
Chapter 2

Regulation impact statement

Background

How tax treaties operate

2.1 Tax treaties reduce or eliminate double taxation caused by the exercise of source and residence country taxing rights on cross-border income flows. They do so by treaty partners agreeing (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 exercise their right to tax.

2.2 In addition, tax treaties provide an agreed basis for determining the allocation of profits within a multinational company and whether the profits on related party dealings by members of a multinational group operating in both countries reflect the pricing that would be adopted by independent parties. Tax treaties are therefore an important tool in dealing with international profit shifting through transfer pricing.

2.3 To prevent fiscal evasion, tax treaties include provision for exchange of information held by the respective revenue authorities. Treaties may also provide for cross-border collection of tax debts and may preclude certain types of tax discrimination. Taxpayers can also avail themselves of the mutual agreement procedures provided for in treaties which allow the two revenue authorities to consult with a view to developing a common interpretation and to resolving differences arising out of application of the treaty.

2.4 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 Organisation for Economic Co-operation and Development (OECD) *Model Tax Convention on Income and on Capital* (OECD Model) (Australia being a member of the OECD and involved in the development of that Model). There are, however, a few instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model.

The Japanese tax treaty

2.5 The existing Australia-Japan tax treaty was signed on 20 March 1969 and has been in effect in Australia since the income year commencing 1 July 1970 in respect of income taxes and withholding taxes.

2.6 On 17 November 2006 the then Treasurer announced that it had been agreed that the necessary preparations for discussions to revise the existing tax treaty with Japan, signed in 1969 should commence.

Australia's investment and trade relationship with Japan¹

Trade

2.8 Japan has been Australia's largest export market for 40 years.

2.9 Bilateral merchandise trade in 2006/2007 totalled A\$50 billion, with the balance of trade in Australia's favour.

2.10 Total exports (goods and services) in 2006/2007 were valued at A\$35.5 billion, an increase of 11 per cent on 2005. Key exports include coal, beef, and aluminium and iron ores. Japan is a larger buyer of Australian exports than the combined total of exports purchased from Australia by China and the United States.

2.11 Total imports from Japan in 2006/2007 were valued at A\$17.4 billion. Imports comprised mainly manufactured items, with major items being passenger motor vehicles (A\$6.2 billion) and transport vehicles (A\$1.4 billion).

Investment

2.12 Japan is Australia's third largest investor, with a total stock of investment worth A\$51 billion at the end of 2006, of which 45 per cent was direct investment, 44 per cent portfolio investment, and 10 per cent other investment (loans, trade credit, derivatives and reserve assets). Japanese direct investment has been essential in many of the export industries that have driven Australia's export performance. Japanese investment has also been important for the development of Australia's export-oriented manufacturing sector. Toyota Motor Corporation Australia, for example, has invested more than US\$1.5 billion in manufacturing and car design facilities since the mid 1990s.

¹ Source: Department of Foreign Affairs and Trade.

2.13 Australia is Japan's 15th largest source of foreign investment. At the end of 2006, Australia's stock of investment in Japan was A\$39.8 billion, equivalent to 4.6 per cent of total Australian investment abroad.

Specification of policy objectives

- 2.14 The objective of this measure is to:
- promote closer economic cooperation between Australia and Japan by reducing barriers to trade and investment between the two countries; and
 - upgrade the framework through which the tax administrations of Australia and Japan can prevent international fiscal evasion.

Identification of implementation option(s)

- 2.15 The internationally accepted approach to meeting the policy objectives specified above is to:
- amend parts of the existing treaty to reflect current policies (amending Protocol); or
 - conclude a new bilateral tax treaty.

Option 1: Limited amending Protocol — rely on the existing tax treaty measures

2.16 This option would rely on the existing tax treaty measures with an amending Protocol covering both countries' desired changes. However, in view of the age of the existing treaty and its outdated approaches and language, the majority of the existing text would require detailed amendment. An amending Protocol is therefore not practicable in this instance.

