ***[Article 7, paragraph 1]***

Determination of business profits

2.72 Profits of a permanent establishment are to be determined for the purposes of this Article on the basis of *arm's length* dealing. The provisions in the tax treaty correspond to international practice and the comparable provisions in Australia's other tax treaties. ***[Article 7, paragraphs 2 and 3]***

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2.73 Paragraph 3 further provides that no deductions are allowed in respect of amounts paid (other than towards reimbursement of actual expense) by the permanent establishment to the head office of certain amounts, except in the case of a banking enterprise, by way of interest on funds lent to the permanent establishment. The specific inclusion of this further provision accords with Mexico's treaty practice and reflects the approach that Australia adopts even in the absence of a specific provision. ***[Article 7, paragraph 3]***

2.74 No profits are to be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise. Accordingly, profits of a permanent establishment will not be increased by adding to them any profits attributable to the purchasing activities undertaken for the head office. It follows, of course, that any expenses incurred by the permanent establishment in respect of those purchasing activities will not be deductible in determining the taxable profits of the permanent establishment. ***[Article 7, paragraph 4]***

Profits dealt with under other Articles

2.75 Where income or gains are otherwise specifically dealt with under other Articles of the tax treaty, the effect of those particular Articles is not overridden by this Article.

2.76 This provision lays down the general rule of interpretation that categories of income or gains which are the subject of other Articles of the tax treaty (e.g. shipping, dividends, interest, royalties and alienation of property) are to be treated in accordance with the terms of those Articles (except where otherwise provided, e.g. by paragraph 6 of Article 10 (*Dividends*) where the asset in respect of which the income is paid is effectively connected to a permanent establishment). ***[Article 7, paragraph 5]***

Inadequate information

2.77 The domestic law of the country in which the profits are sourced (e.g. Australia's Division 13 of the ITAA 1936) may be applied to determine the tax liability of a person, consistently with the principles of the Article. This is of particular relevance where, due to inadequate information, the correct amount of profits attributable on the *arm's length* principle basis to a permanent establishment cannot be determined, or can only be ascertained with extreme difficulty. This is consistent with Australia's treaty practice. ***[Protocol, Item 2]***

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Insurance with non-residents

2.78 Each country has the right to continue to apply any provisions in its domestic law relating to the taxation of income from insurance. However, if the relevant law in force in either country at the date of signature of the tax treaty is varied (otherwise than in minor respects so as not to affect its general character), the countries must consult with each other with a view to agreeing to any amendment of this paragraph (i.e. paragraph 6) that may be appropriate. An effect of this paragraph is to preserve, in the case of Australia, the application of Division 15 of Part III of the ITAA 1936 (Insurance with Non-Residents).

2.79 For the purposes of paragraph 6, an insurance enterprise of Australia shall, except in regard to reinsurance, be deemed to have a permanent establishment in Mexico if it collects premiums in Mexico or insures risks situated in Mexico through a dependent agent (to whom paragraph 7 of Article 5 (*Permanent Establishment*) applies).

2.80 For reasons of its internal law, Mexico finds it useful to deem a non-resident to have a permanent establishment in respect of its insurance activities. On the other hand, Australia's treaty policy is to preserve the internal law treatment of non-resident insurance without reference to the permanent establishment concept. A solution was reached whereby taxing rights concerning non-resident insurance are allocated in accordance with the domestic laws of both countries, but for the purposes of Mexican tax law a permanent establishment is deemed to exist in relation to non-resident insurance activities. ***[Article 7, paragraph 6]***

Trust beneficiaries

2.81 The principles of this Article will apply to business profits derived by a resident of one of the countries (directly or through one or more interposed trust estates) as a beneficiary of a trust estate. ***[Protocol, Item 2]***

2.82 In accordance with this Article, Australia has the right to tax a share of business profits, originally derived by a trustee of a trust estate (other than a trust estate that is treated as a company for tax purposes) from the carrying on of a business through a permanent establishment in Australia, to which a resident of Mexico is beneficially entitled under the trust estate. Item 2 of the Protocol ensures that such business profits will be subject to tax in Australia where, in accordance with the principles set out in Article 5 (*Permanent Establishment*), the trustee of the relevant trust estate has a permanent establishment in Australia in relation to that business.

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Article 8 – Profits from the Operation of Ships and Aircraft

2.83 The main effect of this Article is that the right to tax profits from the operation of ships or aircraft in international traffic, including profits derived from participation in a pool service or other profit sharing arrangement, is generally reserved to the country in which the operator is a resident for tax purposes. ***[Article 8, paragraphs 1 and 3]***

2.84 However, this Article reflects Australian and Mexican treaty policy in reserving to the source country the right to tax profits from internal traffic and profits from other coastal and continental shelf activities, including the provision of accommodation and other non-transport shipping and aircraft activities, within its own waters and airspace. ***[Article 8, paragraph 2; Protocol, Item 3]***

2.85 Thus, the term *transport* is not used in the title of this Article, as the Article applies to survey ships, oil drilling ships, where transport is not necessarily involved.

2.86 Contrary to subparagraph 8(d) and paragraph 9 of the OECD Model commentary on Article 8 (*Shipping, inland waterways transport and air transport*), Australia and Mexico agreed that for the purposes of the tax treaty, the international operation of ships and aircraft does not include inland transportation such as road transport. Profits from such transportation is not covered by paragraph 1 of this Article. ***[Protocol, Item 3]***

Internal traffic

2.87 Paragraph 4 of this Article clarifies that any shipment by sea or air from a place in Australia (including the continental shelf areas and external territories) for discharge at another place in Australia or for return to that place in Australia, is to be treated as constituting internal traffic. ***[Article 8, paragraph 4]***

Example 2.1

Profits that are derived from the transport of goods between Sydney and Perth, that were uploaded in Sydney onto a ship operated by a Mexican enterprise making that stopover as part of an international voyage from Manzanillo to Perth, would be profits from internal traffic. As such, 5% of the amount paid in respect of the internal traffic carriage would be deemed to be taxable income of the operator for Australian tax purposes pursuant to Division 12 of Part III of the ITAA 1936.

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Article 9 – Adjustments to Profits of Associated Enterprises

Reallocation of profits

2.88 This Article deals with associated enterprises (parent and subsidiary companies and companies under common control). It authorises the reallocation of profits between related enterprises in Australia and Mexico on an *arm's length* basis where the commercial or financial arrangements between the enterprises differ from those that might be expected to operate between unrelated enterprises dealing wholly independently with one another.

2.89 This Article would not generally authorise the rewriting of accounts of associated enterprises where it can be satisfactorily demonstrated that the transactions between such enterprises have taken place on normal, open market commercial terms. ***[Article 9, paragraph 1]***

2.90 Each country retains the right to apply its domestic law relating to the determination of the tax liability of a person (e.g. Australia's Division 13 of the ITAA 1936) to its own enterprises, provided that such provisions are applied, so far as it is practicable to do so, consistently with the principles of the Article. ***[Protocol, Item 4]***

2.91 Australia's domestic law provisions relating to international profit shifting arrangements were revised in 1981 in order to deal more comprehensively with arrangements under which profits are shifted out of Australia, whether by transfer pricing or other means. The broad scheme of the revised provisions of the domestic law is to impose *arm's length* standards in relation to international dealings, but where the Commissioner cannot ascertain the *arm's length* consideration, it is deemed to be such an amount as the Commissioner determines. Item 4 of the Protocol is designed to preserve the application of those domestic law provisions and is consistent with Australia's treaty practice.

Correlative adjustments

2.92 Where a reallocation of profits is made (either under this Article or, by virtue of Item 4 of the Protocol, under domestic law) so that the profits of an enterprise of one country are adjusted upwards, a form of double taxation would arise if the profits so reallocated continued to be subject to tax in the hands of an associated enterprise in the other country. To avoid this result, the other country is required to make an appropriate compensatory adjustment to the amount of tax charged on the profits involved to relieve any such double taxation, if that country agrees with the initial adjustment made by the country where the enterprise is situated. This proviso reflects the general understanding that the treaty

country is only obliged to make the compensatory adjustment if it considers that the initial adjustment by the other country is in accordance with the tax treaty, that is, where that adjustment was made in accordance with *arm's length* principles.

2.93 It would generally be necessary for the affected enterprise to apply to the competent authority of the country not initiating the reallocation of profits for an appropriate compensatory adjustment to reflect the reallocation of profits made by the other treaty partner country. If necessary, the competent authorities of Australia and Mexico will consult with each other to determine the appropriate adjustment. ***[Article 9, paragraph 2]***

Fraud

2.94 In a reservation to Article 9 (*Associated enterprises*) of the OECD Model, Mexico reserves the right not to include paragraph 2 of that Article in its tax treaties. While Mexico has agreed to include an equivalent of that paragraph in this treaty, it considers that the correlative relief benefits of paragraph 2 should not be extended to cases of fraud, for example, where a correlative adjustment was sought by an enterprise in a non bona fide situation. Paragraph 3 ensures that correlative relief is not available in cases of fraud. ***[Article 9, paragraph 3]***

Article 10 – Dividends

2.95 This Article broadly allows both countries to tax dividends flowing between them, but in general limits the rate of tax that the country of source may impose on dividends payable by companies that are residents of that country to residents in the other country who are beneficially entitled to the dividends. ***[Article 10, paragraph 1]***

Rate of tax

2.96 This Article provides that Australia will not tax franked dividends flowing to Mexican companies who directly hold at least 10% of the voting power in the Australian company paying the dividends. Reciprocally, Mexico will not tax dividends fully taxed at the corporate level (i.e. dividends that have been paid from the 'net profit account'). ***[Article 10, subparagraphs 2(a) and 3(a)]***

2.97 In all other cases, the tax treaty provides that Australia and Mexico will generally limit their tax to 15% of the dividend. In the case of Australia, this will mean that the normal withholding tax rate imposed on unfranked dividends will be reduced from 30% to 15%. ***[Article 10, subparagraph 2(b)]***

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2.98 There is also provision for flexibility if there is a change to either country's general approach to taxing dividends, such as a change to Australia's domestic law arrangements for franked dividends flowing overseas. In such a case, the two countries are obliged to consult to consider appropriate amendments to this paragraph. ***[Article 10, paragraph 2]***

Profits not paid out of the Mexican 'net profit account'

2.99 Item 5 of the Protocol refers to Mexican dividends which have not been paid out of the 'net profit account'.

2.100 Mexico currently taxes corporate profits at 35% (reducing to 32% by 2005). Once a company has paid its income tax, after-tax earnings may be distributed to shareholders without any further tax. Such earnings are normally paid out of the 'net profit account'. However, if the company makes a distribution out of earnings that for any reason have not been subject to company tax, it will have to pay 35% out of those earnings. In Mexico, dividends are not subject to any tax at the shareholder level, only at the corporate level and Mexico currently imposes no withholding tax on dividends paid to residents or non-residents.

2.101 Item 5 of the Protocol was included at Mexico's request. Its purpose is to clarify that, notwithstanding subparagraph 2(b) of Article 10, which applies a maximum dividend withholding tax rate of 15% on all dividends which are not within subparagraph 2(a), the profits out of which previously untaxed dividends are paid may be taxed at the corporate tax rate rather than the dividend withholding tax rate. ***[Protocol, Item 5]***

Exception to limitation

2.102 The limitation on the tax of the country in which the dividend is sourced does not apply to dividends derived by a resident of the other country who has a permanent establishment or fixed base in the country from which the dividends are derived, if the holding giving rise to the dividends is effectively connected with that permanent establishment or fixed base.

2.103 Where the holding is so effectively connected, the dividends are to be treated as *business profits* or income from independent personal services and therefore may be subject to the full rate of tax applicable in the country in which the dividend is sourced (in accordance with the provisions of Article 7 (*Business Profits*) or Article 14 (*Independent Personal Services*), as the case may be). In practice, however, under the full imputation system of company taxation in Australia's domestic law,

such dividends, to the extent that they are franked dividends, remain exempt from Australian tax. Unfranked dividends that are effectively connected with a permanent establishment in Australia will be subject to withholding tax at the rate of 15% instead of being taxed by assessment. ***[Article 10, paragraph 6]***

Extra-territorial application precluded

2.104 The extra-territorial application by either country of taxing rights over dividend income is precluded by providing, broadly, that one country (the first country) will not tax dividends paid by a company resident solely in the other country, unless:

- the person deriving the dividends is a resident of the first country; or
- the shareholding giving rise to the dividends is effectively connected with a permanent establishment or fixed base in the first country.

