

Two Double Taxation Agreements — United Kingdom and Mexico

Introduction

- 2.1 The Committee has examined several double taxation agreements since it was first established in 1996. Generally, the objectives of such agreements are to facilitate trade and investment and combat fiscal evasion. The two proposed agreements tabled in September and considered here have some differences in background and approach but are based around similar objectives.
- 2.2 The objectives of the *Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and Protocol, done at Mexico City on 9 September 2002*, are to improve Australia's relations with Mexico, facilitate trade and investment, combat fiscal evasion, protect Australian tax revenues, and maintain Australia's position in the international tax community.
- 2.3 The objectives of the *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, done at Canberra on 21 August 2003, and an Associated Exchange of Notes* are similar, but it replaces an existing double taxation treaty with the United Kingdom that was signed in 1967 and modified in 1980. According to the National Interest Analysis (NIA), the agreement

‘moves towards a more residence-based tax treaty policy and updates an important part of Australia’s aging (sic) treaty network.’¹

2.4 The Department of the Treasury’s efforts at quantifying the costs and benefits of double taxation agreements in order to better assess their effectiveness are noted, and these efforts will be discussed later in this Chapter.

2.5 The Committee heard that the broad objectives of taxation treaties can be categorised as follows:

Firstly, they aim to promote the flow of investment, trade and skilled personnel between the two countries by eliminating double taxation and providing a reasonable element of legal and fiscal certainty for commerce between the respective countries. Secondly, they aim to improve the integrity of the tax system by creating a framework through which the tax administrations of both countries can prevent international fiscal evasion and eliminate double taxation. Thirdly, they aim to develop and improve bilateral relations with the countries concerned. Fourthly, they aim to maintain Australia’s position in the international tax community. At the highest level, these treaties form part of the network of tax treaties which ultimately support Australia’s geopolitical, strategic, security and regional interests.²

United Kingdom

2.6 The economy of the United Kingdom is the fourth-largest in the world. The NIA states that its average real economic growth of 2 per cent per annum since the mid-1990s underlines the importance of the UK as a treaty partner.³ The Committee understands that Australia’s investment and trade relationship with the UK is the largest that Australia has with any European country.⁴ There are over 1,000 Australian companies active in the United Kingdom with a large

1 National Interest Analysis (NIA), para. 4.

2 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 2.

3 NIA, para. 10.

4 NIA, para. 11.

number using Britain as a base for trade and investment into the European Union.⁵ According to the NIA:

The international economic significance of the United Kingdom, the size of the Australia-United Kingdom investment and trade relationships, and the gateway relationships that the United Kingdom has with Europe and Australia has with Asia, show the importance of an updated DTC.⁶

Purpose of the DTA with the United Kingdom

2.7 The Committee heard that the treaty, originally negotiated in 1967 and updated in 1980, ‘needed updating to reflect changes to Australian and UK treaty policy and business practices’,⁷ and that this is consistent with the Government’s response to the *Review of International Taxation Arrangements*.⁸ The Committee understands that the update of the treaty will bring it into line:

with international norms, as set out in the OECD’s *Model Tax Convention*, and with the direction set in the recent Protocol to the Australia-US Double Tax Convention.⁹

2.8 The Committee also understands that strategic aspects of the proposed treaty impact on Australia’s relations with the United Kingdom:¹⁰

These include the implications of the maturing of the Australian economy, the endorsement by the Government of the recommendations of the Review of International Taxation Arrangements (RITA), the extension to the United Kingdom of the WHT outcomes of the recent US Protocol, and the globalising force of international capital mobility.¹¹

2.9 In reference to the extension of the outcomes of the recently renegotiated and ratified US protocol to the UK, the Business Council of Australia (BCA) notes that:

5 Regulation Impact Statement (RIS), para. 15.

6 NIA, para. 7.

7 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 2.

