

Documents tabled on 12 March 2008:

National Interest Analysis [2008] ATNIA 12

with attachments on consultation and background information on relevant international tax issues

**Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, and Protocol,
done at Tokyo on 31 January 2008**

[2008] ATNIF 1

Regulation Impact Statement

NATIONAL INTEREST ANALYSIS: CATEGORY 2 TREATY

SUMMARY PAGE

Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, and Protocol, done at Tokyo on 31 January 2008, [2008] ATNIF 1

Nature and timing of proposed treaty action

1. The proposed treaty action is to bring the *Convention between Japan and Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, and Protocol* (the Treaty) into force. The Treaty will enter into force, pursuant to Article 31, on the thirtieth day after the date of exchange of diplomatic notes indicating approval in accordance with the legal procedures of each State. The provisions of the Treaty will take effect in two stages, being applicable from 1 January or 1 July in the calendar year following entry into force.

2. The existing *Agreement between the Commonwealth of Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, and Protocol*, signed at Canberra on 20 March, 1969 [1970] ATS 9 (the existing Australia-Japan Agreement), will terminate and be replaced by the Treaty when the Treaty's provisions on taxes are applicable in accordance with Article 31(2). However, Article 15 of the existing Australia-Japan Agreement, which provides an exemption from tax levied on the income of certain temporarily resident professors or teachers, shall continue to apply to persons eligible for the benefits of that article until such time that they are no longer eligible under the existing Australia-Japan Agreement.

Overview and national interest summary

3. The key objectives of the Treaty are to i) promote closer economic cooperation between Australia and Japan by reducing barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries; and ii) upgrade the framework through which the tax administrations of Australia and Japan can prevent international fiscal evasion.

4. The Treaty is generally consistent with recent tax treaties concluded by Australia. Key differences from the existing Australia-Japan Agreement include: reduced rates of withholding taxes (WHT) on dividends, interest and royalties; and, improved integrity measures, in particular, rules for the exchange of information on tax matters. The Treaty also introduces rules for real property which align the Capital Gains Tax treatment closely with that of the Organisation for Economic Co-operation and Development (OECD).

5. Under the Treaty, reduced WHT rates on interest and royalty payments will make it cheaper for Australian businesses to obtain business loans and intellectual property from Japan. The Treaty will reduce the WHT rate on dividend payments from an Australian subsidiary to its Japanese parent company. The Treaty provides a WHT limit for distributions from Real Estate Investment Trusts and their Japanese equivalents. The Treaty also exempts certain bodies from interest WHT. These measures are expected to encourage Japanese businesses to make direct investments into Australia.

Reasons for Australia to take the proposed treaty action

Reducing barriers to bilateral investment and trade

6. The Treaty is expected to reduce barriers to bilateral trade and investment caused by overlapping taxing jurisdictions of Australia and Japan. This is to be done primarily by reducing WHT on dividend, interest and royalty payments between the two countries. Rather than taking unilateral action to reduce WHT under domestic law, Australia has adopted the approach of agreeing to any such reductions on a reciprocal, bilateral basis. This approach “locks-in” the WHT limits in both countries, ensuring a steady financial framework for business between the treaty partner countries. It also means that Australia is able to exclude “tax havens” from accessing these concessions. See **Attachment B** for an overview of how Australia’s WHT rules work.

7. In particular, reduced WHT on interest and royalty payments is expected to make it cheaper for Australian businesses to obtain business loans and intellectual property from Japan. While the Japanese company is legally liable for the interest and royalty income earned in Australia, contracts are often structured so that the Australian company is required to absorb the tax (this commercial practice is often referred to as “gross up” clause arrangements). Consequently, lowered WHT on interest and royalties is expected to reduce costs for Australian businesses. See **Attachment C** for further details.

8. The Treaty also reduces WHT on dividend payments from an Australian subsidiary to its Japanese parent company. This is expected to encourage Japanese businesses to make direct investments into Australia. It has been recognised that inbound foreign direct investment can bring significant economic benefits to Australia, including transfers of technology, formation of human capital, integration of Australian businesses in international trade, and the creation of a more competitive business environment in Australia. See **Attachment D** for further details.

9. More generally, the Treaty will provide important benefits to Australian businesses looking to expand into Japan. See **Attachment E** for further details.

Upgrade the frameworks to prevent international fiscal evasion

10. The Treaty enhances the existing treaty framework to prevent international tax evasion by updating the exchange of information rules in line with the 2005 OECD standard.