2.105 An example of the effect of this paragraph is that Australia may not tax dividends paid by a Mexican company to a resident of Mexico out of profits derived from Australian sources, unless the Mexican shareholder has a permanent establishment or a fixed base in Australia with which the holding is effectively connected. ***[Article 10, paragraph 7]***

Definition of 'dividends'

2.106 The term ***dividends*** in this Article means income from shares and other income assimilated to income from shares by the law, relating to tax, of the country of which the company making the distribution is a resident. Item 6 of the Protocol clarifies that an issue of bonus shares is included in the term 'dividends'. Bonus shares are generally treated as dividends for Australian tax purposes to the extent to which the paid-up value represents a capitalisation of profits. ***[Article 10, paragraph 5; Protocol, Item 6]***

Article 11 – Interest

Rate of tax

2.107 This Article provides for interest income to be taxed by both countries but requires the country in which the interest arises to generally limit its tax to either 10% or 15% of the gross amount of the interest where a resident of the other country is beneficially entitled to the interest. ***[Article 11, paragraphs 1 and 2]***

2.108 Paragraph 2 limits the taxation by the country in which the interest arises to either 10% or 15% of the gross amount of interest. The lower 10% rate limit applies where the interest is derived by or from a bank, from certain bonds or securities, or from credit sales of machinery or equipment.

2.109 The 10% tax rate limit applies to interest derived from bonds and securities that are regularly and substantially traded on a recognised securities market. Item 7(a) of the Protocol defines the meaning of the term *recognised securities market* and generally covers stock exchanges authorised under the law of Australia or Mexico.

2.110 The 15% rate limit applies in all other cases. ***[Article 11, paragraph 2; Protocol, Item 7(a)]***

Back-to-back loan arrangements

2.111 The treaty limits on interest withholding tax will not apply to interest derived from back-to-back loans. In such cases, the interest paid shall be taxable in accordance with the domestic law of the source country. ***[Protocol, Item 7(b)]***

2.112 The treaty rate limits on interest withholding tax will only be denied for interest paid on the component of a loan that is considered to be back-to-back. This provision was inserted at Mexico's request. In practice, this provision will have no effect in Australia, since the domestic law withholding tax rate on interest (currently 10%) does not exceed the lower rate limit provided under the treaty.

Definition of interest

2.113 The term ***interest*** is defined for the purposes of this Article in a way that, in relation to Australia, encompasses items of income such as discounts on securities and payments under certain hire purchase agreements which are treated for Australian tax purposes as interest or amounts in the nature of interest. ***[Article 11, paragraph 4]***

Interest effectively treated as business profits

2.114 Interest derived by a resident of one country which is paid in respect of an indebtedness which is effectively connected to a permanent establishment or fixed base of that person in the other country, will form part of the business profits of that permanent establishment or fixed base and be subject to the provisions of Article 7 (*Business Profits*) or Article 14 (*Independent Personal Services*). Accordingly, the relevant tax rate limitations (10% or 15% tax rate limitation) in paragraph 2 do not apply to such interest in the country in which the interest is sourced. ***[Article 11, paragraph 5]***

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Deemed source rules

2.115 Interest source rules are set out in paragraph 6. These rules operate to allow Australia to tax interest to which a resident of Mexico is beneficially entitled where the interest is paid by a resident of Australia. Australia may also tax interest paid by a non-resident to which a Mexican resident is beneficially entitled if it is an expense incurred by the payer in carrying on a business in Australia through a permanent establishment or fixed base.

2.116 However, consistent with Australia's interest withholding tax provisions, an Australian source is not deemed in respect of interest that is an expense incurred by an Australian resident in carrying on a business through a permanent establishment or fixed base outside Australia. ***[Article 11, paragraph 6]***

2.117 Indebtedness under one loan contract, where part of the loan is attributed to a permanent establishment or a fixed base, may be apportioned between the head office and a permanent establishment or fixed base. The inclusion of this clarification accords with Mexico's treaty practice and reflects Australia's general understanding of the position. ***[Protocol, Item 8]***

Related persons

2.118 This Article also contains a general safeguard against payments of excessive interest where a special relationship exists between the persons associated with a loan transaction – by restricting the 10% or 15% source country tax rate limitation to an amount of interest which might have been expected to have been agreed upon if the parties to the loan agreement were dealing with one another at *arm's length*. Any excess part of the interest remains taxable according to the domestic law of each country but subject to the other Articles of the tax treaty. ***[Article 11, paragraph 7]***

2.119 Examples of cases where a special relationship might exist include payments to a person (either individual or legal):

- who controls the payer (whether directly or indirectly);
- who is controlled by the payer; or
- who is subordinate to a group having common interests with the payer.

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2.120 It also covers relationships of blood or marriage and, in general, any community of interests.

For whatever reason

2.121 The inclusion of the words 'for whatever reason' in paragraph 7 of this Article reflects a former reservation by Mexico to the OECD Model. The inclusion of these additional words permits interest and other payments in respect of certain loans to be dealt with as distributions in a range of circumstances provided for in Mexico's domestic law, including those where the amount of the loan or the rate of interest or other terms relating to it are not what would have been agreed in the absence of a special relationship. This paragraph permits not only the adjustment of the rate at which interest is charged but also the reclassification of the excess interest in such a way as to give it the character of a distribution. The current OECD Model commentary to Article 11 (*Interest*) recognises that this addition is appropriate to enable recharacterisation of the excess interest. ***[Article 11, paragraph 7]***

Limitation of benefits

2.122 At the time of negotiation, Mexico had a reservation to the OECD Model concerning interest on debt claims created or assigned mainly for the purpose of taking advantage of the *Interest* Article and not for bona fide commercial reasons. While, in general, Australia considers such non bona fide transactions would be re-characterised under the tax treaty according to their true nature, it was agreed to include a specific provision to preserve the operation of domestic law in such cases. ***[Article 11, paragraph 8]***

Article 12 – Royalties

Rate of tax

2.123 This Article in general allows both countries to tax royalty flows but limits the tax of the country of source to 10% of the gross amount of royalties paid or credited to residents of the other country beneficially entitled to the royalties. ***[Article 12, paragraphs 1 and 2]***

2.124 The 10% rate limitation does not to apply to natural resource royalties, which, in accordance with Article 6 (*Income from Immovable (Real) Property*), are to remain taxable in the country of source without limitation of the tax that may be imposed.

2.125 In the absence of a tax treaty, Australia taxes royalties paid to non-residents at 30% of the gross royalty.

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Definition of royalties

2.126 The definition of ***royalties*** in the tax treaty largely reflects the definition in Australia's domestic income tax law. The definition encompasses payments for the use of, or the right to use industrial, commercial or scientific equipment. It also includes payments for the supply of scientific, technical, industrial or commercial know-how but not payments for services rendered, except as provided for in subparagraph 3(d). Payments for reproduction or broadcasting rights, where modern technology such as satellite, cable, fibre optics or similar technology including the Internet is used for transmission, also constitute royalty payments. ***[Article 12, paragraph 3; Protocol, Item 9]***

Payments for the supply of know-how versus payments for services rendered

2.127 It is considered that a German Supreme Court decision (*Bundesfinanzhof* (No. IR 44/67) of 16 December 1970) provides a definitive test for distinguishing between a know-how contract and a contract for services. A know-how contract, it was held, involved the supply by a person of their know-how to the paying entity (e.g. teaching a personal expertise), whereas in a contract for services, although it may involve the use of know-how, that know-how is applied by the person in the performance of their services.

2.128 Payments for design, engineering or construction of plant or building, feasibility studies, component design and engineering services may generally be regarded as being in respect of a contract for services, unless there is some provision in the contract for imparting techniques and skills to the buyer.

2.129 In cases where both know-how and services are supplied under the same contract, if the contract does not separately provide for payments in respect of know-how and services, an apportionment of the two elements of the contract may be appropriate.

2.130 Payments for services rendered are to be treated under Article 7 (*Business Profits*) or Article 14 (*Independent Personal Services*).

Spectrum licences

2.131 A provision has been included in the Protocol that deems radiofrequency spectrum licence payments to be royalties for the purposes of the tax treaty. ***[Protocol, Item 9(c)]***

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Forbearance

2.132 Consistent with Australian tax treaty practice, subparagraph 3(f) expressly treats as a royalty, amounts paid or credited in respect of forbearance to grant to third persons, rights to use property covered by the *Royalties* Article. This is designed to address arrangements along the lines of those contained in *Aktiebolaget Volvo v. Federal Commissioner of Taxation* (1978) 8 ATR 747; 78 ATC 4316, where instead of amounts being payable for the exclusive right to use the property they were made for the undertaking that the right to use the property will not be granted to anyone else. This provision ensures that the amounts are subject to tax as a royalty payment under the terms of this Article. ***[Article 12, subparagraph 3(f)]***

The disposition of property or rights

2.133 The tax treaty provides that the term ***royalties*** includes income derived from the sale, exchange or other disposition of any property or right described in this Article to the extent to which the amount realised on such sale, exchange or other disposition are contingent on the productivity, use or further disposition of such property or right. The purpose of this paragraph is to prevent the conversion of royalties into long-term payments for the 'sale' of the underlying property. This provision ensures that the payment continues to fall within the scope of this Article. ***[Article 12, paragraph 4]***

Other royalties effectively treated as business profits

2.134 As in the case of interest income, the withholding tax rate limitation does not apply to royalties paid in respect of property or rights which are effectively connected with a permanent establishment or fixed base in the country in which the income is sourced – such income being subject to full taxation under either Article 7 (*Business Profits*) or Article 14 (*Independent Personal Services*), as the case may be. ***[Article 12, paragraph 5]***

2.135 Contracts under which royalties are paid, where part of the royalties is attributed to a permanent establishment or a fixed base, may be apportioned between the head office and a permanent establishment or fixed base. The inclusion of this clarification accords with Mexico's treaty practice and reflects Australia's general understanding of the position. ***[Protocol, Item 8]***

EXHIBIT A

Deemed source rule

2.136 The royalties source rule provided for in the tax treaty effectively corresponds in the case of Australia with the deemed source rule contained in section 6C (source of royalty income derived by a non-resident) of the ITAA 1936 for royalties paid to non-residents of Australia. It broadly mirrors the *source* rule for interest income contained in paragraph 6 of Article 11 (*Interest*). ***[Article 12, paragraph 6]***

Related persons

2.137 If royalties flow between the payer and the person beneficially entitled to the royalties as the result of a special relationship between them, the 10% source country tax rate limitation will apply only to the extent that the royalties are not excessive. Any excess part of the royalty remains taxable according to the domestic law of each country but subject to the other Articles of this tax treaty. ***[Article 12, paragraph 7]***

Limitation of benefits

2.138 Consistent with Mexico's treaty practice, royalties arising from the rights or property created or assigned mainly for the purpose of taking advantage of this Article are excluded from the scope of this Article and domestic law taxation over such payments is preserved. ***[Article 12, paragraph 8]***

Article 13 – Alienation of Property

Taxing rights

2.139 This Article allocates between the respective countries taxing rights in relation to income, profits or gains arising from the alienation of real property and other items of property.

2.140 The reference to 'income, profits or gains' in this Article is designed to put beyond doubt that a gain from the alienation of property which in Australia is *income*, or a *profit* under ordinary concepts, will be taxed in accordance with this Article, rather than Article 7 (*Business Profits*), together with relevant capital gains.

EXHIBIT A

Real property

2.141 Income, profits or gains from the alienation of real property may be taxed by the country in which the property is situated. The term ***immovable (real) property*** is defined for the purposes of this Article as it is under paragraph 2 of Article 6 (*Income from Immovable (Real) Property*). Where the property is situated is determined in accordance with paragraph 3 of Article 6. ***[Article 13, paragraphs 6 and 7]***

Shares and other interests in land-rich entities

2.142 Paragraph 2 applies to situations involving the alienation of shares or other interests in companies, and other entities, where the value of the assets is principally attributable to the real property, which is situated in the other country. Such income, profits or gains may be taxed by the country in which the real property is situated. This paragraph complements paragraph 1 of this Article and is designed to cover arrangements involving the effective alienation of *incorporated real property*, or like arrangements.

