16/379 Collins Street
Melbourne 3000
GPO Box 1472N
Melbourne 3001
Telephone +613 9610 4222
Facsimile +613 9610 4223
www.bca.com.au

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Business Council of Australia

CORPORATE TAX ASSOCIATION

24 September 2003

Ms Julia Morris
Committee Secretary
Joint Standing Committee on Treaties
Department of House of Representatives
Parliament House
CANBERRA ACT 2600
AUSTRALIA

Dear Ms Morris,

UK TAX TREATY

The Business Council of Australia (BCA) and the Corporate Tax Association (CTA) welcome the opportunity to provide a submission to the Joint Standing Committee on Treaties.

The BCA and CTA support Australia's tax treaty process, which is generally consistent with the OECD's *Model Tax Convention.* Tax treaties are primarily concerned with relieving double taxation and reducing the distortionary effects tax can have on the expansion of trade and the movement of capital, technology and people between countries.

A comprehensive network of up-to-date treaties with Australia's major trading partners is an important supporting framework for our ongoing trade and investment flows with those countries. Business regards some treaties as being more important than others, and we fully support the Government's objective of more regularly updating our treaties with countries that represent a major share of Australia's trade and investment flows. The benefits for Australia of updating treaties will be most substantial where these treaties are with our major trading partners. It is important that those treaties in particular are monitored and appropriately amended to reflect ongoing changes to tax regimes.

International Tax Agreements Amendment Bill 2003

The *International Tax Agreements Amendment Bill 2003* gives the force of law to the 2003 United Kingdom Convention and the Mexican Agreement. This Bill has now passed the House of Representatives without amendment.

The BCA and CTA support the Spring 2003 introduction of this Bill. The Bill contains a number of start dates relevant to the 2003/04 business cycle. Australian businesses need to be given the opportunity to prepare for the changes that come with the treaty and to adjust their systems.

Specifically, the UK tax treaty will have implications for business in relation to fringe benefits tax with a start date of 1 April 2004 with the treaty impacting on other taxes from 1 July 2004. The BCA and CTA believe that it is essential that this Bill be passed promptly to enable the revised UK treaty in particular to enter into force according to the draft, as tabled.

Updating the UK tax treaty

The proposed UK tax treaty moves towards a more residence-based treaty policy which brings it into line with international norms as set out in the OECD's *Model Tax Convention*. The BCA and CTA are supportive of moving towards a more residence-based tax treaty policy.

The proposed UK tax treaty will replace the existing treaty which was first negotiated in 1946 and then re-negotiated more than 25 years ago in 1967. The BCA and CTA believe that it is essential that this treaty be updated to reflect changes to Australian and UK treaty policy and business practices.

The UK is Australia's second largest source of inwards foreign investment, the second largest destination for outbound investment, and our third largest trading partner. This Bill will update the existing treaty without significantly compromising the revenue base.

The proposed UK tax treaty will align with modern business practices, the respective tax systems in each country, contemporary treaty policy, and serve to facilitate trade and investment between the UK and Australia. The tax treaty also clarifies the taxation position of income flows between parties in the two countries.

US Protocol

The proposed UK tax treaty extends to the UK the outcomes of the recently re-negotiated and ratified US protocol. It would be regarded as inequitable treatment to not extend similar withholding tax outcomes to an important treaty partner. The BCA and CTA believe it is important to ensure consistent treatment in Australian tax treaties to maintain integrity of Australia's treaty network. This is important not only for diplomatic reasons but also to ensure that our international tax law is not inefficient or distortionary.

Alienation of Property Article

The inclusion of the *Alienation of Property Article* facilitates investment between countries by making the taxation treatment of capital gains more certain and reducing the risk of double taxation. Further, this Article will address the potential for double taxation arising from the application of Australia's capital gains tax to temporary workers departing Australia. In the absence of this Article the ability of Australian located companies to attract and retain a skilled temporary work force, needed to assist Australian businesses to expand, is negatively impacted.

