Regulation impact statement

THE 2006 FRENCH CONVENTION

Background

How tax treaties operate

#.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 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.

#.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.

#.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 (Australia being a member of the OECD and involved in the development of that Model). There are, however, a number of instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model Tax Convention.

The French tax treaty

#.5 The existing tax treaty with France was signed on 13 April 1976 and has been in effect in Australia since the income year commencing 1 July 1972 in respect of income taxes and 1 January 1973 in respect of withholding taxes. The treaty was amended by a Protocol signed on 19 June 1989 and having effect in Australia in respect of income taxes derived on or after 1 July 1991. Amendments to the Royalties Article and the Pensions Article took effect from 20 June 1989 and 1 July 1987 respectively.

#.6 There is also a separate Airline Profits Agreement with France which was signed on 27 March 1969 and which has been in effect in Australia since the income year commencing 1 July 1966.

#.7 With the entry into force of the Protocol to the United States (US) tax Convention on 12 May 2003 Australia is obliged, under the existing French treaty to provide most favoured nation (MFN) treatment in respect of the rates of tax applicable to dividends, interest and royalties. [1]

#.8 With the entry into force of the new tax treaty with United Kingdom (UK) on 17 December 2003, Australia is also obliged to negotiate the inclusion of a non-discrimination article that operates to protect taxpayers operating in foreign jurisdictions from discriminatory tax practices.

#.9 While the triggering of the MFN clauses imposes certain obligations on Australia, it also presents an opportunity to update certain aspects of the current French treaty including clarifying Australia's rights to apply capital gains tax (CGT).

Australia's investment and trade relationship with the Republic of France[2]

Bilateral Trade

#.10 Australia's commercial links with France are substantial but one-sided, with the balance of trade increasing further in France's favour in recent years. France is Australia's 14th largest merchandise trading partner and 9th largest supplier of imports but is ranked only 22nd as a destination for Australian merchandise exports.

[1] Most favoured nation clauses require a country to enter into negotiations with a view to providing similar treatment to its treaty partner if it subsequently agrees with a third country to a certain specified tax treatment.

[2] Source: Department of Foreign Affairs and Trade.

#.11 Australia's merchandise exports to France for 2005 stood at A$1.1 billion, while Australian merchandise imports from France were A$4.9 billion for the same period. Australia's merchandise trade deficit with France totalled A$3.89 billion in 2005. Australia's exports to France in 2005 were dominated by commodities, particularly coal and iron ore. Medical instruments, medicaments and aircraft and parts were the major manufactured export items. Major products imported from France in 2005 were aircraft and parts, medicaments and passenger motor vehicles.

#.12 Two way services trade between Australia and France stood at a total of A$1.14 billion (with a French surplus of A$318 million) in 2005. Australia’s service imports from France increased by 14 per cent over the previous five years, while service exports to France rose 4 per cent over the same period.

Bilateral Investment

#.13 Total French investment in Australia as at 31 December 2004 was valued at A$15.7 billion. Foreign direct investment from France in Australia was valued at A$7.7 billion, making France the 9th largest direct investor in Australia. Major French investments have been made in the financial services, telecommunications, pharmaceuticals, energy, resources and agribusiness sectors. Some important examples include the acquisition of a 51 per cent stake in National Mutual by insurer AXA, Pernod-Ricardi's purchase of the Orlando-Wyndham group, the participation of Vivendi in the successful bid for the A$1.5 billion project to manage South Australian Water; Transroute's participation in the construction consortium concerning the A$1.5 billion Melbourne City link toll-road; and the purchase of Australian Defence Industries by Thales, as part of a 50-50 joint venture with Australian engineering group, Transfield.

#.14 There are now close to 300 companies in Australia with a French association employing some 70,000 people, with an annual turnover of 12 billion euros, or A$20 billion. A number of companies have chosen to headquarter their regional operations in Australia - such as AXA - or to build very substantial offices with considerable regional responsibilities - such as the hotel group Accor.

