REGULATION IMPACT STATEMENT

Convention between
the Government of Australia and the Government of the Republic of Turkey
for the Avoidance of Double Taxation with Respect to Taxes on Income and
the Prevention of Fiscal Evasion, and Protocol,
done at Ankara on 28 April 2010
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Australia's investment and trade relationship with Turkey

1.1 Australia and Turkey share a growing economic and trade relationship. In 2009 two-way trade was around $800 million. Australian exports to Turkey were $303 million and imports were $468 million. Australia's major exports to Turkey include sales of coal, medicaments (including veterinary), aluminium and butter. In recent times, there have been some successes in diversifying exports, including the sale of a number of fast ferries to the Istanbul municipality. The conclusion of a health protocol for breeding cattle between Australia and Turkey permits the export of live breeding cattle to Turkey. The first shipment of live cattle exports from Australia since 1996 arrived in Turkey in May 2007.

1.2 Australia's imports from Turkey are dominated by dried fruits and nuts, goods and passenger vehicles and household equipment.

1.3 The level of two-way investment between Australia and Turkey is relatively small. Australian companies are pursuing opportunities in Turkey brought about by a growing Turkish market and privatisation programs.

The problem

1.4 The wellbeing of Australians is reduced where taxation barriers restrict the economic relationship between Australia and Turkey.

1.5 International taxation is based on concepts of residency and source. Countries generally tax their residents on their world wide income. Countries also seek to tax non-residents on the income that is earned (or sourced) within their borders.

1.6 Juridical double taxation can therefore arise where two countries impose comparable taxes on the same taxpayer in respect of the same subject matter and for identical periods. The Organisation for Economic Co-operation and Development (the OECD) states in the introduction to the OECD *Model Tax Convention on Income and on Capital* (the OECD Model) that the harmful effects on the exchange goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing obstacles that double taxation presents to the development of economic relations between countries.

1.7 Similarly, high rates of withholding tax on dividends, interest and royalties are generally acknowledged as providing a significant barrier to cross-border investment and transfers of knowledge because investors will require a higher rate of return.

1.8 High compliance costs associated with meeting tax obligations in both Australia and Turkey may also impede cross-border economic activity. For example, an Australian business with operations in Turkey will have to comply with the tax laws of both Australia and Turkey regardless of its operational footprint in Turkey.

1.9 For business and investors generally cross-border investments carry some degree of risk associated with complying with domestic laws. For example, risk is associated with the lack of 'fiscal certainty' as the domestic tax laws can be amended unilaterally. Other barriers may arise from domestic tax laws which are discriminatory.

1.10 Finally, the Australian Taxation Office's (the ATO) ability to administer the tax system to ensure taxpayers meet their Australian tax obligation is impeded where it is unable to access the necessary information to verify transactions. Tax evasion resulting from people hiding money offshore is a problem for every country.

Policy objective

1.11 The objective of this measure is to:

- promote closer economic cooperation between Australia and Turkey by reducing taxation barriers; in particular avoiding double taxation of income arising from overlapping tax jurisdictions; and
- improve the integrity of the tax system by providing the framework through which the tax administrations of Australia and Turkey can prevent international fiscal evasion.

Implementation options

1.12 The implementation options for achieving the objectives are:

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

Option 1: No further action – rely on existing unilateral measures

1.13 If nothing was done, existing tax barriers, such as high withholding tax rates and significant compliance costs in meeting source country taxation obligations, will remain. While domestic law measures will generally provide relief from double taxation they are unable to resolve double taxation resulting from overlapping tax jurisdictions. This will constrain international trade and investment and the cross border movement of people, capital and technology. Tax discrimination will not be prevented and uncertainty with respect to the tax treatment of cross border income flows will remain. Tax administrations will not be able to exchange information necessary for the protection of Australia's tax base and the prevention of international fiscal evasion. Therefore this approach is not practicable in this instance.

Option 2: Conclude the tax treaty

1.14 The internationally accepted approach to meeting the above policy objectives is to conclude a bilateral tax treaty. 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. In particular the proposed treaty includes:

- Reductions in source-country withholding taxes on certain cross-border payments of dividends, interest and royalties;
- Rules to determine when an enterprise or an individual of one country may be taxed on its activities abroad;
- An agreed basis for determining the allocation of profits within a multinational company to reflect the pricing that would be adopted by independent parties. These rules are an important tool in dealing with international profit shifting through transfer pricing;
- Rules that ensure that profits derived from the operation of ships and aircraft in international traffic are generally taxed only in the country of residence of the operator;
- Rules for the taxation of income, profits or gains from the alienation of property;
- Provisions that ensure that pension and annuities are taxed only in the country of residence of the recipient;
- A general obligation for both countries to relieve double taxation on cross-border income by permitting tax paid under the other country's laws, and in accordance with the proposed Treaty, to be allowed as a credit against tax payable under their own laws;
- Mechanisms through which the Australian and Turkish administrators may by mutual agreement resolve tax disputes and relieve double taxation;
- Rules to protect nationals and businesses of one country from tax discrimination in the other country; and
- A framework to provide for the full exchange of taxpayer information.

1.15 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.

How tax treaties operate

1.16 Tax treaties facilitate international investment by removing or reducing tax barriers to cross-border movement of people, capital or technology.

1.17 International taxation is based on concepts of residency and source. Countries generally tax their residents on their world wide income. Countries also seek to tax non-residents on the income that is earned (or sourced) within their borders.

1.18 Double taxation can therefore arise when the country of residence and the country where the income is sourced both seek to tax the same income.