Option 2: Conclude a new tax treaty

2.17 This option would replace the existing treaty with a new bilateral tax treaty that reflects the current policies and practices of both countries.

2.18 A new tax treaty would be largely based on the current OECD Model and the United Nations *Model Double Taxation Convention between Developed and Developing Countries*, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

2.19 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 a new treaty include:

- a reduction in the maximum royalty withholding tax rates from 10 per cent to 5 per cent;
- a reduction in interest withholding tax from 10 per cent to zero where interest is paid to a financial institution, body performing governmental functions, central bank or certain specified Australian and Japanese institutions;
- a reduction of dividend withholding tax from 15 per cent to zero for intercorporate dividends on non-portfolio holdings of more than 80 per cent, subject to certain conditions, 5 per cent dividend withholding tax for other intercorporate non-portfolio holdings and 10 per cent dividend withholding tax for all other dividends;
- a withholding tax rate limit of 15 per cent on certain distributions from real estate investment trusts;
- inclusion of a comprehensive *Alienation of Property* Article which allocates taxing rights over capital gains;
- special provisions confirming Japan's taxing rights over income derived through Japanese sleeping partnerships (Tokumei Kumiai);
- improved integrity measures — in particular, updated rules for the exchange of information on tax matters and limitations on treaty benefits to prevent treaty shopping and other inappropriate access to the treaty concessions; and
- new rules to prevent tax discrimination against Australian nationals and businesses operating in Japan and vice versa.

Assessment of impacts (costs and benefits)

Difficulties in quantifying the impacts of tax treaties

2.20 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.

2.21 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (eg, the 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. Tax treaties provide increased certainty and reduce complexity and compliance costs for business.

Impact group identification

2.22 A revised tax treaty with Japan is likely to have an impact on:

- Australian residents doing business with Japan, including principally:
 - Australian residents investing directly in Japan (either by way of a subsidiary or a branch);
 - Australian real estate investment trusts with Japanese resident investors;
 - Australian residents investing in Japanese real estate investment trusts;
 - Australian banks and the other specified Australian institutions lending to Japanese borrowers;
 - Australians borrowing from Japanese banks and the other specified Japanese institutions;

- Australian residents using technology and know-how supplied by Japanese residents;
- Australian residents supplying consultancy services to Japan; and
- Australian residents exporting to Japan;
- Australian employees working in Japan;
- Australian residents receiving pensions from Japan;
- the Australian Government; and
- the Australian Taxation Office (ATO).

Assessment of benefits

Renegotiation provides a better outcome for all stakeholders

2.23 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 has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or Japan.

2.24 A new bilateral tax treaty would comprehensively modernise and update the existing treaty. As well as revising the allocation of taxing rights between the two countries and the tax rate limits prescribed in the treaty, Australia would also be able to achieve improved integrity measures — in particular, updated rules for the exchange of information on tax matters and updated anti-avoidance and comprehensive limitation of benefit rules.

2.25 A new tax treaty would provide benefits to Australian business and to the Australian revenue by ensuring certainty of legislative outcomes based on the treaty. It would be another step forward in providing Australian business with an internationally competitive tax treaty network and business tax system.

2.26 A renegotiated treaty will provide a better outcome for all stakeholders. Given the long-term nature of such arrangements, a revised tax treaty is expected to promote greater certainty than the existing tax treaty. It would also contribute to the updating of Australia's ageing treaty network.

Economic benefits

Withholding tax reductions

2.27 A new bilateral tax treaty would address business concerns about the lack of competitiveness of Australia's tax treaty network with business particularly seeking reductions in withholding tax rates.