2.143 This is to be the case whether the real property is held directly or indirectly through a chain of interposed entities. While not limited to chains of companies, or even chains of entities only some of which are companies, the example of chains of companies is used to make clear that the *corporate veil* should be lifted in examining direct or indirect ownership.

2.144 This provision responds to the tax planning opportunities exposed by the decision of the Full Federal Court in the *Commissioner of Taxation v. Lamesa Holdings BV* (1997) 77 FCR 597. It is designed to protect Australian taxing rights over income, profits or gains on the alienation or effective alienation of Australian real property (as defined) despite the presence of interposed bodies corporate or other entities. ***[Article 13, paragraph 2]***

Permanent establishment

2.145 Paragraph 3 deals with income, profits or gains arising from the alienation of property (other than real property covered by paragraph 1) forming part of the business assets of a permanent establishment of an enterprise or pertaining to a fixed base used for performing independent personal services. It also applies where the permanent establishment itself (alone or with the whole enterprise) or the fixed base is alienated. Such income, profits or gains may be taxed in the country in which the permanent establishment or fixed base is situated. This corresponds to the rules for taxation of business profits and income from independent personal services contained in Articles 7 (*Business Profits*) and 14 (*Independent Personal Services*) respectively. ***[Article 13, paragraph 3]***

EXHIBIT A

Disposal of ships or aircraft

2.146 Income, profits or gains from the disposal of ships or aircraft operated in international traffic, or of associated property (other than real property covered by paragraph 1), are taxable only in the country in which the enterprise alienating the ships or aircraft is resident. This rule corresponds to the operation of Article 8 (*Ships and Aircraft*) in relation to profits from the international operation of ships or aircraft. ***[Article 13, paragraph 4]***

2.147 For the purposes of this Article, the term 'international traffic' does not include any transportation which commences at a place in a country and returns to that place or another place in that country, after travelling through international waters or airspace but not visiting another country (e.g. 'voyages to nowhere' by cruise ships). ***[Article 3, subparagraph 1(i)]***

Capital gains

2.148 This Article contains a sweep-up provision in relation to capital gains which enables each country to tax, according to its domestic law, any gains of a capital nature derived by its own residents or by a resident of the other country from the alienation of any property (including shares or other rights in a company). It thus preserves the application of Australia's domestic law relating to the taxation of capital gains in relation to the alienation of such property. ***[Article 13, paragraph 5]***

Exemption from former residence country taxation

2.149 Australia's law provides for taxation of individuals who cease to be a resident of Australia on gains arising from the deemed disposal of assets (other than those having the necessary connection with Australia) (subsections 104-165(2) and (3) of the ITAA 1997).

2.150 The taxation of unrealised gains can give rise to cash flow problems because proceeds from the gains are not available to pay the tax. Australia's domestic law provides relief by allowing departing individuals to defer tax on unrealised gains if they elect to treat assets to which the gains relate as having the necessary connection with Australia (subsections 104-165(2) and (3) of the ITAA 1997). The effect of the election is that a gain on the subsequent disposal of the property will be taxable in Australia even though the individual is not an Australian resident.

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2.151 Paragraph 8 of this Article provides an exemption from taxation in the former country of residence for gains deferred by an individual on ceasing to be a resident of that country, if the individual is a resident of the other country when the gains are crystallised. ***[Article 13, paragraph 8]***

2.152 An individual departing Australia who defers tax by electing for an asset to have the necessary connection with Australia will, for instance, be exempt in Australia on a gain arising from a subsequent disposal of the asset if the individual is a resident of Mexico at the time of the disposal. This will reduce compliance difficulties for departing residents, ensure post-residence change gains on foreign assets are not taxable in Australia and ensure that appropriate relief is provided from double taxation.

2.153 Paragraph 8 will not affect the taxation of gains derived from the disposal of assets that, prior to a residence change, already have the necessary connection with Australia. A requirement of paragraph 8 is that an individual must elect to defer tax on a residence change gain. This requirement will not be satisfied for assets that have the necessary connection with Australia because there is no deemed disposal of these assets when an individual ceases to be an Australian resident. Australia may therefore continue to tax gains realised on the disposal of these assets.

2.154 Similarly, paragraph 8 will not affect the inclusion in assessable income of a discount on a qualifying share or right that has been deferred under an employee share acquisition scheme. Again, this is because there is no taxation deferred as a result of a residence change. Paragraph 8 can operate, however, to exempt gains accrued on shares after allocation where an individual ceases to be a resident of Australia and elects to defer the residence change gain.

Double tax relief

2.155 In the event that the operation of this Article should result in an item of income or gain being subjected to tax in both countries, the country of which the person deriving the income or gain is a resident (as determined in accordance with Article 4 (*Residence*)) would be obliged by Article 23 (*Methods of Elimination of Double Taxation*) to provide double tax relief for the tax imposed by the other country.

EXHIBIT A

Article 14 – Independent Personal Services

Taxing rights

2.156 Under this Article, income derived by an individual in respect of professional services or other activities of an independent character will be subject to tax in the country in which the services or activities are performed if either:

- the recipient has a fixed base regularly available in that other country for the purposes of performing their activities; or
- the individual is present in the other country for a period or periods exceeding in the aggregate 183 days in any 12 month period commencing or ending in the fiscal year or year of income.

2.157 If either of these conditions is met, the country in which the services or activities are performed will be able to tax so much of the income as is attributable to the activities performed during such period or periods or that are exercised from that fixed base. ***[Article 14, paragraph 1]***

2.158 If the above tests are not met, the income will be taxed only in the country of residence of the recipient.

2.159 Remuneration derived as an employee and income derived by public entertainers are the subject of other Articles of the tax treaty and are not covered by this Article.

2.160 Item 10 of the Protocol provides that this Article will also apply to income derived by an Australian company from the furnishing of personal services through a fixed base in Mexico. In such a case, Mexican tax on the income of the Australian company from such services may be computed on a net basis as if the income were attributable to a Mexican permanent establishment. This provision is necessary because under Mexican law, a personal service company is not considered to earn business profits. The provision therefore allows Mexico to tax such a company in accordance with subparagraph 1(a) of Article 14. In practice this will provide for the same treatment as if the profits of the company had been taxed in accordance with Article 7 (*Business Profits*). ***[Protocol, Item 10]***

EXHIBIT A

Article 15 – Dependent Personal Services

Basis of taxation

2.161 This Article generally provides the basis upon which the remuneration of visiting employees is to be taxed. However, this Article does not apply in respect of income that is dealt with separately in:

- Article 16 (*Directors' Fees*);
- Article 18 (*Pensions and Annuities*); and
- Article 19 (*Government Service*).

2.162 Generally, salaries, wages and similar remuneration derived by a resident of one country from an employment exercised in the other country will be liable to tax in that other country. However, subject to specified conditions, there is a conventional provision for exemption from tax in the country being visited where visits of only a short-term nature are involved. ***[Article 15, paragraph 1]***

Short-term visit exemption

2.163 The conditions for this exemption are that:

- the period of the visit or visits do not exceed, in total, 183 days in any 12 month period commencing or ending in the fiscal year or year of income of the visited country;
- the remuneration is paid by, or on behalf of, an employer who is a resident of the same country as the employee; and
- the remuneration is not deductible in determining the taxable profits of a permanent establishment or a fixed base which the employer has in the country being visited.

2.164 Where all of these conditions are met, the remuneration so derived will be liable to tax only in the country of residence of the recipient. ***[Article 15, paragraph 2]***

2.165 Where a short-term visit exemption is not applicable, remuneration derived by a resident of Australia from employment in Mexico may be taxed in Mexico. However, the Article does not allocate sole taxing rights to Mexico in that situation.

2.166 Accordingly, Australia would also be entitled to tax that remuneration in accordance with the general rule of the ITAA 1997 that a resident of Australia remains subject to tax on their worldwide income. In common, however, with other situations where the tax treaty allows both countries to tax a category of income, Australia would be required in this situation (pursuant to Article 23 (*Methods of Elimination of Double Taxation*)), as the country in which the income recipient is resident for tax purposes, to relieve the double taxation that would otherwise occur.

2.167 Although Article 23 provides for the double tax relief to be provided by Australia to be in the form of the grant of a credit against Australian tax for the Mexican tax paid, the *exemption with progression method* of providing double tax relief in relation to employment income derived in the situation described would normally be applicable in practice pursuant to the foreign service income provisions of section 23AG of the ITAA 1936. This method takes into account the foreign earnings when calculating the Australian tax on other assessable income the person has derived.

Employment on a ship or aircraft

2.168 Income from an employment exercised aboard a ship or aircraft operated in international traffic may be taxed in the country of which the enterprise is a resident. ***[Article 15, paragraph 3]***

2.169 For the purposes of this Article, the term 'international traffic' does not include any transportation which commences at a place in a country and returns to that place or another place in that country, after travelling through international waters or airspace but not visiting another country (e.g. 'voyages to nowhere' by cruise ships). ***[Article 3, subparagraph 1(i)]***

Article 16 – Directors' Fees

2.170 Under this Article, remuneration derived by a resident of one country in the capacity of a director of a company, which is a resident of the other country, may be taxed in the latter country. In the case of Mexico, similar treatment is given to an '*administrador*' or '*comisario*' who are essentially statutory auditors appointed under Mexican law.

EXHIBIT A

Article 17 – Entertainers and Sportspersons

Personal activities

2.171 Under this Article, income derived by visiting entertainers (which has a reasonably wide meaning in international tax treaty usage) and sportspersons from their personal activities as such may generally be taxed in the country in which the activities are exercised, irrespective of the duration of the visit. The application of this Article extends to income generated from promotional and associated kinds of activities engaged in by the entertainer or sportsperson while present in the visited country. ***[Article 17, paragraph 1]***

Safeguard

2.172 Paragraph 2 is designed to ensure that income in respect of personal activities exercised by an entertainer or sportsperson, where derived by another person (e.g. a separate enterprise which formally provides the entertainer's or sportsperson's services), is taxed in the country in which the entertainer or sportsperson performs, whether or not that other person has a permanent establishment in that country. ***[Article 17, paragraph 2]***

Article 18 – Pensions and Annuities

2.173 Pensions and annuities (the term *annuity* as used in this Article is defined in paragraph 2) are taxable only by the country of which the recipient is a resident. This Article extends to government pensions and annuity payments made to dependants, for example, a widow, widower or children of the person in respect of whom the pension or annuity entitlement accrued where, upon that person's death, such entitlement has passed to that person's dependants. ***[Article 18, paragraphs 1 and 2]***

2.174 The taxing right in respect of alimony and other maintenance payments is allocated solely to the country of residence of the payer. The purpose of this paragraph is to remove any possibility of double taxation of such payments arising by reason of the treatment accorded such payments under the respective domestic law of the two countries. In the case of Australia, those payments will generally remain exempt from Australian tax under the ITAA 1936 and the ITAA 1997 in the hands of the recipient and non-deductible to the payer. ***[Article 18, paragraph 3]***

EXHIBIT A

Article 19 – Government Service

Salary and wage income

2.175 Salary and wage type income, other than government service pensions or annuities, paid to an individual for services rendered in the discharge of governmental functions to a government (including a political subdivision or local authority) of one of the countries, is to be taxed only in that country. However, such remuneration will be taxable only in the other country if:

- the services are rendered in that other country; and
- the recipient is a resident of that other country, who is either:
  - a citizen or national of that country; or
  - did not become a resident of that other country solely for the purpose of rendering the services.

[Article 19, paragraph 1]

Business income

2.176 Remuneration for services rendered in connection with a business, such as trading activities, carried on by any governmental authority referred to in paragraph 1 of the Article is excluded from the scope of this Article. Such remuneration will remain subject to the provisions of Article 15 (*Dependent Personal Services*) and Article 16 (*Directors' Fees*). ***[Article 19, paragraph 2]***

EXHIBIT A

Article 20 – Students

Exemption from tax

2.177 This Article applies to students temporarily present in one of the countries solely for the purpose of their education if the student is, or immediately before the visit was, resident in the other country. In these circumstances, payments from abroad received by the students solely for their maintenance or education will be exempt from tax in the country visited. This will apply even though they may qualify as a resident of the country visited during the period of their visit.

2.178 The exemption from tax provided by the visited country is treated as extending to maintenance payments received by the student that are made for maintenance of dependent family members who have accompanied the student to the visited country.