#.15 In December 2001, the Australian Defence Material Organisation signed an A$1.3 billion contract with France-based company Eurocopter for the delivery and through-life support of 22 'Tiger Armed Reconnaissance' helicopters for the Australian Army, with four to be built in Europe and the remaining 18 assembled at the Australian Aerospace facility in Brisbane, generating up to 180 jobs during the assembly phase. The first two helicopters arrived in Australia in November 2004 and the first Australian built helicopter rolled out on 18 July 2005. In August

2004, Australia also signed an A$1 billion contract with Eurocopter for the delivery of 12 MRH-90 "troop lift" helicopters to the Australian Defence Force.

#.16 Australian investment in France received a significant boost in December 2005 with the French Government's announcement of Macquarie Bank's successful tender - with its French partner Eiffage - for the privatisation of the Autoroutes Paris Rhin Rhône tollway. Macquarie is expected to invest around A$3.9 billion in the project. Prior to this, total Australian investment in France (as at 31 December 2004) was valued at A$13.2 billion including investments by the surf and sportswear companies, Billabong and Rip Curl, in the south west of France; Oceanis Australia Pty Ltd construction of the largest aquarium in France; VitaMan's launch of the first Australian grooming range for men in France and Ingeus's involvement in the French employment services market.

Specification of policy objectives

#.17 The objective of the measure is to:

- meet Australia's MFN obligations[3];
- promote closer economic cooperation between Australia and France by reducing possible tax barriers to trade and investment between the two countries; and
- upgrade the framework through which the tax administrations of Australia and France can prevent international fiscal evasion.

Identification of implementation option(s)

#.18 The internationally accepted approach to meeting the policy objectives specified above is to:

[3] Australia's MFN obligations will be met by the conclusion of the new treaty arrangements with France even though negotiators were not able to agree on satisfactory rules dealing with non-discrimination. Since the current French and Australian tax systems generally do not discriminate in ways that would breach non-discrimination rules, and European Union law constraints are likely to ensure that the French tax system remains non-discriminatory, the non-inclusion of such rules is unlikely to have a negative impact for taxpayers.

- amend an existing treaty to reflect current policies (amending Protocol); or
- conclude a new bilateral tax treaty. [4]

Option 1: Limited amending Protocol (most favoured nation obligations) – rely on the existing tax treaty measures

#.19 In general terms, option 1 would rely on the existing tax treaty measures with an amending Protocol covering, at a minimum, Australia's MFN obligations (dividends, interest and royalties[5]). Australia would also seek to clarify Australia's rights to tax capital gains.

Option 2: Amending Protocol covering most favoured nation obligations and revising the current treaty to the extent possible without entering into a complete renegotiation

#.20 Option 2 is to deal with a number of other issues, in addition to those proposed under option 1, on which both sides would like to modify the treatment in the current treaty but which are not likely to be contentious. Additional areas include the tax treatment of residual types of income not covered by the other articles of the treaty, integrity measures and clarifying the application of the treaty to each country's controlled foreign corporation regimes (a French requirement).

Option 3: Conclude a new tax treaty

#.21 Option 3 is to conclude a new bilateral tax treaty to reflect current tax treaty policies and practice of both countries.

#.22 A new tax treaty would be largely based on the current OECD Model Tax Convention and the United Nations Model Tax Convention, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries. It would also dispense with the need for the separate 1969 Airline Profits Agreement with France.

#.23 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 the new tax treaty are:

[4] There are very few multilateral tax treaties, which reflect the widely differing economic interests and unique tax law structures of most countries.

[5] See footnote 3 for details on the non-discrimination MFN obligation.

- a reduction in the maximum royalty withholding tax rates from 10 per cent to 5 per cent;
- reduction in interest withholding tax from 10 per cent to zero where interest is paid to a financial institution or body performing governmental functions;
- reduction of dividend withholding tax from 15 percent to zero for dividends paid out of profits that have borne the normal rate of company tax on non-portfolio holdings of 10 per cent or more and to 5 per cent dividend withholding tax for other non-portfolio holdings;
- inclusion of a comprehensive *Alienation of Property* Article which allocates taxing rights over capital gains; and
- improved integrity measures; in particular, rules to allow for the cross-border collection of tax debts and updated rules for the exchange of information on tax matters.