2.28 Under its domestic tax law, Australia imposes a final withholding tax on interest, royalty and unfranked dividend payments to non-residents at the rates of 10, 30 and 30 per cent of the gross payment respectively. However, Australia generally agrees to limit these withholding tax rates, on a reciprocal basis, in its bilateral tax treaties. In the existing Japanese treaty, the withholding tax rates for dividend, interest and royalty payments are limited to 15, 10 and 10 per cent of the gross payments respectively.

2.29 Withholding tax reductions below the rates reflected in the existing Japanese tax treaty were first included in the 2001 Protocol amending the Convention with the United States (US) and have been included in Australia's subsequent tax treaties. Extending similar treatment to Japan aligns treatment, where possible, in Australia's recent tax treaties, maintains the integrity of Australia's treaty network and discourages treaty shopping (and the consequent degradation of the tax base of countries where the costs of capital and intellectual property are higher under their treaties as a result of the higher withholding tax rates). However, this treaty would further reduce the maximum withholding tax rate for all dividends from 15 to 10 per cent, as well as including a withholding tax rate limit of 15 per cent for certain distributions from real estate investment trusts, to respond to business concerns and maintain Australia's competitiveness with our major investment partners.

2.30 While a reduction in maximum withholding tax rates will involve a cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

Dividends

2.31 An outcome such as that provided to the US and UK (United Kingdom) (ie, no withholding tax on dividends paid to a company with an 80 per cent or greater voting interest in a listed company in the other jurisdiction and 5 per cent withholding tax where the interest is at least 10 per cent of the voting power) would remove distortions in the raising of capital for direct investment that results from the more favourable terms that currently apply bilaterally in the case of the US and the UK.

2.32 A reduction in the dividend withholding tax rate limit for other dividends from 15 to 10 per cent would align Australia's treaty practice with the current treaty practice of many other countries (such as the US, UK, the Netherlands, Norway and Japan who reduce their treaty dividend rate for other dividends to 10 per cent or below). This would assist in maintaining Australia's attractiveness as a destination for investment, especially in attracting foreign equity investors.

Distributions from real estate investment trusts

2.33 Australia recently introduced a 30 per cent non-final withholding tax on distributions to non-residents from Australian managed investment trusts.

2.34 In response to submissions from Australian business (especially the managed funds industry) and in view of the growing international trend to limit treaty withholding tax rates on distributions from real estate investment trusts, the Standing Committee on Economics recommended in its June 2007 report on Tax Laws Amendment (2007 Measures No. 3) Bill 2007 that when negotiating tax treaties, Australia seek reciprocal withholding tax treatment for distributions to foreign residents from managed investment trusts (including a 15 per cent withholding tax rate limit on certain distributions from real estate investment trusts). The new treaty with Japan is consistent with the Committee's recommendation. The Government has announced that it plans to introduce legislation that will provide 15 per cent withholding tax on distributions for managed investment trusts. The provisions in the Japanese treaty are consistent with that announcement, albeit limited in its application to Japanese investors in Australian real estate investment trusts and vice versa. This is expected to help sustain the viability of the Australian property industry and Australia's status as a financial services hub.

Interest

2.35 A zero Australian interest withholding tax rate on interest derived by Japanese financial institutions will be consistent with the exemption currently provided for interest derived from widely distributed arm's length debenture issues. It also recognises that a 10 per cent interest withholding tax rate on gross interest derived by financial institutions may be excessive given their cost of funds. It should, accordingly, lower the costs of borrowing in those cases where the financial institution can pass the cost represented by the withholding tax on to the Australian borrower.

2.36 As is the case in Australia's other recent tax treaties, the new treaty would include an exemption for interest derived by the Governments of either country (including their political subdivisions and

local authorities), bodies exercising governmental functions and the countries' central banks (in this case, the Bank of Japan and the Reserve Bank of Australia).

2.37 Consistent with the principles underlying these two exemption clauses but for clarity, a specific provision would also be inserted to expressly exempt interest derived by the Japan Bank for International Cooperation, the Nippon Export and Investment Insurance, the Australian Export Finance and Insurance Corporation, a public authority that manages the investments of the Future Fund, or any similar institution agreed in an exchange of notes between the Governments of the two countries.