Employment income

2.179 Where, however, a student from Mexico who is visiting Australia solely for educational purposes undertakes any employment, for example:

- part-time work with a local employer; or
- during a semester break undertakes work with a local employer,

the income earned by that student as a consequence of that employment may, as provided for in Article 15 (*Dependent Personal Services*), be subject to tax in Australia. In this situation the payments received from abroad for the student's maintenance or education will not however be taken into account in determining the tax payable on the employment income that is subject to tax in Australia. No Australian tax would be payable on the employment income if the student qualifies as a resident of Australia during the visit and the taxable income of the student does not exceed the tax-free threshold applicable to Australian residents for income tax purposes.

EXHIBIT A

Article 21 – Other Income

Allocation of taxing rights

2.180 This Article provides rules for the allocation between the two countries of taxing rights to items of income not dealt with in the preceding Articles of the tax treaty. The scope of the Article is not confined to such items of income arising in one of the countries – it extends also to income from sources in a third country.

2.181 Broadly, such income derived by a resident of one country is to be taxed only in the country of residence unless it is from sources in the other country, in which case the income may also be taxed in the other country. Where this occurs, the country of residence of the recipient of the income would be obliged by Article 23 (*Methods of Elimination of Double Taxation*) to provide double taxation relief. This is consistent with Australia's reservation to Article 21 (*Other Income*) of the OECD Model. ***[Article 21, paragraphs 1 and 3]***

2.182 This Article does not apply to income (other than income from immovable (real) property as defined in paragraph 2 of Article 6 (*Income from Immovable (Real) Property*)) where the income is effectively connected with a permanent establishment or fixed base which a resident of one country has in the other country. In such a case, Article 7 (*Business Profits*) or Article 14 (*Independent Personal Services*), as the case may be, will apply. ***[Article 21, paragraph 2]***

Article 22 – Source of Income

Deemed source

2.183 This Article effectively deems income, profits or gains derived by a resident of one country which, in accordance with the tax treaty, may be taxed in the other country to have a source in the latter country for the purposes of the tax law of that country. It therefore avoids any difficulties arising under domestic law source rules in respect of, for example, the exercise by Australia of the taxing rights allocated to Australia by the tax treaty over income derived by residents of Mexico. ***[Article 22, paragraph 1]***

EXHIBIT A

Source of income – double taxation relief

2.184 This Article also ensures that where an item of income, profits or gains is taxable in both countries, double taxation relief will be given by the taxpayer's country of residence (pursuant to Article 23 (*Methods of Elimination of Double Taxation*)) for tax levied by the other country in accordance with the tax treaty. In this way, income derived by a resident of Australia, which is taxable by Mexico under the tax treaty, will be treated as being foreign income for the purposes of the ITAA 1936 and the ITAA 1997, including the foreign tax credit provisions of the ITAA 1936. ***[Article 22, paragraph 2]***

Article 23 – Methods of Elimination of Double Taxation

2.185 Double taxation does not arise in respect of income flowing between the two countries:

- where the terms of the tax treaty provide for the income to be taxed only in one country; or
- where the domestic taxation law of one of the countries exempts the income from its tax.

Tax credit

2.186 It is necessary, however, to prescribe a method for relieving double taxation for other classes of income which, under the terms of the tax treaty, remain subject to tax in both countries. In accordance with international practice, Australia's tax treaties provide for double tax relief to be provided by the country of residence of the taxpayer by way of a credit basis of relief against its tax for the tax of the country of source of the income. This Article also reflects that approach.

Australian method of relief

2.187 This Article requires Australia to provide Australian residents a credit against their Australian tax liability for Mexican tax paid in accordance with the tax treaty on income derived from Mexican sources which is taxable in Australia. ***[Article 23, subparagraph 2(a)]***

2.188 Where a dividend is paid by a Mexican company to an Australian resident company which controls 10% or more of the voting power in the Mexican company, this Article requires Australia to allow a credit for the underlying Mexican tax paid by the company paying the dividend (i.e. the tax paid on the portion of its profits out of which the dividend is paid). This credit is in addition to any credit allowable for the Mexican tax paid in respect of the dividends themselves. ***[Article 23, subparagraph 2(b)]***

2.189 Australia's general foreign tax credit system, together with the terms of this Article and of the tax treaty generally, will form the basis of Australia's arrangements for relieving a resident of Australia from double taxation on income arising from sources in Mexico. As in the case of Australia's other tax treaties, the source of income rules specified by Article 22 (*Source of Income*) for the purposes of this tax treaty will also apply for those purposes.

2.190 Accordingly, effect is to be given to the tax credit relief obligation imposed on Australia by paragraph 2 of this Article by application of the general foreign tax credit provisions of the ITAA 1936 (Division 18 of Part III). This will include the allowance of *underlying tax* credit relief in respect of dividends paid by Mexican resident companies that are related to Australian resident companies, including for unlimited tiers of related companies, in accordance with the relevant provisions of the ITAA 1936 and the ITAA 1997.

2.191 Notwithstanding the credit basis of relief provided for by paragraph 2 of this Article, the *exemption with progression* method of relief will be applicable, as appropriate, in relation to salary and wages and like remuneration derived by a resident of Australia during a continuous period of *foreign service* (as defined in subsection 23AG(7) of the ITAA 1936) in Mexico. ***[Article 23, paragraph 2]***

2.192 Dividends and branch profits derived in Mexico by an Australian resident company that are exempt from Australian tax under the foreign source income measures (e.g. sections 23AH or 23AJ of the ITAA 1936) will continue to qualify for exemption from Australian tax under those provisions. As double taxation does not arise in these cases, the credit form of relief will not be relevant.

Mexican relief

2.193 In the case of a resident of Mexico who is taxable in Mexico on income which is also taxable in Australia under this tax treaty, this Article requires Mexico to allow the Mexican resident a credit for the amount of Australian tax paid on that income. ***[Article 23, subparagraph 1(a)]***

2.194 Where a dividend is paid by an Australian company to a Mexican company which owns at least 10% of the capital of that Australian company, this Article requires Mexico to allow a credit for the underlying Australian tax paid by the company paying the dividends (i.e. the tax paid on the portion of its profits out of which the dividend is paid). This credit is in addition to any credit allowable for the Australian tax paid in respect of the dividends themselves. ***[Article 23, subparagraph 1(b)]***

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Article 24 – Mutual Agreement Procedure

Consultation

2.195 One of the purposes of this Article is to provide for consultation between the *competent authorities* of the two countries with a view to reaching a satisfactory solution in cases where a person is able to demonstrate actual or potential imposition of taxation contrary to the provisions of the tax treaty.

2.196 A taxpayer wishing to use this procedure must present a case to the competent authority of the country of which the person is a resident within three years of the first notification of the action which the taxpayer considers gives rise to taxation not in accordance with the tax treaty. ***[Article 24, paragraph 1]***

2.197 If the competent authority cannot resolve the case unilaterally, the competent authorities of the two countries shall endeavour to resolve the case. Where such a case has been presented to the Australian competent authority, the Mexican competent authority must be notified of the mutual agreement proceedings within four and a half years from the due date of the date of filing the return in Mexico, whichever is the later. If a solution is reached, it shall be implemented in the case of Mexico, within 10 years from the due date or the date of filing of the return in Mexico, whichever is later, or a longer period of permitted under the domestic law of Mexico. The conditions imposed by Mexico regarding the implementation of reliefs and refunds following a mutual agreement are consistent with its treaty practice and its reservation to Article 25 (*Mutual agreement procedure*) of the OECD Model. In the case of Australia, the solution shall be implemented irrespective of any time limits imposed by its domestic taxation law. ***[Article 24, paragraph 2]***

Resolution of difficulties

2.198 This Article also authorises consultation between the competent authorities of the two countries for the purpose of resolving any difficulties regarding the interpretation or application of the tax treaty and to give effect to it. They may also consult together regarding the elimination of double taxation in cases not provided for in the treaty. ***[Article 24, paragraphs 3 and 4]***

General Agreement on Trade in Services dispute resolution process

2.199 Paragraph 5 of this Article deals with disputes that may be brought before the Council for Trade in Services in accordance with paragraph 3 of Article XXII (*Consultation*) of the World Trade Organisation General Agreement on Trade in Services. ***[Article 26, paragraph 5].***

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Background

2.200 Australia and Mexico are both parties to the General Agreement on Trade in Services. Article XVII (*National Treatment*) of this treaty requires a party to accord the same treatment to services and service suppliers of other parties as it accords to its own like services and service suppliers.

2.201 Articles XXII (*Consultation*) and XXIII (*Dispute Settlement and Enforcement*) provide for discussion and resolution of disputes. Paragraph 3 of Article XXII provides that a party may not invoke Article XVII (*National Treatment*) with respect to a measure of another party that falls within the scope of an international agreement between them relating to the avoidance of double taxation. However, if there is a dispute as to whether a measure actually falls within the scope of a tax agreement, either country may take the matter to the Council on Trade in Services for referral to binding arbitration.

2.202 Notwithstanding paragraph 3 of Article XXII, Australia and Mexico have agreed that the consent of both countries is required before a dispute as to whether a measure falls within the scope of this tax treaty may be brought before the Council on Trade in Services. This is seen as the most effective way of dealing with such disputes, and avoids difficult questions as to when a disputed issue falls within the dispute resolution mechanism of this tax treaty or of the General Agreement on Trade in Services.

2.203 This provision is based, in all essential respects, on an OECD Model commentary recommendation, and is common in recent international treaty practice. ***[Article 26, paragraph 5]***

Article 25 – Exchange of Information

Limitations on exchange

2.204 This Article authorises and limits the exchange of information by the two competent authorities to information necessary for the carrying out of the provisions of the tax treaty or for the administration of domestic laws concerning the taxes to which the tax treaty applies. The exchange of information is not limited by Article 1 (*Persons Covered*) of this tax treaty, and may therefore cover persons who are not residents of Australia or Mexico. ***[Article 25, paragraph 1]***

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2.205 The limitation placed on the kind of information authorised to be exchanged means that information access requests relating to taxes not within the coverage provided by Article 2 (*Taxes Covered*), for example, Australia's GST, are not within the scope of this Article.

2.206 Item 11(c) of the Protocol provides that, if Australia in a subsequent tax treaty with a third country agrees that the *Exchange of Information* Article may be used for the purposes of value added taxes imposed by either country, such a clause shall automatically apply for the purposes of the Mexican tax treaty. ***[Protocol, Item 11(c)]***

Purpose

2.207 The purposes for which the exchanged information may be used and the persons to whom it may be disclosed are restricted consistently with Australia's other tax treaties. Any information received by a country shall be treated as secret in the same manner as information obtained under the domestic law of that country. ***[Article 25, paragraph 1]***

2.208 Paragraph 2 of the Article makes it clear that a country is not obliged to supply information that would disclose any trade, business, industrial, commercial or professional secret or trade process or to supply information the disclosure of which would be contrary to public policy. ***[Article 25, subparagraph 2(c)]***

Article 26 – Members of Diplomatic Missions and Consular Posts

2.209 The purpose of this Article is to ensure that the provisions of the tax treaty do not result in members of diplomatic missions and consular posts receiving less favourable treatment than that to which they are entitled in accordance with international conventions. Such persons are entitled, for example, to certain fiscal privileges under the *Diplomatic Privileges and Immunities Act 1967* and the *Consular Privileges and Immunities Act 1972* which reflect Australia's international obligations towards members of diplomatic missions and consular posts.

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Article 27 – Entry into Force

Date of entry into force

2.210 This Article provides for the entry into force of the tax treaty. This will be on the last date on which notes are exchanged notifying that the last of the domestic processes to give the tax treaty the force of law in the respective countries has been completed. In Australia, enactment of the legislation giving the force of law in Australia to the tax treaty, along with tabling the treaty in Parliament and review by the Parliamentary Joint Standing Committee on Treaties, are prerequisites to the exchange of diplomatic notes.

Date of application for withholding taxes

2.211 Once it enters into force, the tax treaty will apply to taxes under Articles 10 (*Dividends*), 11 (*Interest*), and 12 (*Royalties*) on either of two dates depending on the date the treaty enters into force:

- if the treaty enters into force prior to 1 July, the treaty will apply in respect of taxes imposed under those Articles for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force; or

- otherwise, if the treaty enters into force on or after 1 July, the treaty will apply in respect of taxes imposed under those Articles, for amounts paid or credited, on 1 January of the year following the year the treaty enters into force.