Assessment of impacts (costs and benefits) of each option

Difficulties in quantifying the impacts of tax treaties

#.24 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 economic growth factors that make the gains or losses to Australia difficult to estimate (especially as the impact will differ across different sectors of the economy). 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 based on the available information, current estimation techniques, likely behavioural responses, and data accuracy.

#.25 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration of the costs and benefits of treaties previously undertaken (eg 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.

Impact group identification

#.26 A revised tax treaty with France is likely to have an impact on:

- Australian residents doing business with France, including principally:
  - Australian residents investing directly in France (either by way of a subsidiary or a branch);
  - Australian banks lending to French borrowers and vice versa;
  - Australian residents supplying technology and know-how to French residents and vice versa;
  - Australian residents supplying consultancy services to France; and
  - Australian residents exporting to France;
- Australian residents receiving pensions from France;
- the Australian Government; and
- the ATO.

Assessment of benefits

#.27 All options would address long term business concerns about the lack of competitiveness of Australia's tax treaty network with business particularly seeking reductions in withholding tax rates.

#.28 These issues were addressed in the updated Convention with the UK and the Protocol amending the Convention with the US. Extending similar treatment to France 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). 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.

Benefits common to all options

#.29 The economic benefits of the expected major changes which are common to all three options, are summarised in paragraphs #.30 to #.34.

Dividends

#.30 A lower rate of withholding tax on non-portfolio dividends (10 per cent ownership requirement) would, as the MFN clause in the current treaty aims to do, reduce the cost of capital to Australian business, as well as reduce distortions in the raising of capital that results from the more favourable terms that apply bilaterally in the case of the US and the UK. This provides broad reciprocity with Australia's domestic exemption for franked dividends.

Interest

#.31 A nil Australian interest withholding tax rate on interest derived by French financial institutions will be consistent with the exemption currently provided under domestic law 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. Conversely, it may encourage French businesses to source funds from Australian banks.

Royalties

#.32 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to French 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. Conversely, it may encourage the French to use Australian technology and intellectual property.

Alienation of property

#.33 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.

Compliance and administration cost reduction benefits

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

Comparative advantage of option 1

#.35 Option 1 involves minimal changes to the existing treaty.

Comparative advantages of option 2

#.36 The advantage of option 2 is that Australia, in addition to addressing its MFN obligations, would be able to achieve improved integrity measures; in particular, rules to allow for the cross-border collection of tax debts and updated rules for the exchange of information on tax matters.

#.37 This option represents an advance on option 1 and recognises that the rates of withholding tax negotiated in the US Protocol were agreed as part of an overall package of measures (including CGT coverage). It would allow Australia to seek a more balanced update of the existing treaty.

Comparative advantages of option 3

Renegotiation provides a better outcome for all stakeholders

#.38 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 is clear that it has become outdated (no coverage of CGT, for example) and no longer reflects current tax treaty policies and practices of either Australia or France.

#.39 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.

#.40 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 be consistent with the Government's decision in response to the *Review of International Taxation Arrangements,* to move towards a more residence-based tax treaty policy, and would contribute to the updating of Australia's ageing treaty network.

Other benefits

#.41 Where Australians invest directly in France, the existing treaty prevents France from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment in France. A revised 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 French resident invests directly into Australia. Other benefits also include:

- The appropriate treatment of income derived through partnerships; and
- The protection of Australian expatriates who temporarily reside in France from paying French capital taxes on non-French assets.

Revenue benefits

#.42 New treaty arrangements with France would represent a significant 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.

Compliance and administration cost reduction benefits

#.43 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 tax treaty arrangements has resulted in considerable uncertainty and the risk of costly legal arguments.

#.44 Administrative costs 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.