Royalties

2.38 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to Japanese residents would benefit from a reduced royalty withholding tax rate. Commercial practice indicates that, as with interest, the cost represented by the royalty withholding tax is commonly passed on to the payer of the royalty. This means that they may bear the cost of higher rates of withholding tax and place them at a competitive disadvantage in competing with businesses from other countries with lower rates. The effect of lowering the cost of new technology and intellectual property may encourage the development of Australia's economy through use of the most up to date technology and processes. Additionally it may encourage Japanese residents to use Australian technology and intellectual property.

Alienation of property

2.39 The updating of the *Alienation of Property* Article to address taxing rights over capital gains would provide certainty to taxpayers and reduce the risk of double taxation. Australia's source country taxing rights over capital gains on real property, land-rich companies and assets which form the business property of a permanent establishment in Australia would be retained. More generally, the changes bring into line Australia's treaty practice with international practice. This will encourage investment in Australia and result in generally lower compliance costs.

Non-Discrimination

2.40 Inclusion of a *Non-Discrimination* Article will insert rules to prevent tax discrimination against Australian nationals and businesses operating in Japan and vice versa.

Other benefits

2.41 Where Australians carry on business activities in Japan, the existing treaty prevents Japan from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment (such as a branch) in Japan. A new tax treaty would further refine the concept of when a permanent establishment should be taken to exist and the level of activity that would constitute a permanent establishment. This principle also applies where a Japanese enterprise carries on business activities in Australia.

2.42 Other benefits also include:

- the clarification of the residency rules;
- clarifying that treaty relief is not available on certain income, profits or gains that are exempt in a country because the recipient is a temporary resident of that country;
- clarifying the treatment of income derived through trusts;
- special provisions confirming Japan's taxing rights over income derived through Japanese sleeping partnerships (Tokumei Kumiai);
- refined anti-profit shifting (transfer pricing) rules, including new time limits for initiating audit activity; and
- the inclusion of anti-avoidance and limitation of benefits rules.

Revenue benefits

2.43 New treaty arrangements with Japan would represent another step in facilitating a competitive and modern treaty network for Australian companies and would help to maintain Australia's status as an attractive place for business and investment. While a reduction in maximum withholding tax rates will involve a cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

2.44 Small revenue benefits should also result from enhanced tax integrity measures over a broader range of taxes.

Compliance and administrative cost reduction benefits

2.45 Tax exemptions in respect of withholding taxes are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax.

2.46 The closer alignment with more recent Australian and international treaty practice would generally be expected to reduce compliance costs. In particular, interpretative issues relating to the extent Australia can tax capital gains under the existing treaty arrangements has resulted in considerable uncertainty and the risk of costly legal arguments.

2.47 Administrative costs incurred 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 updating the treaty text, should also decrease compliance costs and uncertainty.

Improved international relationships

2.48 New treaty arrangements with Japan will also assist the bilateral relationship by updating an important treaty in the existing network of commercial treaties between the two countries. It 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 — types of costs

Revenue costs

2.49 Treasury has estimated the impact of the first round effects on forward estimates as \$350 million, with the identifiable costs to revenue associated with the reductions in dividend, interest and royalty withholding tax rates. As Australia has a number of ‘most favoured nation’ clauses regarding dividend withholding tax rates in its existing treaties, Australia would be obliged to enter into negotiations with a view to offering similar withholding tax reductions to those countries (including the proposed 10 per cent rate limit for other dividends), which may create an additional pressure on revenue cost. Countries that offer bilateral treaty withholding tax reductions for distributions from real estate investment trusts would also be expected to seek the 15 per cent withholding tax rate limit for such payments proposed for Japan, which may also create a pressure on revenue cost.