Date of application for other Australian taxes

2.212 In Australia, the treaty will first apply to other Australian taxes on income, profits or gains of the Australian year of income beginning on or after 1 July in the calendar year next following that in which the tax treaty enters into force.

2.213 Where a taxpayer has adopted an accounting period ending on a date other than 30 June, the accounting period that has been substituted for the year of income beginning on 1 July of the calendar year next following that in which the tax treaty enters into force will be the relevant year of income for the purposes of the application of other Australian tax. For this purpose, ‘year of income’ takes its meaning from section 6 of the ITAA 1936.

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Date of application for other Mexican taxes

2.214 In Mexico, this tax treaty will first have effect, in relation to other Mexican taxes, on or after 1 July in the calendar year next following that in which the treaty enters into force.

Article 28 – Termination

2.215 The tax treaty is to continue in effect indefinitely. However, either country may give written notice of termination of the tax treaty through the diplomatic channel on or before 30 June in any calendar year beginning after the expiration of five years from the date of its entry into force.

Cessation in Australia

2.216 In the event of either country terminating the tax treaty, the treaty would cease to be effective in Australia for the purposes of withholding tax on income derived by a non-resident in relation to income derived on or after 1 July in the calendar year next following that in which the notice of termination is given.

2.217 For other Australian tax, the treaty would cease to be effective in relation to income, profits or gains of any year of income beginning on or after 1 July in the calendar year next following that in which the notice of termination is given.

Cessation in Mexico

2.218 The tax treaty would correspondingly cease to be effective in Mexico on or after 1 July in the calendar year next following that in which the notice of termination is given.

Protocol, Item 11(a) – Asset tax imposed in Mexico

2.219 The Mexican assets tax operates as an alternative minimum income tax under which resident and non-resident companies are obliged to pay the tax if, and to the extent that, it exceeds the companies' income tax liability for a given tax year.

2.220 Mexican domestic law requires resident companies and non-resident companies which maintain assets in Mexico to calculate the assets tax on those assets. The assets tax rate is currently 1.8% and is applied to the net asset balance. The net asset balance is the total value of the taxpayer's business assets, minus any debts to Mexican companies.

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2.221 Under Item 11(a) of the Protocol, Australian residents who do not have a permanent establishment in Mexico, and therefore are not taxable on their business profits in Mexico in accordance with Article 7 (*Business Profits*), are not subject to the assets tax. However the exclusion does not apply to assets covered by the definition of royalties, that are used by a Mexican resident. In this case, Mexico would grant a credit against the assets tax for the withholding tax that would have been paid on the royalties under the domestic law, rather than the amount payable under the treaty. ***[Protocol, Item 11(a)]***

Example 2.2

> Under the Protocol, an Australian taxpayer would have to calculate their assets tax liability on intangibles at the rate of 1.8%. However, that taxpayer would be entitled to a credit against the assets tax liability for royalty withholding tax paid at the higher domestic royalty withholding tax rate even though a royalty withholding tax of 10% is actually paid in accordance with the treaty.

2.222 Australia is not required to give a credit for Mexican assets tax paid by Australian residents.

Protocol, Item 11(b) – Non-discrimination

2.223 The Protocol provides that, if Australia agrees to include a *Non-Discrimination* Article in a subsequent tax treaty with another country (which is given effect under the *International Tax Agreements Act 1953*), then Australia will enter into negotiations with a view to providing Mexico the same treatment as is provided for in that other tax treaty. The United Kingdom treaty (which is proposed to be given the force of law in this bill) includes such an Article.

Protocol, Item 11(c) – Exchange of Information and value added taxes

2.224 The Protocol provides that, if Australia in a subsequent tax treaty with a third country agrees that the *Exchange of Information* Article may be used for the purposes of value added taxes imposed by either country, such a clause shall automatically apply for the purposes of the Mexican tax treaty.

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Chapter 3
Miscellaneous

What will the amendments do?

3.1 Schedule 3 to this bill will amend subsection 170(14) of the ITAA 1936 to reflect the replacement of the existing United Kingdom tax treaty (signed in 1967) text in the Agreements Act. This Schedule will also update references in the *Taxation (Interest on Overpayments and Early Payments) Act 1983* to the Agreements Act. In addition, this Schedule will clarify the application of Australia's tax treaties with respect to returns on debt interests.

3.2 These amendments will:

- substitute a new paragraph (a) into the definition of *relevant provision* in subsection 170(14) of the ITAA 1936 and omit the definition of *United Kingdom agreement* from the same subsection;
- replace the cross-references to the Agreements Act within the definitions section of the *Taxation (Interest on Overpayments and Early Payments) Act 1983* with the correct short title of the Agreements Act; and
- clarify that a reference in a tax treaty to either income from shares or income from other rights participating in profits does not include a reference to a return on a *debt interest* (as defined in Subdivision 974-B of the ITAA 1997) ***[Schedule 3, item 3, new subsection 3(2A) of the Agreements Act].***

Commencement

3.3 The amendments will apply from the day this bill receives Royal Assent.

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Reasons for the amendments

New definition of 'relevant provision'

3.4 This is a consequential amendment following the replacement of the 1967 United Kingdom tax treaty with the new United Kingdom tax treaty and the Exchange of Notes.

3.5 Subsections 170(9B) and (9C) of the ITAA 1936 deal with time limits for amending income tax assessments for the purpose of giving effect to a *relevant provision*. Paragraph (a) of the definition for *relevant provision* in subsection 170(14) defines ***relevant provision*** as paragraph (3) of Article 5 or paragraph (1) of Article 7 of the existing tax treaty with the United Kingdom (currently defined as *United Kingdom agreement* within subsection 170(14)), or a provision of any other tax treaty that corresponds with either of those paragraphs. These paragraphs in Australia's tax treaties allow for adjustments to the profits of permanent establishments or associated enterprises on an arm's length basis.

3.6 This amendment replaces the references to the provisions in the existing tax treaty with the United Kingdom with a broad, generic description of the relevant provisions found in Australia's tax treaties. Examples of such provisions in Australia's tax treaties are paragraph 2 of Article 7 (*Business profits*) and paragraph 1 of Article 9 (*Associated enterprises*) of the new tax treaty with the United Kingdom ***[Schedule 1, item 14]***). Substituting this general description will reduce the need to amend the definition of *relevant provision* as a result of future tax treaty changes.

3.7 As a consequence of the change to a generic description of paragraph (a) of the definition of *relevant provision*, the definition of *United Kingdom agreement* in subsection 170(14) is no longer necessary and will be repealed by this bill.

Cross-references to Agreements Act

3.8 These amendments are technical corrections to update the cross-references to the Agreements Act in subsection 3(1) of the *Taxation (Interest on Overpayments and Early Payments) Act 1983*.

References to income from shares and to income from other rights participating in profits

Debt and equity rules

3.9 This is a consequential amendment following the enactment of Australia's debt and equity rules in 2001. Broadly, the debt and equity rules determine whether a financial interest constitutes equity in a company (an *equity interest*, as defined in Subdivision 974-C of the ITAA 1997) or constitutes debt (a *debt interest*, as defined in Subdivision 974-B of the ITAA 1997). This then determines the tax treatment of a return on a financing interest issued by a company – that is, whether it is frankable or may be deductible.

3.10 Broadly, an interest in a company will be a *debt interest* if, at the time of its issue, there is a scheme that is a *financing arrangement* (as defined in section 974-130 of the ITAA 1997) under which the company is obliged to pay an amount to the holder of the interest at least equal to its issue price. Shares that give rise to *debt interests* (e.g. compulsorily redeemable preference shares that satisfy the *debt test* under subsection 974-20(1) of the ITAA 1997) are called *non-equity shares* (defined in subsection 6(1) of the ITAA 1936 as a share that is not an equity interest in a company).

Domestic withholding tax definitions of 'interest' and 'dividend'

3.11 The debt and equity concepts also apply to Division 11A of Part III of the ITAA 1936, which imposes withholding tax on Australian sourced dividends, interest and royalties paid to non-residents.

3.12 For the purposes of determining the boundary between interest and dividend withholding tax, the definition of *interest* in paragraph 128A(1AB)(d) of the ITAA 1936 includes an amount that is a 'dividend paid in respect of a non-equity share'. For consistency, the definition of *dividend* in paragraph 128A(1)(b) excludes 'a dividend paid in respect of a non-equity share'. This ensures that interest withholding tax applies to these amounts, rather than dividend withholding tax.

Tax treaty definitions of 'interest' and 'dividends'

3.13 Most Australian tax treaties include a definition of *interest* that extends to income which is subjected to the same domestic tax treatment as income from money lent (see, for instance, paragraph 5 of Article 11 (*Interest*) of the new tax treaty with the United Kingdom ***[Schedule 1, item 14]***). In Australia's case, this would cover those amounts encompassed by the paragraph 128A(1AB)(d) of the ITAA 1936

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definition of *interest* – including a dividend paid in respect of a non-equity share. This extended definition of interest is intended to align the treaty definition with the domestic law definition of interest.

3.14 With the exception of the existing tax treaty with the United Kingdom, all of Australia's tax treaties include a definition of *dividends* which refers to 'income from shares'. Some of these treaties also include a reference to 'other rights participating in profits'. Most of Australia's tax treaties also extend the definition of *dividends* to other amounts which are subjected to the same domestic tax treatment as income from shares (see, for instance, paragraph 4 of Article 10 (*Dividends*) of the new tax treaty with the United Kingdom). This extended definition of dividends is intended to align the treaty definition with the domestic law definition.

Amendment to Agreements Act

3.15 The change to the Agreements Act confirms that the provisions of Australia's tax treaties dealing with dividends and interest are to be interpreted in accordance with the internationally accepted view that the *Dividends* Article in tax treaties apply to equity interests and the *Interest* Article applies to debt interests.

3.16 This amendment clarifies that a payment that is treated as a return on a debt interest, under Australia's domestic law, is not treated as a dividend for the purposes of Australia's tax treaties. The amendment does this by clarifying that the references to income from shares and to income from other rights participating in profits, which commonly occur in the dividends definition in Australia's tax treaties, do not include a reference to a return on a debt interest. Such a return on a debt interest would generally be treated as an interest payment for the purposes of Australia's tax treaties.

3.17 The amendment ensures alignment between the treaty treatment and the domestic law treatment, so that such returns on debt interests are generally only subjected to the terms of the *Interest* Articles in Australia's tax treaties (including the tax rate limits specified in those Articles), as intended.

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Application

3.18 The debt interest amendment has been expressed in general terms to deal with all cases where an agreement includes a reference to income from shares or to income from other rights participating in profits (including the new tax treaties with Mexico and with the United Kingdom). Legislation expressed in general terms will, in addition, deal with these references in future tax treaties.

3.19 The provision applies to amounts paid after commencement of this section. However, as the inclusion of this provision is intended to clarify, rather than change, the treatment of returns on debt interests under Australia's tax treaties, such amounts paid before the commencement of this section will generally also be subject only to the terms of the *Interest* Articles in Australia's tax treaties.

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Chapter 4
Regulation impact statements

THE 2003 UNITED KINGDOM CONVENTION

Specification of policy objectives

4.1 Two key objectives of the existing Australia-United Kingdom tax treaty are to:

- promote closer economic cooperation between Australia and the United Kingdom by eliminating possible barriers to trade and investment caused by the overlapping taxing jurisdictions of the two countries; and
- create a framework through which the tax administrations of Australia and the United Kingdom can prevent international fiscal evasion.

4.2 The negotiation of a new tax treaty (to replace the 1967 tax treaty and Protocol of 1980) is intended to advance these objectives by:

- providing an enhanced element of legal and fiscal certainty within which cross-border trade and investment can be carried on, over and above that currently afforded under the existing 1967 tax treaty and Protocol;
- improving the level of cooperation between the tax administrations of the two countries;
- modernising the tax treaty to reflect changes to tax treaty policies and practices of both countries since the existing tax treaty's conclusion;
- ensuring broad consistency in the taxation treatment of Australia's major trading partners, particularly in light of the recently signed Protocol to the Australia-United States of America tax treaty;

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- facilitating and promoting future commercial relations between Australia and the United Kingdom; and
- giving effect to the Government's announcement of 11 November 1999 that priority be given to renegotiating Australia's aging tax treaties with major trading partners.

