US Protocol amending the Australia-USA double taxation convention

1. Specification of policy objective

The key objective in updating Australia’s tax treaty with the United States is to make a significant advance in providing a competitive tax treaty network for companies located in Australia by reducing the rate of dividend withholding tax (DWT) on US subsidiaries and branches of Australian companies. An important secondary goal is to prevent double taxation of capital gains derived by US residents on the disposal of interests in Australian entities while retaining Australian taxing rights.

2. Background

The stated purpose of tax treaties is to avoid double taxation and prevent fiscal evasion with respect to taxes on income, but their wider function is to facilitate investment, trade, movement of technology, and movement of personnel between countries. They are widely used to develop and strengthen bilateral relationships between countries, especially in commercial areas. Tax treaties also provide certainty and protection regarding the level of taxation on investments abroad which may, for instance, be valued by business when deciding on the location of a regional headquarters. The impact of new tax treaties and the amendment of existing tax treaties on tax policy flexibility is marginal because Australia already has a substantial tax treaty network.

Ralph Review of Business Taxation

The Government agreed in its Stage 2 response to the Ralph Report's Review of Business Taxation recommendations that priority be given to renegotiating Australia's aging tax treaties with major trading partners (in particular, with the United States, the United Kingdom and Japan) and that Australian investment offshore would significantly benefit from a lowering of DWT on non-portfolio dividends (ie, dividends paid on 10 percent or greater shareholdings) under these older tax treaties.

How tax treaties operate

Australian tax treaties are usually based on the OECD Model Tax Convention on Income and on Capital (OECD Model) with some influences from the United Nations’ Model Double Taxation Convention between Developed and Developing Countries (UN Model). In addition, countries propose variations to these Models to reflect their particular economic interests and legal circumstances.

Tax treaties reduce or eliminate double taxation caused by the overlapping taxing jurisdictions because treaty partners agree (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 have a right to tax.

Australia seeks an appropriate balance between source and residence country taxing rights. Generally the allocation of taxing rights under Australia's tax treaties is similar to international practice as set out in the OECD Model, but there are a number of instances where it leans more towards source country taxing rights.

In addition, tax treaties provide 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. Tax treaties are therefore an important tool in dealing with international profit shifting.

To prevent fiscal evasion, tax treaties normally include 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.

Background to the US tax treaty

The current tax treaty with the United States was signed on 6 August 1982 and had effect from 1 December 1983 (for Australian income tax purposes) replacing an earlier tax treaty signed in 1953. The current tax treaty, although signed in 1982, largely reflects the positions agreed by both countries in the early 1970's.

Talks to update the US tax treaty were held in March and June 2001 following scoping talks in November 2000.

Australia's Investment and Trade Relationship with the United States[1]

As at 1999-2000, the United States was Australia's second largest merchandise trading partner after Japan and our second largest export destination, with two-way trade totalling $A33.0 billion or 16 percent of total trade.

Exports to the United States in 1999-2000 totalled $A9.68 billion. The United States remains Australia's largest market for services ($A4.6 billion in 1999-2000). The major services exports were transportation and travel.

Australia's imports from the United States amounted to $A23.34 billion in 1999-2000.

As at 1999-2000, the United States was the largest foreign investor in Australia ($A215 billion). US investment in Australia is diversifying, with many US firms establishing regional headquarters and other operations here. The United States is the largest investment destination for Australian investment abroad, with investment of $A156.7 billion as at 1999-2000, of which $A90 billion is direct equity investment (with earnings in 1999-2000 of $A3 billion) that would benefit from reduced US DWT. The level of Australian investment in the United States has increased rapidly in recent years. Australia's direct equity investment in the United States, for instance, exceeded US direct equity investment in Australia during 1999-2000 by $A27.7 billion (US direct equity investment in Australia was $A62.3 billion).

[1] Source: Department of Foreign Affairs and Trade and Australian Bureau of Statistics

3. Identification of implementation option(s)

The policy objectives can realistically only be achieved by updating the US tax treaty.

Option 1: Update the tax treaty

The proposed Protocol would update the tax treaty to:

- reduce the rate of DWT on US subsidiaries and branches of Australian companies; and
- prevent the double taxation of capital gains derived by US residents on the disposal of Australian entities while retaining Australian source country taxing rights.

Option 2: Do not update the tax treaty

Unless the tax treaty is updated, the rate of DWT on US subsidiaries and branches of Australian companies will continue to be higher than for competitors from many other countries that have negotiated lower rates of DWT with the US. There is also a risk that double taxation could arise on capital gains. The tax treaty generally does not cover taxes on capital gains and thus provisions in the treaty that provide relief from double taxation in respect of such gains may not be available.

4. Assessment of impacts (costs and benefits) of each option

Broadly, both sides had particular policy objectives to achieve in updating the tax treaty and some major departures from Australia's long standing treaty practice were required to reach a mutually acceptable agreement. These departures include reductions in withholding tax on royalties and for certain dividend and interest income. While the withholding tax reductions involve a cost to revenue, the benefits are much more widely spread in the economy, with the most direct benefits accruing to business. Indirect revenue benefits may arise from increased trade and investment between the countries and reduced tax credit obligations for US taxes.