Withholding taxes

The proposed UK tax treaty provides that dividends, interest and royalties will generally remain taxable in both countries, but with limits on the tax that the source country may impose on residents of the other country who beneficially own that income. Subject to a number of broad exceptions, a general limit of 15 per cent would continue to apply to dividends and 10 per cent to interest. The general limit for royalties would be reduced from 10 to 5 per cent.

Dividend withholding tax

In relation to dividends, the proposed UK tax treaty would ensure that withholding tax is reduced to 5 per cent where the dividend recipient is a company that holds directly at least 10 per cent of the voting power of the company paying the dividends, and will be further reduced to zero where the recipient is a company that holds directly at least 80 per cent of the voting power of the company paying the dividend.

The UK has, for some time, not charged withholding tax on dividend payments, and Australia has not, since 1987, charged withholding tax on the franked portion of dividends. Consequently, the proposed amendments will have limited direct impact on dividends paid by UK resident companies. From an Australian perspective, the proposed amendments would mostly impact the amount of withholding tax collected on unfranked dividends paid to UK resident companies that directly hold the required 10 or 80 per cent voting power. We note, however, that UK residents controlling 10 per cent or more of the voting power in Australian companies would generally be able to influence dividend policies so that the payment of unfranked dividends is minimised.

Interest withholding tax

The general withholding tax rate on interest is to remain at 10 per cent, but a zero rate would apply where the recipient is either a government body of the other country, or a financial institution resident in the other country. The cost of debt capital for companies borrowing from such entities would thus be reduced, thereby improving their overall cost of funds.

The proposed reduction to interest withholding tax is likely to result in reduced borrowing costs for some Australian businesses. This positive effect on cost of funds will improve the competitiveness of the companies concerned, leading to increased economic activity and jobs growth.

Royalty withholding tax

The amendments propose a reduction in the rate of withholding tax on royalties from 10 to 5 per cent.

We have prepared the following simple example to explain the net impact of the proposed change where an Australian resident taxable company pays a royalty to a UK resident entity and where the UK royalty recipient requires a net after Australian withholding tax return.

The example demonstrates that the immediate cost of $58 to the Australian taxation revenue through reduced withholding tax would be partially offset by an increase of $17 in company tax payments (through increased profits due to reduced deductible royalty costs), and an increase of $11 in tax collections from resident shareholders through increased dividend receipts. Thus, the first round impact on tax collections would be $30 net cost in this example.

That reduction would, however, flow through to shareholders to the extent the additional profits of the company are distributed as dividends. That additional income should become available for further consumption, saving or investment in Australia. Overall that would produce a net economic benefit in Australia.

The example makes an assumption that the net reduction in royalty costs would have only a direct effect on profitability available for dividends. In practice, it could be expected that the reduced costs would have a flow-through impact on production costs and/or prices for goods and services, and therefore some impact on demand and sales volumes. To the extent that such impacts occur, profitability would be further enhanced, ultimately leading to additional dividend payments to shareholders and thus increased tax collections.

	10 % WHT rate $	5 % WHT rate $	Change to taxes $
Gross royalty payment	1,111	$1,053	
Australian WHT paid	(111)	(53)	(58)
Net receipt in the United Kingdom	1,000	1,000	
Company Payer			
Royalty deduction against taxable income	1,111	1,053	
Company tax saving @ 30%	(333)	(316)	17
After tax cost of royalty	778	737	
Resident Individual Shareholders			
Increased dividend distributions		41	
Franking gross-up @ 30%		17	
Increased taxable income		58	
Increased gross income tax payable @ 48.5%		28	
Increased franking credit		(17)	
Increased net income tax payable		11	11
Increased net return to shareholders		30	(30)

Broad effects of the UK tax treaty

The BCA and CTA recently conducted a survey of members in relation to tax treaties in general. Members provided comments on the broad effects they would expect from tax treaties including the UK tax treaty. These are summarised below.