Background

4.3 The stated policy objective of tax treaties is to avoid double taxation and prevent fiscal evasion with respect to taxes on income, but their wider function is to facilitate investment, trade, movement of technology, and movement of personnel between countries. They are widely used to develop and strengthen bilateral relationships between countries, especially in commercial areas. Tax treaties also provide certainty and protection regarding the level of taxation on investments abroad which may, for instance, be valued by business when deciding on the location of a regional headquarters.

4.4 A renegotiated tax treaty is important for the future commercial relations between Australia and the United Kingdom, particularly because the United Kingdom is the second largest foreign investor in Australia[1] and the second largest destination for Australian investment abroad[2]. The United Kingdom is also a particularly important gateway for European Union investment in Australia and will be an increasingly important window for Australian investment in the European Union.

How tax treaties operate

4.5 Australian tax treaties are usually based on the OECD Model with some influences from the UN Model. In addition, negotiating countries propose variations to these models to reflect their particular economic interests and legal circumstances.

4.6 Tax treaties reduce or eliminate double taxation caused by the overlapping taxing jurisdictions because treaty partners agree (in certain situations) to limit taxing rights over various types of income. The respective countries also agree on methods of reducing double taxation where both countries have a right to tax.

[1] A$224 billion as at June 2002.
[2] A$71 billion as at June 2002.

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4.7 Australia seeks an appropriate balance between source and residence country taxing rights. Generally the allocation of taxing rights under Australian tax treaties is similar to international practice as set out in the OECD Model, but there are a number of instances where Australian practice leans more towards source country taxing rights.

4.8 In addition, tax treaties provide an agreed basis for determining whether the income returned or expenses claimed on related party dealings by members of a multinational group operating in both countries can be regarded as acceptable. Tax treaties are therefore an important tool in dealing with international profit shifting.

4.9 To prevent fiscal evasion, tax treaties include exchange of information provisions. The two tax administrations can also use the mutual agreement procedures available for treaties to develop a common interpretation and resolve differences of application of the tax treaty. There is also provision for residents of either country to instigate a mutual agreement procedure.

The United Kingdom tax treaty

4.10 The existing Australia-United Kingdom tax treaty was signed on 7 December 1967 and has effect from 1 July 1967 (for Australian tax purposes) replacing an earlier tax treaty signed in 1946. The 1967 tax treaty was amended in 1980 mainly to update the *Dividends* Article to reflect changes made to the treatment of dividends under United Kingdom domestic tax law. While the 1967 tax treaty and 1980 Protocol have served the interests of both countries well over the intervening years, it is now considered that these arrangements (based in many respects on the tax treaty practice of the time, rather than modern models) are outdated. This applies both in regard to the tax treaty practices of Australia and of the United Kingdom, and that of the international community more generally.

4.11 Renegotiation of the Australia-United Kingdom tax treaty commenced in February 2001, a second round of negotiations were held in March 2002 and a third round in November 2002.

Australia's investment and trade relationship with the United Kingdom[3]

4.12 Trade and investment ties between Australia and the United Kingdom are very significant. In 2000-2001, the United Kingdom was Australia's third largest trading partner, and sixth largest

[3] Source: Department of Foreign Affairs and Trade.

merchandise trading partner. In 2002, total two-way trade totalled A$18.7 billion with Australian merchandise exports of A$5.6 billion. Major Australian exports included non-monetary gold (A$1,285 million), alcoholic beverages (A$920 million), coal (A$363 million), aircraft and parts (A$192 million), and lead (A$177 million). In 2002 Australian exports of services totalled A$3.6 billion.

4.13 Australia's merchandise imports from the United Kingdom amounted to A$5.8 billion in 2002. Principal imports included medications (A$962 million), passenger motor vehicles (A$363 million), aircraft and parts (A$183 million), and telecommunications equipment (A$181 million).

4.14 As at June 2002, the United Kingdom was the second largest foreign investor in Australia (A$224 billion) and the second largest destination for Australian investment abroad (A$71 billion). Around a third of all regional headquarters' operations in Australia are European, and of these almost half are British.

4.15 There are over 1,000 Australian companies active in the United Kingdom with a large number using Britain as a base for trade and investment into the European Union.

Identification of implementation option(s)

4.16 The implementation options for achieving the policy objectives are:

- no further action – rely on the existing tax treaty measures; or
- conclude a new tax treaty.

Option 1: No further action – rely on the existing tax treaty measures

4.17 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since its inception, it is clear that the existing tax treaty has become outdated and does not adequately reflect the current tax treaty policies and practices of either Australia or the United Kingdom, nor modern international norms.

4.18 In particular, relying on the existing tax treaty would not involve any adaptation of the tax treaty to modern developments, such as

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recent changes to the United Kingdom dividend taxation regime and modern ways of doing business, and legal and fiscal certainty would thus reduce over time. Furthermore, this option would not address the taxation of capital gains, and therefore the current uncertainty over taxing rights in this area would continue.

Option 2: Conclude a new tax treaty

4.19 The internationally accepted approach to meeting the policy objectives specified above is to conclude a new bilateral tax treaty or to amend an existing treaty to reflect current policies.[4] The dated language of the existing tax treaty and the developments in both countries' domestic law, commercial practices, and treaty policies and practices support a revision of the full text.

4.20 As mentioned earlier, a new tax treaty would be largely based on the current OECD Model and the UN Model, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

4.21 Both countries have particular policy objectives to achieve in updating the tax treaty and the end result ultimately represents compromises necessary to achieve a mutually acceptable agreement. The key changes in the new tax treaty are:

- a reduction in the maximum royalty withholding tax rates from 10% to 5 %;
- nil interest withholding tax where interest is paid to a financial institution or body performing governmental functions;
- nil dividend withholding tax for dividends on certain non-portfolio holdings of 80% or more and 5% dividend withholding tax for non-portfolio holdings between 10% and 80%; and
- inclusion of a comprehensive *Alienation of property* Article preserving source country taxing rights over most capital gains.

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[4] There are very few multilateral tax treaties, which reflects the widely differing economic interests and unique tax law structures of most countries.

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4.22 The specific application of a revised tax treaty to dual listed companies and expatriates has been clarified, and a number of other technical matters (such as the treatment of pensions and the definitions of 'permanent establishment' and 'royalties') have also been addressed in accordance with Australia's established tax treaty practice.

Assessment of impacts (costs and benefits) of each option

Difficulties in quantifying the impacts of tax treaties

4.23 Only a partial analysis of costs and benefits can be provided because all the impacts of tax treaties cannot be quantified. While the direct cost to Australian revenue of withholding tax changes can be quantified relatively easily, other cost impacts such as compliance costs are inherently difficult to quantify. There are also efficiency and growth gains and losses to Australia that provide estimation problems. Analysis has been conducted to establish plausible impacts on Australian economic activity and consequent tax revenue flowing from implementation of the tax treaty. The tax revenue estimates are subject to more uncertainty than the estimates of costs but are best estimates given the technology of estimation, the availability of estimates of behavioural responses, and data.

4.24 Benefits that flow to business are generally equally difficult to quantify. Some impacts can be determined with greater authority, for instance, the direct revenue impact of reducing rates of withholding tax. The evidence from international consideration (e.g. OECD) and from consultation with business strongly indicates, however, that while the quantum of benefits is very difficult to assess, a modern tax treaty provides a clear positive benefit to trade and investment relationships.

Impact group identification

4.25 A revised tax treaty with the United Kingdom is likely to have an impact on:

- Australian residents doing business with the United Kingdom, including principally:
  - Australian residents investing directly in the United Kingdom (either by way of a subsidiary or a branch);

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  - Australian banks lending to United Kingdom borrowers;
  - Australian residents supplying technology and know-how to United Kingdom residents;
  - Australian residents supplying consultancy services to the United Kingdom; and
  - Australian residents exporting to the United Kingdom;
- Australian employees working in the United Kingdom;
- Australian residents receiving pensions from the United Kingdom;
- the Australian Government; and
- the ATO.

Assessment of benefits

Option 1: No further action – rely on existing unilateral measures

4.26 By adopting this option there would be no need for further action and resources could be devoted to other tax treaty issues. However, this option is not current Government policy.

Option 2: Conclude a new tax treaty

4.27 The immediate benefits to be derived from a new tax treaty with the United Kingdom are expected to be significant. Given the long-term nature of such arrangements, a revised tax treaty is expected to promote greater certainty than the existing tax treaty and will have the following benefits.

Economic benefits

4.28 Business has for many years raised concerns about the lack of competitiveness of Australia's tax treaty network and has particularly sought a reduction in withholding tax rates. Submissions received have also expressed the need for certainty over the taxation of capital gains, as well as raising a range of other desired features in a revised tax treaty with the United Kingdom.

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4.29 These issues were addressed in the recently signed Protocol amending the Australia-United States of America tax treaty. Ensuring consistent treatment, where possible, in Australia's revised tax treaties maintains the integrity of Australia's treaty network and discourages treaty shopping. While a reduction in maximum withholding tax rates will involve a cost to revenue, the benefits to the revenue and the wider economy are much more widely spread, with the most direct benefits accruing to business. Indirect revenue benefits may arise from increased trade and investment between the countries.

4.30 The economic benefits of the expected major changes from the existing tax treaty are summarised in paragraphs 4.31 to 4.46.

Dividends

4.31 Under the existing tax treaty, a 15% rate of United Kingdom dividend withholding tax notionally applies to dividends paid to Australian companies. However, the United Kingdom unilaterally (via its domestic law) exempts such payments. The achievement of a nil or 5% United Kingdom dividend withholding tax in a revised tax treaty on non-portfolio dividends would provide certainty for business that this situation will continue, even if, for example, the domestic law changes so that there is no longer a general exemption.

4.32 The achievement of a reduced rate of Australian dividend withholding tax on non-portfolio dividends is widely supported by Australian business, and would make Australia's taxation treatment of subsidiaries and branches more consistent (as branches are not subject to dividend withholding tax) as well as making direct investment in Australia more attractive. Business views the current 15% Australian dividend withholding tax rate on non-portfolio dividends as making Australia a less attractive investment location compared to other countries, which reduces Australia's ability to attract foreign capital.

Interest

4.33 A nil Australian interest withholding tax rate on interest derived by United Kingdom financial institutions will be consistent with the exemption currently provided for interest derived from widely distributed arm's length debenture issues and recognises that a 10% interest withholding tax rate on gross interest derived by financial institutions may be excessive given their cost of funds. The cost to Australian business of raising capital from United Kingdom financial institutions is expected to reduce, making this source of capital more affordable for marginal investment projects.

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Royalties

4.34 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to United Kingdom residents would benefit from a reduced royalty withholding tax rate. Consultation with business representatives have indicated that such gross-up obligations are commonly imposed on the payer of the royalty, so that they may bear the cost of the higher rate, in comparison with payers from other countries.

4.35 Australian residents who derive royalty income from the United Kingdom may also benefit from a reduced United Kingdom royalty withholding tax rate. Additional tax payable in Australia due to a reduced credit for United Kingdom royalty withholding tax would generally result in imputation credits that can be passed on to shareholders.

Alienation of property

4.36 The inclusion of an *Alienation of property* Article, which preserves Australia's source country taxing rights, would ensure Australian taxing rights over capital gains are retained. It would also facilitate investment between the countries by making the taxation treatment of capital gains more certain and reducing the risk of double taxation. Further, the Article would address widespread business concerns about the potential for double taxation arising from the application of Australia's CGT to expatriates departing Australia. These concerns have negatively affected the ability of Australian located companies to attract and retain skilled expatriate staff. They also have the potential to affect headquarters location decisions to Australia's detriment. The Article would also improve arrangements for taxing gains accrued on assets held by departing residents by reducing compliance difficulties and ensuring appropriate relief is provided from double taxation.

Revenue benefits

4.37 Analysis has been undertaken to establish the plausible impacts on Australian economic activity of the Australia-United Kingdom tax treaty. This analysis indicates that the proposed reduction in interest withholding tax is likely to result in reduced interest rates for Australian business, increased domestic investments, and an increase in GDP. This increase in economic activity is likely to result in increased tax revenue in the order of A$70 million from each year's reduction in interest withholding tax.

