Regulation impact statement

THE MEXICAN AGREEMENT

SPECIFICATION OF POLICY OBJECTIVE

1. 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 the double tax agreement operates

2. 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.

3. 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 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. 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.

5. 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.

6. 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[1]

7. 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.

8. 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.

9. 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)

10. 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

11. 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

12. The internationally accepted approach to meeting the above policy objectives is to conclude a bilateral tax treaty.[2] 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 tax treaty also records important bilateral undertakings in relation to exchange of information.

---

1 Source: Department of Foreign Affairs and Trade

2 Possibly reflecting the widely differing economic interests and tax law structures of countries, there are very few multilateral tax treaties.

13. 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.

14. 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

15. 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); and
- the ATO.

Assessment of costs

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

16. 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.

17. 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.

18. 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 the double tax agreement

19. The negotiation and enactment of this tax treaty would cost approximately $150,000. 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.

20. 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.

21. The tax treaty is not expected to result in increased compliance costs for taxpayers.

22. 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.

23. 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

24. 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 double tax agreement

25. 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.

  – 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.[3]

- Furthermore, it is only in the context of a tax treaty[4] 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. 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

---

3 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.

4 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.

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 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

26. 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.

27. Before negotiations in July 1997, informal consultations took place with banking interests in respect of the tax treaty.

28. 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.

29. 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.

30. The Treasury and the ATO monitor tax treaties, as part of the whole taxation system, on an ongoing basis. In addition the ATO has consultative arrangements to obtain feedback from professional and small business associations and through other taxpayer consultation forums.

CONCLUSION AND RECOMMENDED OPTION

31. 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.

32. 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.

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