Difficulties in quantifying the impacts of tax treaties

Only a partial analysis of costs and benefits can be provided because the impacts of tax treaties cannot be quantified in a number of important areas. Estimates of the expected growth in trade and investment, for instance, tend to be speculative because of a lack of information and difficulties associated with determining the range and impacts of behavioural responses with any certainty. Benefits that flow to business are generally equally difficult to quantify. Some impacts can be determined with greater authority, for instance, the direct revenue impact of reducing rates of withholding tax.

Impact group identification

The Protocol is likely to impact on Australian residents who derive income or capital gains from the United States and on US residents who derive such amounts from Australia. The main groups affected by a reduction in the rate of US DWT and from

comprehensively covering the taxation of capital gains are likely to be the approximately 70 publicly listed Australian companies with investments in the United States and 200 publicly listed US companies with investments in Australia. Australian persons that have or are seeking debt finance from US financial institutions or know how from US persons may benefit from the interest withholding tax exemption for interest paid to US financial institutions or the reduced royalty withholding tax rate. Persons may also be indirectly affected by the facilitation of investment flows between the countries (eg, persons may benefit from a growth in economic activity that improves employment opportunities). Some tax entities (eg, certain discretionary trusts which do not have a substantial connection with either Australia or the United States) may cease to be eligible for treaty benefits where they do not satisfy the requirements of the new *Limitation on Benefits Article.* The Article is intended to prevent residents of third countries from inappropriately accessing treaty benefits.

The Australian Taxation Office (ATO) will need to administer the changes to the tax treaty.

Assessment of costs

Option 1: Update the tax treaty

<u>Revenue costs</u>

The net yearly cost to revenue of the Protocol is estimated to be $190m. This cost is largely attributable to:

- a reduction in DWT to nil or 5 percent on non-portfolio dividends derived by US companies (down from 15 percent for unfranked dividends, franked dividends are already exempt from DWT under Australia’s domestic law);

- an interest withholding tax (IWT) exemption for interest paid to US financial institutions (down from 10 percent); and

- a reduction in the general royalty withholding tax (RWT) rate to 5 percent (down from 10 percent).

Some potential offsetting gains to the Australian revenue have been unable to be quantified as discussed later in the section on "(offsetting) revenue benefits".

<u>Knock-on revenue costs</u>

Over time the lower withholding tax rates may be extended to other countries, for instance, as a result of most favoured nation clauses in some existing treaties. As noted above this will come at a cost to the revenue in relation to countries exporting capital and technology to Australia but will lower the cost of capital to Australian businesses seeking funding in those countries and reduce the cost of accessing new technologies. The amount by which costs to Australian businesses will be reduced depends on the extent to which those businesses currently bear the costs of the relevant withholding taxes.

Business costs

No DWT rate limit will apply in the US for dividends paid on certain substantial holdings in US real estate investment trusts (REITs). These dividends may therefore be taxed at the US domestic law rate which is currently 30 percent for companies (up from 15 percent). The negative impact of this increase is significantly reduced because non-portfolio REIT dividends derived by certain publicly listed Australian unit trusts (the main group potentially impacted) will generally continue to qualify for the 15 percent DWT rate. Others affected will have until at least 1 July 2003 to reduce their holding in a REIT.

Administration costs

There would be a small unquantifiable cost in administering the changes made by the Protocol, including minor implementation costs to the ATO in educating the taxpaying public and ATO staff concerning the new arrangements. Some additional administrative costs may arise for the ATO in considering applications for treaty benefits from persons who do not qualify based on the general tests in the *Limitation on Benefits Article*. The need to make an application would also increase compliance costs for the applicant.

Option 2: No further action - rely on the existing tax treaty

This option represents a continuance of the current position. Continuing higher rates of US DWT, uncertainty on the taxation of capital gains and the potential for double taxation could have an ongoing negative but unquantifiable impact on investment between the countries. Uncertainty regarding the taxation of capital gains is currently giving rise to major interpretive issues resulting in compliance and administrative costs (and the possibility of litigation).

Assessment of benefits

Option 1: Update the tax treaty

Economic benefits

Major Australian companies have for many years raised concerns about the lack of competitiveness of Australia's tax treaty with the United States, and in particular the high level of US DWT permitted under the current tax treaty. They have welcomed the reduction in withholding tax rates made by the Protocol, particularly on non-portfolio dividends.

Dividends

The 15 percent rate of US DWT currently applying to non-portfolio dividends paid to Australian companies is a significant impediment to the expansion of the activities of Australian companies in the United States, with these companies facing an effective US tax rate of around 50 percent on repatriated earnings. Given companies from other countries generally face a significantly lower US DWT rate (5 percent), the 15 percent rate of US DWT is a significant penalty on multinationals operating out of Australia and adversely affects their cost of capital.