Australia as an attractive headquarters location

As a package of measures, the proposed reductions in dividend, interest and royalty withholding tax rates will help enhance Australia's attractiveness as a business location.

Achieving a lower dividend withholding tax rate on non-portfolio dividends will assist in making direct investment in Australia more attractive. The current 15% dividend withholding tax which applies to unfranked dividends is regarded as a negative factor when considering Australia as an investment destination. At the margin, this reduces Australia's ability to attract foreign capital.

The interest withholding tax rate reductions for bank borrowings will reduce the cost of debt capital in some cases. It will achieve this by opening up additional opportunities to access overseas debt markets in a cost effective way. Halving royalty withholding tax rates will help reduce business costs while at the same time improving the competitiveness of Australian-owned intellectual property.

In combination, these measures will improve Australia's attractiveness as a regional headquarters location. This in turn will lead to increased job creation in both the headquarters company itself and ancillary businesses that provide services to those regional headquarters.

Reduced cost of business inputs

Survey responses from BCA and CTA members indicate that tax treaties provide a positive environment for reduced business input costs and increased profitability. This outcome from the proposed UK tax treaty would lead to increased competitiveness and consequently we would expect increased economic growth and additional business activity. Members also expect an increase in job creation stemming directly from this increased economic activity.

Flow-on impact of treaty modernisation

The proposed amendments are important in a broader context than just the current re-negotiations with the UK. The reduced rates of WHT are likely to be noted in the negotiation and renegotiation of treaties with other nations, particularly European Union nations. It is therefore important to secure the proposed reductions as an important step towards securing the benefits of similar reductions withholding tax rates with other nations.

Tax treaties provide an opportunity for repatriation of profits from offshore to Australia. BCA and CTA members have indicated that where withholding taxes are reduced or removed, there is a greater incentive to repatriate profits to Australia. These profits would be either distributed to shareholders or reinvested in other activities. This increases economic activity, leading to increased tax collections. In the absence of the reduction in withholding taxes as a result of the tax treaty, such profits will remain offshore and be re-invested elsewhere.

A more positive investment climate

BCA and CTA members have indicated that improved tax certainty as a result of the UK tax treaty has a positive impact on business investment confidence. Reductions in withholding tax rates is a trend throughout the global tax treaty network as countries around the world are realising the competitive benefits to be gained from reducing the taxation on mobile business inputs such as capital and intellectual property. Australia's is rapidly moving to the position of being a net exporter of equity capital on an annual flows basis, and our position in relation to intellectual property has also been improving gradually. The re-negotiation of treaties with our major trading partners will further assist this positive trend.

Conclusion

The new treaty will substantially reduce withholding tax on certain dividend, interest and royalty payments in line with the outcomes achieved in the recent amending protocol with the US. BCA and CTA believe this will provide long-term benefits for business, making it cheaper for Australian based businesses to obtain intellectual property, equity and finance for offshore expansion. It will also remove obstacles currently inhibiting Australian corporate expansion offshore.

The proposed treaty will produce positive outcomes for Australia. Gains include a larger and faster growing Australia economy with flow-on effects on employment, trade and investment and a more outward focus for business. The expected withholding tax cost to the revenue is expected to be more than offset by a consequential increase in future corporate taxes and GDP-boosted gains to revenue.

A broader network of up to date treaties with Australia's major trading partners will improve the flow of investment and increase activity. BCA and CTA believe that it is important that treaties are monitored and appropriately amended to reflect ongoing changes to tax regimes.

If you have any queries in relation to the content of this submission, please contact Frank Drenth, Executive Director, Corporate Tax Association on 03-9600 4411 or Freya Marsden, Director Policy, Business Council of Australia, 03-9610 4210.

Yours faithfully

Katie Lahey
Chief Executive
Business Council of Australia

Frank Drenth
Executive Director
Corporate Tax Association