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4.38 A further second round effect is the revenue gain to the Federal Budget that flows from Australian companies no longer claiming Australian tax relief for the former higher levels of United Kingdom withholding tax on interest and royalties. Estimates of these gains are less precise than the estimates of revenue costs of withholding tax changes and are estimated at A$5 million – A$10 million annually.

Compliance and administration cost reduction benefits

4.39 Compliance costs would be significantly reduced by clarifying Australia's right to tax United Kingdom companies on capital gains derived from the disposal of an Australian subsidiary. Interpretative issues relating to the extent Australia can tax these gains under the existing tax treaty have resulted in considerable uncertainty and costly legal arguments. Administrative costs in explaining the ATO view and responding to legal arguments would also be significantly reduced. Clarifying other areas of uncertainty, such as tax treaty tests of 'residency' and the relationship of the tax treaty with current United Kingdom domestic dividend taxation, should also decrease compliance costs and uncertainty.

Other benefits

4.40 Where Australians invest directly in the United Kingdom, the United Kingdom would not generally be able to tax an Australian resident unless that Australian resident carries on business through a permanent establishment in the United Kingdom. A revised tax treaty would, to some extent, further refine the basis for allocation of profits to that permanent establishment and further clarify what level of activity would constitute such an establishment. A revised tax treaty may also establish a specific rule for taxation of income from real property and the alienation of property, both of which are currently lacking in the existing tax treaty.

4.41 Likewise, for Australians investing through a United Kingdom subsidiary, a revised tax treaty will modernise the internationally accepted framework for dealing with parent-subsidiary transactions and other transactions between associated enterprises. In this regard, a revised tax treaty clearly offers superior protection to the domestic rules of the two countries because it will provide for mutual agreement to be reached between the two taxing authorities as to the methodology to be applied for taxing the profits of the respective enterprises.

4.42 To some extent, the revised rules embodied in a new tax treaty will further reduce the risks for Australians investing in the United Kingdom (and vice versa) because a new tax treaty would record agreement between the two Governments on an enhanced framework for

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taxation of cross-border investments. In the case of mining investments that cannot easily be relocated, this reduction in risk may be quite important.

4.43 Commodity exporters would be assisted in some respects because of the way a revised tax treaty would restrict the circumstances in which Australians trading with the United Kingdom are to be taxed by requiring the existence of a permanent establishment in the United Kingdom before United Kingdom taxation will take place.

4.44 A revised tax treaty will also assist in making clear the taxation arrangements for individual Australians working in the United Kingdom, either independently as consultants or as employees. Income from professional services and other similar activities are now likely to be taxed under the permanent establishment rules rather than the former international standard provided in the existing tax treaty. This required that the services are attributable to a fixed base of the person concerned in that country.

4.45 Employees' remuneration would generally be taxable in the country where the services are performed. However, where the services are performed during certain short visits to one country by a resident of the other country, the income would generally be exempt in the country visited.

4.46 A revised tax treaty will also assist the bilateral relationship by updating an important treaty in the existing network of commercial treaties between the two countries. A revised tax treaty would also promote greater cooperation between taxation authorities to prevent fiscal evasion and tax avoidance. Updating the tax treaty to take account of changes to the OECD Model would also help to maintain Australia's status as an active OECD member, which in turn would maintain Australia's position in the international tax community.

Assessment of costs

Option 1: No further action – rely on the existing tax treaty measures

4.47 As this option represents a continuance of the current position, the revenue, administration and compliance costs that apply to the existing tax treaty would not change.

4.48 Nevertheless, even though both countries have bilaterally agreed to measures to prevent double taxation of cross-border investments, this option does not resolve all areas of difference. For example, the existing

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tax treaty does not have an Article dealing specifically with the alienation of property (i.e. the taxation of capital gains), although such an Article is now standard practice in Australia's recent tax treaties with other countries and features in both the OECD Model and the UN Model. This lack of a specific Article comprehensively dealing with capital gains has given rise to major interpretation issues and the ATO was required to issue a public ruling to provide guidance to taxpayers on how capital gains derived by British residents should be taxed in Australia. Even though officials from the ATO and the Inland Revenue consider that the existing tax treaty does not limit Australia's right to tax capital gains, in the event of an adverse court decision, the potential revenue cost could be high. Compliance costs to taxpayers would also be higher because of this uncertain legal position.

4.49 Furthermore, this option does not allow either country to take advantage of more modern treaty practices adopted by the international community in tax treaties generally since 1967 (such as the lowering of certain maximum withholding tax rates). Nor does it reflect subsequent unilateral changes to the internal laws of both countries designed to regulate current business and investment practices. Since the tax treaty generally overrides other tax laws, its operation in the light of changed domestic laws since it was negotiated (such as changes to United Kingdom dividend taxation) is often far more complex than in more modern tax treaties. This option also prevents Australia from better reflecting its current position as both a significant capital exporter and a significant capital importer, a position quite different to that pertaining in 1967.

4.50 Australian investors view the existing United Kingdom treaty as an impediment to business expansion, making countries with more modern tax treaties with Australia relatively more attractive as investment destinations. It is also seen as disadvantaging our investors in the United Kingdom compared with investors from other countries with more modern tax treaties with the United Kingdom (such as United States of America enterprises).

Option 2: Conclude a new tax treaty

Revenue costs

4.51 The direct cost to revenue from the renegotiated agreement is estimated to be approximately A$100 million per annum. This cost is attributed to the main changes appearing in a revised tax treaty, being:

- a reduction in dividend withholding tax to nil or 5% on non-portfolio dividends derived by United Kingdom

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companies down from 15% for unfranked dividends (franked dividends are already exempt from dividend withholding tax under Australia's domestic law);

- an interest withholding tax exemption for interest paid to United Kingdom financial institutions (down from 10%); and
- a reduction in the general royalty withholding tax rate to 5% (down from 10%).

Knock-on revenue costs

4.52 A recognised consequence of the recently signed Protocol amending the Australia-United States of America tax treaty was that over time the lower withholding tax rates contained therein are likely to be extended to other countries because of most favoured nation clauses in some existing treaties. This will come at a cost to the revenue in relation to countries exporting capital and technology to Australia but will lower the cost of capital to Australian businesses seeking funding in those countries and reduce the cost of accessing new technologies. The amount by which costs to Australian businesses will be reduced depends on the extent to which those businesses currently bear the costs of the relevant withholding taxes.

4.53 The United Kingdom will be the first country seeking the lower withholding tax rates, notwithstanding that the existing United Kingdom tax treaty does not contain a most favoured nation clause. Requests for similar reductions in withholding from other countries which also do not currently have a most favoured nation with Australia are expected, but of course some concessions of benefit to Australian business can be sought in return.

Taxpayer costs

4.54 No material costs to taxpayers have been identified as likely to arise from the renegotiation of this tax treaty. The closer alignment with more recent treaty practice would generally be expected to reduce compliance costs, and any tax exemptions (such as on certain interest payments) would be likely to reduce such costs.

Administration costs

4.55 There would be a small unquantifiable cost in administering the changes made by the revised tax treaty, including minor implementation costs to the ATO in educating the taxpaying public and ATO staff concerning the new arrangements.

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4.56 The cost of negotiation and enactment of a new tax treaty with the United Kingdom will be small. Most of these costs will be borne by the ATO, the Treasury, and the Department of Foreign Affairs and Trade. There will also be an unquantified but small cost in terms of parliamentary time and drafting resources in enacting the proposed new tax treaty.

4.57 There are also 'maintenance' costs to the ATO and the Treasury associated with tax treaties in terms of dealing with enquiries, mutual agreement procedures (including advance pricing arrangements) and OECD representation. However, these costs also apply to the existing tax treaty. Bringing the United Kingdom tax treaty into basic conformity with modern treaty practice will, over time, reduce these costs, as the existing tax treaty has many unusual and difficult aspects due to many of its features deriving from traditional United Kingdom tax treaty practise rather than modern OECD or UN Models.

Other costs

4.58 Government policy in relation to taxation of United Kingdom residents would be to some extent constrained by changes to treaty obligations, but as the more significant changes would not be unique in our tax treaty practice, that is not likely to be a major constraint. Ultimately, the tax treaty could be terminated if it became out of step with Government policy, though such termination is very rare in international tax treaty practice.

4.59 The impact of new tax treaties on tax policy flexibility is generally quite marginal because Australia already has a substantial tax treaty network.

Consultation

4.60 Information on the revision of the existing tax treaty has been provided to the States and Territories by the Commonwealth through the Commonwealth/State Standing Committee on Treaties' Schedule of Treaty Action following the Government's 11 November 1999 announcement concerning its Stage 2 response to *A Tax System Redesigned*.

4.61 Since the Government's acceptance of the Review of Business Taxation recommendation to update aging treaties, the business community has been aware that Australia would be renegotiating with its major trading partners, including the United Kingdom. Submissions from

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the business community were formally requested through the tax treaty Advisory Panel. In addition, specific companies from various industry sectors have been approached to provide practical perspectives on the operations of the existing tax treaty and any desirable features of a revised tax treaty.

4.62 Treasurer’s Press Release No. 3 of 25 January 2002 announced the dates of the talks and invited submissions from stakeholders and the wider community. As negotiations proceeded, further targeted and confidential consultation was undertaken with business and industry groups, professional bodies, and the main affected companies.

4.63 In general, business and industry groups supported the recently concluded Protocol amending the Australia-United States of America tax treaty and encouraged the Government to pursue a similar result in the revised tax treaty with the United Kingdom. While some of those consulted recommended going further than the changes negotiated with the United States of America, most recognised the need for both a consistent treaty policy and a degree of moderation in the extent to which Australia can afford to concede taxing rights.

4.64 The new tax treaty will also be considered by Commonwealth Joint Standing Committee on Treaties, which provides for public consultation in its hearings.

Conclusion and recommended option

4.65 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it is clear that it has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or the United Kingdom, nor modern international norms.

4.66 The existing tax treaty is also seen by business as impeding the expansion of trade and investment, especially the absence of provisions for the taxation of capital gains, and its rates of withholding taxes applying to remittances of dividends, interest and royalties.

4.67 A new tax treaty with reductions in the maximum rates of withholding taxes similar to that recently agreed with the United States of America will provide significant benefits to Australian business. It will be another step forward in providing Australian business with an internationally competitive tax treaty network and business tax system. It will also directly facilitate trade and investment between the countries,

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provide a boost to GDP and hence tax revenues, further reduce fiscal evasion and improve the integrity of the tax system (especially protecting our tax base by clarifying our right to tax United Kingdom residents in respect of capital gains), improve Australia-United Kingdom relations, and maintain Australia's position in the international tax community.

4.68 There is a direct cost to revenue from the new tax treaty, largely sourced in reduced withholding tax collections. The compliance costs associated with this measure are considered to be small.

4.69 On balance, the benefits of a revised tax treaty outweigh the cost to revenue. Option 2 is therefore recommended as the preferred option.

THE MEXICAN AGREEMENT

Specification of policy objectives

4.70 The three key objectives of the Australia-Mexico tax treaty are to:

- avoid double taxation of incomes arising from overlapping tax jurisdictions;
- prevent international fiscal evasion; and
- facilitate trade and investment between Mexico and Australia.

Background

How tax treaties operate

4.71 The proposed tax treaty is based on the OECD Model with some influences from the UN Model. In addition, both countries have included variations reflecting their economic interests and legal circumstances.

4.72 The tax treaty would reduce or eliminate double taxation caused by the overlapping taxing jurisdictions, because under the tax treaty, Australia and Mexico agree (in specified situations) to limit taxing rights over various types of income. The countries also agree on methods of

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reducing double taxation where both countries have a right to tax. For example, the tax treaty contains the standard tax treaty provision that neither country would tax business profits derived by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment and the income is attributable to a permanent establishment (Article 7).

4.73 In negotiating the sharing of taxing rights, Australia seeks an appropriate balance between source and residence country taxing rights. Generally the allocation of taxing rights under the tax treaty is similar to international practice as set out in the OECD Model, but (consistent with Australian practice) there are a number of instances where it is biased more towards source country taxing rights; the definition of ‘permanent establishment’ is wider in some respects than the OECD Model, and the *Business Profits, Ships and Aircraft, Royalties*, *Alienation of Property* and *Other Income* Articles also give greater recognition to source country taxing rights.

4.74 In addition, the tax treaty provides an agreed basis for determining whether the income returned or expenses claimed on related party dealings by members of a multinational group operating in both countries can be regarded as acceptable (Articles 7 and 9). This is an example of how a tax treaty is used to address international profit shifting.