11. The upgraded arrangements reflect the Government’s desire to provide for more effective exchange of information on a broader range of taxes, for example, Goods and Services Tax.

Obligations

12. Article 25 of the Treaty sets out a general principle for the Parties to relieve double taxation on cross-border income. Article 26 contains a general non-discrimination principle, requiring each State to treat nationals of the other no less favourably than it treats its own nationals. Article 27 establishes procedures for dispute resolution by mutual agreement on issues that may arise under the Treaty, including a mechanism for individuals to present complaints on the operation of the Treaty to the relevant State.

13. Article 28 creates obligations for the exchange of information between the two States, including a specific obligation to gather and provide information upon request. Article 28(2) imposes a correlative obligation on the State receiving any such information to treat it in the same manner as information obtained under its domestic laws. Article 28(3) allows either State to decline to provide requested information on limited grounds, including where to do so would be contrary to law or public policy. Article 2 imposes an obligation to notify Japan of any significant changes to laws relating to the taxes to which the Treaty applies.

14. The Treaty does not impose any greater obligations on residents of Australia than Australian domestic tax laws would otherwise require, and in some cases reduces the obligations of Australians operating or investing in Japan (Articles 10 (*Dividends*), 11 (*Interest*), and 12 (*Royalties*)).

Implementation

15. As the Treaty affects Commonwealth income tax legislation, enabling legislation must be enacted by the Commonwealth to give the Treaty the force of law in Australia. This will be achieved by incorporating the text of the Treaty as a schedule to the *International Tax Agreements Act 1953* prior to the Treaty entering into force in Australia. No action is required by the States or Territories. There is no change to the existing roles of the Commonwealth, or the States and Territories, in tax matters that will arise as a consequence of implementing the Convention.

Costs

16. 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 providing similar WHT reductions to those countries (including the proposed 10 per cent rate limit for other dividends), which may create an additional pressure on revenue cost.

17. No other material costs have been identified as likely to arise from the implementation of the Treaty. Tax exemptions in respect of withholding taxes are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax. 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.

18. There would be a small, unquantifiable cost in administering the changes made by the Treaty, including minor implementation costs to the Australian Taxation Office (ATO) in educating the taxpaying public and ATO staff concerning the new arrangements. There are also ‘maintenance’ costs to the ATO and the Department of the Treasury in terms of dealing with inquiries, rulings and other interpretative decisions, mutual agreement procedures (including advance pricing arrangements) and OECD representation. However, these costs also apply to the existing Australia-Japan Agreement and will continue to be managed within existing agency resources.

Second round impact of the Treaty

19. The costings do not include second round impacts on taxation revenue that arise from the flow on effects of the Treaty. The second round impacts on revenue are the impacts that arise as the change flows through to prices, wages and activity in other areas of the economy, which has a positive effect on tax revenue.

20. Treasury has not estimated the second round impact of the Treaty. This is because Treasury does not quantify the second round impact of new policy proposals as the benefits in any given year are likely to be small relative to the direct impacts and the timescale over which they accrue is extremely uncertain. However, Treasury expects that the proposed interest withholding tax rate changes will reduce the effective cost of borrowing as Australian borrowers bear the burden of tax through 'gross up' clause arrangements (see paragraph 7).

21. As a result of the reduction in the cost of borrowing from Japan, Treasury expects that the Treaty could lead to an increase in foreign investment in Australia and economic activity. The increase in economic activity is likely to lead to increases in other forms of tax collection.

Regulation Impact Statement

22. A Regulation Impact Statement is attached.

Future treaty action

23. The Treaty does not create obligations concerning the negotiation of future legally binding instruments. Nor does it contain any amendment procedure. However, Article 39 of the *Vienna Convention on the Law of Treaties 1969* makes it clear that a treaty may be amended by agreement between the Parties. Any amendments would be subject to the domestic treaty process, including tabling and consideration by the Joint Standing Committee on Treaties.

Withdrawal or denunciation

24. Either State can terminate the Treaty after a period of five years from the date of its entry into force, provided six months prior written notice of termination is given (Article 32). Termination by Australia would also be subject to our domestic treaty process. The Treaty will then cease to be effective for different types of income from either 1 January or 1 July in the calendar year following the end of the six month notice period.

Contact details

Tax Treaties Unit
International Tax & Treaties Division
Department of the Treasury.