1.19 Tax treaties reduce or eliminate double taxation 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. For instance, countries agree to reduce withholding tax imposed on

dividends, interest and royalties by the source state. In the absence of rules to relieve the resulting double taxation, international commerce would be seriously inhibited.

1.20 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.

1.21 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.

1.22 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 (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.

Assessment of impacts

Difficulties in quantifying the impacts of tax treaties

1.23 Only a partial analysis of costs and benefits can be provided because all of 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 offsetting increases in Australian revenue as a result of the other country reducing its taxes under the treaty. The 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.

1.24 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (for example, by 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

1.25 A tax treaty with Turkey is likely to have an impact on:

- Australian resident individuals with cross-border dealings in Turkey;
- Entities with cross-border dealings in Turkey. It is expected that this will comprise large multinationals and Australian companies with foreign shareholdings;
- People receiving pensions from the other country;

- Tax practitioners who have clients with cross-border dealings in Turkey;
- Software developers, financial planners and bookkeepers who have clients with cross-border dealings in Turkey;
- the Australian Government; and
- the ATO.

Analysis of costs/benefits – Option 2: Conclude the tax treaty

Economic benefits

1.26 A new tax treaty with Turkey, a country with which Australia does not currently have a treaty, would assist the competiveness of Australian business and their dealings in Turkey. In particular, the treaty would provide for the following reductions in withholding tax rates on dividends, interest and royalties in Turkey:

- for dividends; the current rate of 15 per cent is reduced to 5 per cent for certain dividends and the current rate is 'locked in' for all others;
- for interest; the general rate of 15 per cent is reduced to 10 per cent and the domestic exemption for certain government investments is 'locked in'; and
- for royalties; the domestic rate of 20 per cent is reduced to 10 per cent.

1.27 It is only in the context of a tax treaty that Turkey would agree to limit domestic withholding tax rates on such payments. The new treaty provides for similar rates of withholding on dividends, interest and royalties to those provided for under Turkey's other tax treaties.

1.28 The new treaty also provides for similar reductions in the rate of Australian withholding taxes. While a reduction in maximum withholding tax rates, insofar as those reductions affect Australian withholding taxes, will involve a cost to Government 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.

Other benefits

1.29 Where Australians carry on business activities in Turkey, the new treaty would prevent Turkey 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 Turkey. The tax treaty would also establish an arm's length basis for allocating profits to that permanent establishment. This principle also applies where a Turkish enterprise carries on business activities in Australia. In addition to reducing Turkish income tax payable by Australians, the treaty would limit the circumstances in which Turkey could impose tax on capital gains.

1.30 Other benefits also include:

- clarifying the residency rules;
- clarifying the treatment of profits derived through trusts from business activities;

- establishing specific rules for taxation of shipping and airline profits and income from real property;

- providing anti-profit shifting (transfer pricing) rules;

- establishing non-discrimination rules to prevent tax discrimination against Australian nationals and enterprises operating in Turkey and vice versa; and

- establishing a framework to allow the Australian and Turkish tax administrations to exchange taxpayer information, in accordance with the internationally agreed tax standard for exchange of information. This will further enhance Australia's efforts to combat tax avoidance and evasion, and will support global action on improving information exchange and transparency.

Revenue benefits

1.31 While a reduction in source taxation generally involves a cost to revenue, there are expected to be benefits to revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

1.32 Including exchange of information provisions in the new treaty with Turkey will potentially expand the range of taxpayer information available to the Commissioner of Taxation. This is expected to improve taxpayer compliance and increase tax revenue.

Compliance and administrative cost reduction benefits

1.33 The establishment of a treaty between Australia and Turkey, which is broadly consistent with international norms, would generally be expected to reduce compliance costs.

Revenue costs

1.34 Treasury has estimated the impact of the first round effects on forward estimates as 'unquantifiable' with an indicative cost to revenue not expected to exceed $5 million per annum.

Administration costs

1.35 The administrative impacts on the ATO from the changes made by the new treaty are considered to be minimal.

1.36 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 of this treaty. Therefore a number of ATO information products will need to be updated.

1.37 The cost of negotiation and enactment of new tax treaty arrangements with Turkey is minimal and have mostly been borne by Treasury. 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.

1.38 There are also 'maintenance' costs to the ATO associated with tax treaties and mutual agreement procedures (dispute resolution procedures, including advance pricing arrangements). Given that tax treaties are deals struck between the two countries that

reflect specific features of the bilateral relationship, some level of differential treatment or wording between Australia's normal practice and the proposed new treaty with Turkey, which may require interpretation or explanation by the ATO, is inevitable.

Consultation

1.39 Confidential consultation on tax treaty negotiations with peak industry and professional bodies is carried out on an on-going basis through the Tax Treaties Advisory Panel.

Conclusion and recommended option

1.40 While the existing unilateral tax rules go some way to satisfying the policy objectives of this measure by providing a measure of protection against double taxation of Australian investments in Turkey, they are unable to resolve all areas of difference. For example, differences could arise over fundamental matters such as the source of the income and residence of taxpayers. Unilateral measures are also unable to remove tax barriers, such as limited or no double tax relief in the other country, high withholding tax rates and significant compliance costs in meeting source country taxation obligations. These barriers can only be addressed by concluding a tax treaty.

1.41 By establishing an internationally accepted framework for the taxation of cross-border transactions the proposed new treaty would also reduce investor risk. The tax treaty is unlikely to result in increased compliance costs for business.

1.42 There would also be benefits to both Australia and Turkey in terms of the bilateral relationship and information exchange, which would help both countries better enforce their tax laws.

1.43 On balance the benefits of the proposed tax treaty outweigh the costs. The tax treaty should be enacted.