4.75 To prevent fiscal evasion the tax treaty includes an exchange of information facility. The two tax administrations can also use the mutual agreement procedures to develop a common interpretation and resolve differences of application of the tax treaty. There is also provision for residents of either country to instigate a mutual agreement procedure.

Australia’s investment and trade relationship with Mexico[5]

4.76 For Australia the major impact of a tax treaty will be on Australian enterprises trading with and investing in Mexico. While Australia’s trade and investment relationship with Mexico is the largest Australia has with any Latin American country, it does not figure among Australia’s top ten relationships. However, the size of the Mexican economy (ninth largest in the world) and its growth prospects emphasise the potential importance of the relationship.

5 Source: Department of Foreign Affairs and Trade

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4.77 Total Australia-Mexico trade exceeded A$1 billion in 2002 with Australian exports over the last five years growing at an annual rate of more than 27%. Australian merchandise exports were A$439 million and merchandise imports A$514 million with services imports and exports of A$28 million and A$15 million respectively. Major Australian exports to Mexico were coal and agricultural products while major imports included telecommunications equipment, computers and computer parts, and motor vehicle parts.

4.78 The stock of Australian direct investment in Mexico is fairly modest at just over A$300 million. Australian interests have invested in over 60 Mexican enterprises in the manufacturing, mining, fisheries, and service sectors. There is little or no direct investment by Mexico in Australia, and portfolio investment is low.

Identification of implementation option(s)

4.79 The implementation options for achieving the objectives are:

- no further action – rely on existing unilateral measures; or
- conclude the tax treaty.

Option 1: No further action – rely on existing unilateral measures

4.80 If nothing was done – that is, the tax treaty was not concluded – it could be argued that many of the above policy objectives will nevertheless be achieved. Many of the policy objectives have already been met to a significant extent through the internal tax laws of both the Mexican and Australian Governments. For example unilateral enactment of foreign tax credit measures by Australia already provides substantial relief from juridical double taxation.

Option 2: Conclude the double tax agreement

4.81 The internationally accepted approach to meeting the above policy objectives is to conclude a bilateral tax treaty.[6] The tax treaty regulates the way the two countries would reduce double taxation, by agreeing to restrict their taxing rights in accordance with its terms. The

[6] Possibly reflecting the widely differing economic interests and tax law structures of countries, there are very few multilateral tax treaties.

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tax treaty also records important bilateral undertakings in relation to exchange of information.

4.82 For business and investors generally the tax treaty has the advantage of providing some degree of legal and fiscal certainty – unlike domestic laws which can be amended unilaterally.

4.83 As mentioned earlier, the tax treaty would be largely based on the OECD Model and the UN Model, with some mutually agreed variations reflecting the economic, legal, and cultural interest of the two countries.

Assessment of impacts (costs and benefits) of each option

Impact group identification

4.84 A tax treaty with Mexico is likely to have an impact on:

- Australian residents doing business with Mexico, including principally:
  - Australian residents investing directly in Mexico (either by way of a subsidiary or a branch);
  - Australian banks lending to Mexican borrowers;
  - Australian residents supplying technology and know-how to Mexican residents;
  - Australian residents exporting to Mexico; and
  - Australian residents supplying consultancy services to Mexican residents,
- Australian employees working in Mexico;
- certain departing Australian residents who subsequently become Mexican residents;
- people receiving pensions from the other country (although the number of cross-border pension payments is understood to be minimal);
- the Australian Government; and
- the ATO.

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Assessment of costs

Option 1: No further action – rely on existing unilateral measures

4.85 As this option represents a continuance of the current position, it would be expected that the administration and compliance costs of this option would be minimal. Revenue costs would also be expected to be very small.

4.86 On the other hand, even though both countries have unilaterally introduced measures to prevent double taxation of cross-border investments, this option would not resolve all areas of difference; for example, even if both countries had very similar mechanisms for allowing credit for foreign tax paid, differences could arise over fundamental matters such as the source of income and residence of taxpayers. Furthermore this option does not protect against future unilateral changes to the internal laws and does not limit source country taxing of, for example, dividends, interest, and royalties.

4.87 In addition, investors are concerned that unilateral tax laws do not provide the longer term certainty desirable for making substantial long term investments offshore. This is because the Governments of either country can vary key tax conditions unilaterally. Similarly, so far as the tax administrations are concerned, unilateral rules do not provide a dependable long term framework for information exchange.

Option 2: Conclude a new tax treaty

4.88 The negotiation and enactment of this tax treaty would cost approximately A$0.15 million. Most of these costs would be borne by the ATO, although other agencies, such as Treasury, the Department of Foreign Affairs and Trade and the Australian Government Solicitor would bear some of these costs. There would also be an unquantified cost in terms of Parliamentary time and drafting resources in enacting the proposed tax treaty.

4.89 There is a ‘maintenance’ cost to the ATO associated with tax treaties in terms of dealing with enquiries, mutual agreement procedures and advance pricing agreements, and OECD representation. In some cases arrangements have emerged to exploit aspects of tax treaties which have required significant administrative attention. Of course it is unknown whether such arrangements would emerge in relation to this particular tax treaty. There is therefore a small unquantified cost in administering a tax treaty. There would also be minor implementation costs to the ATO relating to changes in withholding tax rates.

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4.90 The tax treaty is not expected to result in increased compliance costs for taxpayers.

4.91 There would be some reduction in Australian Government revenue from taxation of Mexican investments and other business activities in Australia (because, for example, the tax treaty restricts source country taxation of certain items of income). Treasury estimates this revenue loss at A$2 million. On the other hand, limitation of Mexican taxation rights in circumstances where Australia may have given credit for Mexican taxation is likely to lead to increased Australian tax revenue that more than offsets the revenue loss. Given the modest investment and trade relationship between our two countries, any revenue cost is not expected to be significant.

4.92 It should also be recognised that the limitations agreed to by the two countries, places limits on their policy flexibility in relation to cross-border taxation. However because Australia already has a substantial treaty network, the cost of the proposed tax treaty in terms of a reduced policy flexibility would only be marginal.

Assessment of benefits

Option 1: No further action – rely on existing unilateral measures

4.93 This option represents the status quo. By adopting this option there would be no need for further action and resources could be devoted to other issues. In the domestic context the two Governments would be free to act without being restricted by treaty obligations.

Option 2: Conclude a new tax treaty

4.94 A tax treaty with Mexico would have the following broad effects:

- Where Australians invest directly in Mexico, Mexico would not generally be able to tax an Australian resident unless the resident carries on business through a permanent establishment in Mexico. In addition to reducing Mexican income taxes payable by Australians, the tax treaty would have a similar effect on their liability to Mexican assets taxes. The tax treaty would, to some extent, establish a basis for allocation of profits to that permanent establishment. The tax treaty would also establish specific rules for taxation of shipping profits and income from real property.

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- Likewise for Australians investing through a Mexican subsidiary, the tax treaty would set out an internationally accepted framework for dealing with parent-subsidiary transactions and other transactions between associated enterprises. In this regard the tax treaty clearly offers superior protection compared to the domestic rules of the two countries, because it would provide for mutual agreement to be reached between the two taxing authorities.

- To some extent, the rules embodied in the tax treaty would reduce the risks for Australians investing in Mexico (and vice versa) because the tax treaty records agreement between the two Governments on a framework for taxation of cross-border investments. Especially in the case of mining investments which cannot easily be relocated, this reduction in risk may be quite important.[7]

- Furthermore, it is only in the context of a tax treaty[8] that Mexico would agree to limit domestic withholding taxes on royalties and certain interest. (Australia reduces royalty and certain dividend withholding taxes under its tax treaties.)

  - The tax treaty would reduce Mexican taxation on royalties and certain interest thereby making Australian **suppliers of capital and technology** more competitive. This is particularly significant in the banking sector.

[7] A common theme in relation to all Australian offshore investment is that a DTA would reduce investor risks by putting in place an agreed framework for taxation of cross-border activities which would prevent double taxation. However, it should be noted that a *DTA is not guaranteed to always* prevent double taxation. For example, the definition given to certain terms by the internal law of the two countries may result in cases where the treaty allocates the same taxing rights over the same income to both countries. This is a problem with all tax treaties based on the OECD Model.

On the other hand because the proposed DTA is largely based on standard international tax models (which have a body of supporting commentaries) it can be said there is a common international understanding of the meaning of many of its provisions. In addition it contains procedures to enable the two governments to mutually agree on matters of interpretation and application to prevent double taxation.

[8] The requirement for bilateral agreement on reduction of source country taxation is understandable because both countries wish to be assured of reciprocal treatment of their residents.

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Reduction in source country taxation is also likely to result in timing advantages for such investors, because the source country taxation is generally withheld when the income is derived, whereas residents are generally taxed by assessment on income derived during a financial year after the end of that financial year. The Australian revenue might also benefit to the extent that greater after-tax profits are remitted to Australia and subject to Australian tax. Of course there are similar advantages in relation to Mexican investment in Australia. Again the tax treaty would assist Australian investors by increasing the certainty of the taxation rules applying to cross-border investment.

- **Commodity exporters** would be assisted in some respects because of the way the tax treaty would restrict the circumstances in which Australians trading with Mexico are to be taxed by requiring the existence of a permanent establishment in Mexico before Mexican taxation could take place. However, in practice this benefit is not great because Mexico's domestic taxing rules adopt a similar approach.

- The tax treaty would also assist in making clear the taxation arrangements for individual Australians working in Mexico, either independently as **consultants,** or as employees. Income from **professional services** and other similar activities provided by an individual would generally be taxed only in the country in which the recipient is resident for tax purposes. However, remuneration derived by a resident of one country in respect of professional services rendered in the other country might be taxed in the latter country, where derived through a fixed base of the person concerned in that country, or if the person is present for more than 183 days in that country.

  – **Employee's** remuneration would generally be taxable in the country where the services are performed. However, where the services are performed during certain short visits to one country by a resident of the other country, the income would generally be exempt in the country visited.

- The tax treaty would relieve double taxation of capital gains on certain assets held by **departing Australian residents**, where such residents elect to defer taxation on unrealised

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gains under Australia's domestic tax law and subsequently become Mexican residents and dispose of the assets. In these cases, the gains are taxable only in Mexico.

- There are important impacts on the **Governments** which are party to the tax treaty. As mentioned the revenue impact for the Australian Government is not expected to be significant. The tax treaty would assist the bilateral relationship by adding to the existing network of commercial treaties between the two countries. It also completes our tax treaty network with North American Free Trade Area countries. As mentioned the tax treaty would promote greater cooperation between taxation authorities to prevent fiscal evasion and tax avoidance.

Consultation

4.95 Information on the tax treaty has been provided to the States and Territories through the Commonwealth-State Standing Committee on Treaties' Schedule of Treaty Action.

4.96 Before negotiations in July 1997, informal consultations took place with banking interests in respect of the tax treaty.

4.97 The ATO established an advisory panel of private sector representatives and tax practitioners to review draft treaties before enactment. The draft tax treaty was submitted to this panel in February 2002.

4.98 The tax treaty would be subject to scrutiny by the Joint Standing Committee on Treaties which would probably provide for public consultation in its hearing. This body is charged with the task of examining and reporting to the Parliament on matters arising from treaties or international instruments.

4.99 The Treasury and the ATO monitor tax treaties, as part of the whole taxation system, on an ongoing basis. In addition Treasury has consultative arrangements to obtain feedback from professional and small business associations and through other taxpayer consultation forums.

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Conclusion and recommended option

4.100 Present unilateral arrangements for elimination of double taxation go much of the way to satisfying the policy objectives of this measure. However, while these arrangements provide some measure of protection against double taxation, it is clear the tax treaty would further reduce the possibility of double taxation – especially in relation to associated enterprises. By establishing an internationally accepted framework for the taxation of cross-border transactions it would also reduce investor risk. In addition, a tax treaty would also reduce certain source country withholding taxes on dividend, interest and royalties. The tax treaty is unlikely to result in increased compliance costs for business.

4.101 There would be benefits to both Australia and Mexico in terms of improved bilateral relationships and information exchange. On the other hand the tax treaty would reduce the governments' policy flexibility.

4.102 On balance the benefits of the proposed tax treaty outweigh the costs. The tax treaty should be enacted.

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