Administration costs

2.50 The administrative impacts on the ATO from the changes made by any new treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example, private binding rulings, concerning the application of the treaty. Staff from the ATO, clients and tax professionals will need to be made aware of the entry into force and changes from the previous treaty. Therefore a number of ATO information products will need to be updated.

2.51 The cost of negotiation and enactment of new tax treaty arrangements with Japan is minimal and have mostly been borne by Treasury and the ATO. There will also be an unquantified but small cost in terms of parliamentary time and drafting resources in enacting the proposed new tax treaty arrangements.

2.52 There are also ‘maintenance’ costs to the ATO associated with tax treaties and mutual agreement procedures (including advance pricing arrangements). These costs also apply to the existing arrangements. By bringing the Japanese treaty into basic conformity with modern treaty practice these costs would be reduced. However, as treaties are deals struck between the two countries that reflect specific features of the bilateral relationship, some level of differential treatment or wording between treaties, which may require interpretation or explanation by the ATO, is inevitable.

Other costs

2.53 Government policy flexibility in relation to taxation of Japanese residents would be further constrained by changes to treaty obligations, for example, with respect to taxation of capital gains. However, such constraints are also placed on Japanese law makers, providing long term certainty to businesses. As such, the cost of such constraints is outweighed by the benefits. Ultimately, the tax treaty could be terminated if it became out of step with Government policy. Such termination is very rare in international tax treaty practice, however, and could be expected to be resisted by the business community and others who benefit from the treaty.

2.54 The impact of new tax treaty arrangements on tax policy flexibility is generally quite minimal as tax treaties are based on broad and generally accepted taxation principles.

Assessment of costs

Taxpayer costs

2.55 No material additional costs to taxpayers have been identified as likely to arise from the renegotiation of the Japanese treaty.

2.56 Businesses that collect withholding taxes would need to make small system changes to change the rate at which they withhold to reflect the new treaty withholding tax rate limits. Previous experience and anecdotal evidence suggests that these changes will be straight forward and easily accommodated.

2.57 No costs for the community or other parties have been identified.

Administration costs

2.58 The requirement on the ATO to exchange information on a broader range of taxes is also considered to be of minimal impact. In most cases the ATO will already have the required information in its possession which will limit the related administrative costs.

Consultation

2.59 The then Treasurer's Press Release No. 124 of 17 November 2006 invited submissions from stakeholders and the wider community in relation to issues that might be raised during negotiations with Japan. Treasury has also sought comments from the business community through the Tax Treaties Advisory Panel.

2.60 In general, business and industry groups support outcomes which are consistent to those in the 2003 Australia-UK Convention and the updated Australia-US tax treaty. They also favour withholding tax reductions for distributions from real estate investment trusts.

2.61 The state and territory governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information on the negotiation of this treaty was included in the Schedules of treaties to state and territory representatives from August 2006.

2.62 The proposed treaty arrangements will be considered by the Commonwealth Joint Standing Committee on Treaties, which provides for public consultation in its hearings.

Conclusion and recommendation

2.63 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 has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or Japan, nor modern international norms.

2.64 A new bilateral tax treaty would address long term business concerns about the lack of competitiveness of withholding tax rate limits in Australia's tax treaty network.

2.65 Developments in both countries' domestic law, commercial practices, and treaty policies and practices support a full revision of the treaty. This also provides an opportunity to update the text in accordance with modern OECD practice.

2.66 The proposed new treaty arrangements with Japan are consistent with Australia's recent move towards a more residence-based tax treaty policy and contributing to the updating of Australia's ageing treaty network. It would bring Australia's arrangements with Japan more into line with international norms, as set out in the OECD Model and would provide outcomes similar to Australia's treaties with the US and the UK.

2.67 There is a direct cost to revenue, largely sourced in reduced withholding tax collections. On balance, the benefits of concluding a new treaty outweigh the cost to revenue.

2.68 A new bilateral tax treaty is therefore recommended.