Improved international relationships

#.45 New treaty arrangements with France 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 Tax Convention 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

Costs common to all options

Revenue costs

#.46 The Treasury has estimated that the revenue impact of the first round effects of the proposals would be around $10 million per annum across the forward estimates period. The 3 options do not present material differences in estimated direct cost to revenue as the only identifiable costs to revenue are associated with the reductions in dividend, interest and royalty withholding tax rates.

Administrative costs

#.47 The administrative impacts on the ATO in administering the changes made by any revised treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example, private binding rulings, concerning the application of the new treaty arrangements. ATO staff, 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.

#.48 The costs of negotiation and enactment of new tax treaty arrangements with France are minimal and have mostly been borne by the 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.

#.49 There are also ‘maintenance’ costs to the ATO associated with tax treaties in terms of dealing with enquiries, rulings and other interpretative decisions and mutual agreement procedures (including advance pricing arrangements). These costs also apply to the existing arrangements. By bringing the French 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

#.50 Government policy flexibility in relation to taxation of French residents would be to some extent constrained by changes to treaty obligations, but as the more significant changes would accord with the Government’s tax treaty policy the cost of such constraints should be outweighed by the benefits. Ultimately, the tax treaty could be terminated if it became inconsistent to a significant degree 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.

#.51 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.

Costs common to Options 1 and 2

#.52 Options 1 and 2 primarily represent a continuation of the current treaty position subject to adjustment to withholding tax rates. Accordingly, administration and compliance costs that apply to the existing tax treaty would not change materially.

Taxpayers

#.53 Even though these options would address Australia’s MFN obligations, they would leave a number of areas of significant difference or uncertainty unresolved. For example, the treatment of French partnerships would not be resolved under Options 1 or 2. This may result in on-going compliance costs for taxpayers.

Costs associated with Option 3

Taxpayer costs

#.54 No material costs to taxpayers have been identified as likely to arise from the renegotiation of the French treaty. The closer alignment with more recent treaty practice and resolution of areas of current uncertainty would generally be expected to reduce compliance costs.

Administration costs

#.55 The requirement on the ATO to exchange information on a broader range of taxes and to provide assistance in the collection of tax debts are also considered to be of minimal impact. In most cases the ATO will already have the required information in its possession, and safeguards in the treaty which limit the obligations to provide collection assistance will limit the related administrative costs.

Consultation

#.56 The Board of Tax consulted widely during the *Review of International Taxation Arrangements* on the direction of Australia's tax treaty policy. The Board's recommendations supported a move towards a more residence-based treaty policy in substitution for treaty policies (reflected in most of Australia's treaties, including the existing French treaty) based on the source taxation of income.

#.57 The Minister for Revenue and Assistant Treasurer's Press Release No. C101 of 6 November 2003 invited submissions from stakeholders and the wider community in relation issues that might be raised during negotiations with MFN countries such as France. Prior to this announcement, Treasury had already sought comments from the business community through the Tax Treaties Advisory Panel.

#.58 In general, business and industry groups supported similar outcomes as those in the UK agreement and the Protocol with the US.

#.59 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 October 2003.

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

Conclusion and recommended option

#.61 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 France, nor modern international norms.

#.62 All options would address long term business concerns about the lack of competitiveness of Australia's tax treaty network with respect to withholding tax rates. They also address Australia's MFN obligations in the existing treaty.

#.63 However, developments in both countries' domestic law, commercial practices, and treaty policies and practices support a full revision of the treaty (Option 3). This option also provides an opportunity to update the text in accordance with modern OECD practice.

#.64 The proposed new treaty arrangements with France are consistent with the Government's response to the *Review of International Taxation Arrangements,* moving towards a more residence-based treaty policy and contributing to the updating of Australia's ageing treaty network. It would bring Australia's arrangements with France more into line with international norms, as set out in the OECD Model Tax Convention and would provide outcomes similar to Australia's treaties with the US and UK.

#.65 There is a direct cost to revenue common to all options, largely sourced in reduced withholding tax collections. The compliance costs associated with option 3 are considered to be minimal. On balance, the benefits of concluding a new treaty outweigh the cost to revenue.

#.66 Option 3 is therefore recommended as the preferred option.