The importance of this issue has recently been brought to public attention by James Hardie's restructuring that involved moving its parent company from Australia to the Netherlands. While the move was not aimed solely at reducing rates of US DWT, the high level of US DWT was said to have been a contributing factor.

The achievement of a nil or 5 percent US DWT rate for non-portfolio dividends paid to Australian companies will also significantly improve the ability of Australian multinationals to manage their capital base by freeing capital flows from tax. In some cases this could see a return of capital to Australia.

A nil Australian DWT rate would make the treatment of subsidiaries and branches of US businesses in Australia more consistent in that branches in Australia are not subject to DWT on distributions of profits. Economic efficiency may be improved by this reduction to the extent in which taxation considerations are a factor in deciding whether to structure operations through a branch or a subsidiary.

Interest

A nil Australian IWT rate on interest derived by US financial institutions would be consistent with the exemption currently provided for interest derived from widely distributed arm's length debenture issues and recognises that a 10 percent IWT rate on gross interest derived by financial institutions may be excessive given their cost of funds. The cost to Australian business of raising capital from US financial institutions may also be reduced making this source of capital more affordable and increasing competition in capital markets.

Royalties

Australian residents required to meet the cost of Australian RWT on royalty payments made to US residents will benefit from the reduced RWT rate. Consultations with business representatives have indicated that such gross-up obligations are commonly imposed.

Australian residents who derive royalty income from the United States may also benefit from the reduced US RWT rate. Additional tax payable in Australia due to a reduced credit for US RWT will generally result in imputation credits that can be passed on to shareholders.

Alienation of Property

Changes to the *Alienation of Property Article* will ensure Australian taxing rights are retained and facilitate investment between the countries by making the taxation treatment of capital gains more certain and reducing the risk of double taxation. The Protocol also addresses widespread business concerns about the potential for double taxation arising from the application of Australia's capital gains tax to expatriates departing Australia. These concerns have negatively affected the ability of Australian located companies to attract and retain skilled expatriate staff, and has the potential to affect headquarters location decisions to Australia's detriment. The Protocol will improve arrangements for taxing gains accrued on assets held by departing residents by reducing compliance difficulties and ensuring appropriate relief is provided from double taxation.

Compliance and administration cost reduction benefits

Compliance costs would be significantly reduced by clarifying Australia's right to tax US companies on capital gains derived from the disposal of an Australian subsidiary. Interpretative issues relating to the extent Australia can tax these gains under the existing treaty have resulted in considerable uncertainty and costly legal arguments. Administrative costs in explaining the ATO view and responding to legal arguments would also be significantly reduced.

(Offsetting) revenue benefits

A lower US DWT rate on non-portfolio dividends would not directly result in additional tax revenue for Australia because Australian companies are exempt on dividends they derive from their US subsidiaries. Some (unquantifiable) additional revenue may however be collected when unfranked profits referable to US dividends are distributed to shareholders, and if Australian multinationals reduce the capitalisation of their US subsidiaries. A reduced US DWT rate would also result in a comparable reduction in the imputation credit available for foreign DWT (once implemented). There may also be an (unquantifiable) increase in capital gains tax collections if improved post tax profits boost the market value of shares in Australian companies that have US operations.

Option 2: No further action - rely on the existing tax treaty

The existing tax treaty would continue to provide relief from double taxation and limitation of source country taxation in relation to most income, but high US DWT and uncertainty over capital gains would remain. Failure to deal with these issues would be a serious retrograde step in achieving an internationally competitive business tax system.

5. Consultation

Information on the revision of the existing tax treaty has been provided to the States and Territories through the Commonwealth-State Standing Committee on Treaties' Schedule of Treaty Action.

The ATO's Tax Treaties Advisory Panel of industry representatives and tax practitioners was consulted on the changes along with the American Chamber of Commerce in Australia. Industry representatives of parties that may be negatively affected by the changes to the taxation of REIT dividends indicated that they were satisfied with the REIT provision in the Protocol. The Protocol will also be considered by the Parliamentary Joint Standing Committee on Treaties which provides for public consultation in its hearings.

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 fora.

6. Conclusion and Recommended Option

The reduction under the Protocol in rates of DWT in particular, as well as RWT and IWT, will provide significant benefits to Australian business, and mark a major step forward in providing Australian located companies with an internationally competitive treaty network and business tax system. It will also directly help facilitate trade and investment between the countries.

These benefits come at a direct cost to revenue. The revenue costs are considered to be outweighed by the overall benefits of updating the tax treaty. In addition, clarifying Australia's right to tax US residents in respect of capital gains is an important tax base protection measure.

The Protocol is unlikely to significantly increase compliance costs for business and the clarification of the taxation of capital gains will reduce compliance and administrative costs (as well as the potential for double taxation).

The benefits of a Protocol outweigh the costs. Option 1 is therefore recommended as the preferred option.