ATTACHMENT A

Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income, and Protocol, done at Tokyo on 31 January 2008, [2008] ATNIF 1

CONSULTATION

1. 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. Prior to this announcement, Treasury had already sought comments from the business community through the Tax Treaties Advisory Panel members of which include:

- Business Council of Australia.
- CPA Australia.
- Corporate Tax Association.
- Institute of Chartered Accountants in Australia.
- International Fiscal Association.
- Investment and Financial Services Association.
- Law Council of Australia.
- Minerals Council of Australia.
- Taxation Institute of Australia.
- Property Council of Australia.

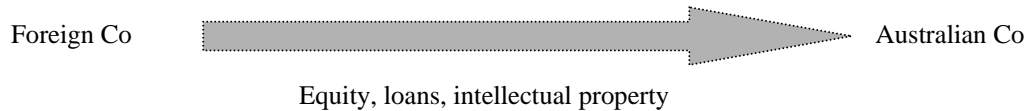
2. In general, business and industry groups supported similar outcomes to those in the 2003 United Kingdom tax Convention [2003] ATS 22 and the 2001 United States Protocol [2003] ATS 14. The proposed Treaty with Japan provides such similar outcomes.

3. 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.

ATTACHMENT B

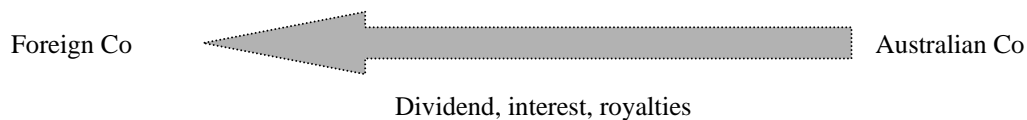
How do withholding taxes work?

Step 1



An Australian company (Australian Co) obtains equity, loans, and intellectual property from a Foreign company (Foreign Co).

Step 2



In return for equity, loans, and intellectual property, Australian Co pays dividends (for equity), interest (for loans), and royalties (for intellectual property) to Foreign Co.

Step 3



Foreign Co earned dividend, interest, and royalties from Australia, so it is liable to pay Australian tax on that amount.

However, it is difficult for the Australian Taxation Office to collect tax from Foreign Co, since it is located outside Australia. Rather than requiring Foreign Co to lodge an Australian tax return, Australian Co is instead required to collect tax, by “withholding” an amount from its payment of dividend, interest, and royalties to Foreign Co. This amount of tax is referred to as a “withholding tax”.

ATTACHMENT C

Economic benefits of lower interest and royalty withholding taxes

Withholding taxes on outbound interest and royalty payments – increased business costs for Australians

The Japanese recipients of outbound interest and royalty payments have the legal liability for withholding tax (WHT) on those payments. However, in commercial practice, those taxes will often be borne by the Australian payers. This is because:

- International lenders often have low profit margins. Consequently, they would not have an incentive to lend to Australian borrowers if those lenders had to bear the burden of interest WHT.
- An international owner of a unique intellectual property (for example, know-how, technology, etc) may be in a sufficiently strong bargaining position to demand that the Australian payer of the royalty also bear the cost of royalty WHT.

Under those circumstances, WHT on outbound interest and royalty payments will be borne by Australian businesses, effectively increasing their business costs.

Reduced withholding taxes under proposed Treaty

While interest WHT rates will continue to be 10 per cent, the proposed Treaty does provide an exemption (that is, a zero rate of WHT) for interest derived by Japanese financial institutions engaged in lending activities.

Further, the proposed Treaty includes an exemption from interest WHT for interest derived by: the Export Finance and Insurance Corporation; a public authority that manages the investments of the Future Fund; the Japan Bank for International Cooperation; and the Nippon Export and Investment Insurance organisation. The Treaty also allows for any similar organisation as may be agreed upon from time to time between the Governments of the Contracting States through an exchange of diplomatic notes.

The general limit for royalties will be reduced from 10 to 5 per cent.

Expected economic benefits of lowered withholding taxes

Lowered interest WHT rates are expected to reduce the burden of repayment placed on the Australian borrowers of Japanese debt as they often have to bear the burden of the interest WHT:

- This is expected to make it cheaper for Australian businesses to borrow from Japanese lenders.
- Other things being equal, this should lead to increased economic activity.
- In turn, this is expected to result in an increase in the annual tax revenue, which should offset the cost of the interest WHT component of the proposed Treaty.

Similarly, lowered royalty WHT rates are expected to reduce the cost to Australian businesses that make royalty payments to foreign owners, since they often have to bear the burden of the royalty WHT:

- This is expected to make it cheaper for Australian businesses to obtain intellectual property from Japan.
- Other things being equal, the cheaper cost of intellectual property should lead to increased economic activity.
- In turn, this is expected to result in an increase in the annual tax revenue, which should offset the revenue cost of the royalty WHT component of the proposed Treaty.

ATTACHMENT D

Encouraging foreign direct investment through lower dividend withholding taxes (WHTs)

The recognised economic benefits of inbound foreign direct investment (FDI)

It has been recognised that inbound FDI can bring significant economic benefits to Australia, including:

- *Transfers of technology:* Foreign direct investors may bring new production and product technologies, new management concepts, and improved institutional and governance standards.
- *Human capital formation:* Foreign direct investors may provide training and skill upgrading, improving the productivity of Australia's human capital resources.
- *International trade integration:* Inbound FDI may lead to increased exports and imports in the Australian subsidiary. This is done by expanding the Australian subsidiary's capabilities through transfers of technology and human capital formation, as discussed. It may also be done by providing the Australian subsidiary with access to world-wide product distribution systems.
- *More competitive business environment:* Entry of foreign enterprises may increase competition in Australia, ensuring efficient production methods and benefiting Australian consumers through lower prices.

The impact of lower dividend withholding taxes

The proposed Treaty will provide a zero rate of WHT on dividend WHT, if a Japanese company directly holds at least 80 per cent of the voting power of the Australian subsidiary paying the dividend, subject to certain conditions. This exemption seeks to encourage Japanese parent companies to make FDI into Australia, by ensuring that dividend payments from the Australian subsidiary to the Japanese parent are not subject to WHT.

International flows of FDI are thought to be highly sensitive to country tax rates. OECD economic research shows that a 1 per cent point reduction in tax rates can lead to a 4.28 per cent increase in inflows of FDI.¹ On that basis, it is expected that the exemption from dividend WHT would encourage Japanese investors to increase their FDI into Australia.

¹ Ruud A de Mooij and Sjef Ederveen, "How does foreign direct investment respond to taxes?", Study prepared for the OECD Working Party 2 meeting on 31 May to 2 June 2005, CTPA/CFA/WP2 (2005) 16/REV1.

ATTACHMENT E

How revised tax treaties can help Australian businesses expanding offshore

"...The tax treaty was in need of review because it was an impediment to the ability of Australian companies to optimise their business development in the US. The overall result was outstanding, a win for business and government and future economic ties between the two countries ..."

Charles Blunt, National Director of the American Chamber of Commerce and Industry, on the 2001 Protocol to the Australia-United States (US) tax treaty.

Many Australian businesses have found that recently-revised tax treaties provided a boost to their operations offshore.

- **Revised tax treaties allow easier repatriation of profits back into Australia.** Previously, many Australian businesses found it difficult to bring back their profits from their operations offshore, given the high rates of withholding tax (WHT) which would apply under the old tax treaties. According to PricewaterhouseCoopers: *"...there was no doubt that the withholding tax issue led to a massive earnings lock-up in the US [before the 2001 Protocol to the Australia-US tax treaty] ... our firm's clients alone had profits locked up in excess of \$1 billion ..."*

This provided a disincentive to Australian businesses looking for lucrative commercial opportunities outside Australia.

The revised tax treaties, with reduced WHT rates, have largely resolved this problem. According to Amco: *"... the withholding tax was a disincentive to bring money back to Australia whereas now there is an incentive to bring money back if and when you need it ..."* Australian businesses now have greater freedom to look offshore for opportunities to maximise their earnings.

- **They provide greater certainty to Australian businesses looking to expand offshore.** Australian businesses have also welcomed the recently-revised tax treaties, which provide greater certainty in their tax positions as they expand offshore. Outdated tax treaties can create uncertainties for Australian businesses looking to expand offshore.

Revised tax treaties assist Australian businesses by providing greater certainty with respect to important tax rules such as the capital gains tax rules, as they seek to expand offshore.

- **They provide a competitive advantage to Australian lenders and owners of intellectual property:** Australia's recently-revised tax treaties provide for lower interest and royalty WHT rates. The lower interest WHT will effectively remove obstacles for Australian banks seeking to expand offshore, thereby improving Australia's status as a global financial centre. The lower royalty WHT will make Australia a more attractive destination for overseas investment in research and development.