8 NIA, para. 4. RITA is a Treasury Consultation Paper which was released in August 2002.

9 NIA, para. 4.

10 NIA, para. 14.

11 NIA, para. 14.

It would be regarded as inequitable treatment to not extend similar withholding tax outcomes to an important treaty partner.¹²

- 2.10 The Committee understands that renegotiation of the Australia-UK treaty commenced in February 2001. A second round of negotiations was held in March 2002 and a third round in November 2002.¹³

Features of the UK Agreement

- 2.11 The Committee recognises the claims by the Department of the Treasury that the existing double taxation treaty has become out of step with modern treaty practice, in particular it:
- does not deal with Australian capital gains
 - does not include an *Income from Real Property* Article
 - does not include an *Other Income* Article
 - does not include a *Source of Income* Article
 - does not include a *Residence* Article
 - deals with 'industrial or commercial profits' rather than 'business profits'
 - does not expressly deal with Australia's Petroleum Resource Rent Tax
 - does not deal with taxation of fringe benefits
 - does not include a *Non-discrimination* Article
 - does not define some terms and contains narrower definitions than those now found in Australia's tax treaties (such as the definitions of 'permanent establishment' and 'royalties').¹⁴
- 2.12 The NIA states that the proposed Treaty will reduce rate limits for dividend withholding tax (DWT) and royalty withholding tax (RWT), apply a nil interest withholding tax (IWT) rate limit to interest paid to a financial institution, preserve Australia's right to tax capital gains, and 'locks-in' these arrangements.¹⁵

12 Business Council of Australia (BCA), *Submission*, pp. 2-3.

13 RIS, para. 10.

14 *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol*, tabled at public hearing on 8 September 2003, paras 9 and 10.

15 NIA, para. 5.

2.13 The Committee understands the importance of the shift in tax treaty policy towards a more residence-based approach, in line with the recent US Protocol. The Committee also recognises that this shift was recommended by the Board of Taxation,¹⁶ and is supported by the Business Council of Australia (BCA) and the Corporate Tax Association (CTA).¹⁷ Ms Ariane Pickering, from the Department of the Treasury, explained that:

The residence basis [of tax treaties] is that residents are taxed on their worldwide income. The source basis is that nonresidents and residents are taxed on income arising from sources within a country... Traditionally, we have sought to protect our revenue base as much as possible by having a stronger focus on source taxation—that is, by taxing nonresidents on their Australian sourced income. The shift in the last few treaties has been towards saying ‘there are benefits from claiming less source taxation and focusing more on residence based taxation’—that is, focusing more on the taxation of our own residents.¹⁸

2.14 The Committee understands that the reduction in WHT, which is a tax on source, demonstrates the move towards residence based taxation, bringing it into greater alignment with Organisation for Economic Co-operation and Development (OECD) norms.

2.15 The Committee was advised that the proposed treaty aims to minimise disincentives to the expansion of international trade and investment in a number of ways:

- by clearly allocating tax jurisdictions between the parties
- where taxing rights are allocated to both countries, source country taxation rights are given priority and double tax is avoided through the provision of tax relief by the residence country
- by providing mechanisms to resolve disputes in a contentious area
- by mutually reducing WHT rate limits.¹⁹

2.16 The Committee was advised that the new treaty will:

16 NIA Annexure – Consultations.

17 BCA, *Submission*, p. 2.

18 Ms Ariane Pickering, *Transcript of Evidence*, 8 September 2003, p. 22.

19 NIA, paras 19 and 21.

Provide long-term benefits for businesses, making it cheaper for Australian-based businesses to obtain intellectual property, equity and finance for expansion. It will also remove obstacles currently inhibiting Australian corporate expansion offshore.²⁰

Mexico

- 2.17 Australia's trade and investment relationship with Mexico is the largest Australia has with any Latin American country but 'it does not figure' among Australia's top ten relationships.²¹ Total Australia-Mexico trade exceeded A\$1 billion in 2002, with exports growing at an annual rate of more than 27 per cent over the past five years.²² The NIA suggests that the size of the Mexican economy (ninth largest in the world) and its growth rate underlines the potential importance of the economic relationship²³ and that a tax treaty with Mexico is 'clearly important for future economic relations', given Mexico's international economic significance.²⁴

Purpose of DTA with Mexico

- 2.18 The treaty will complete Australia's tax treaty network with North American Free Trade Agreement (NAFTA) countries.²⁵ The NIA states that the international economic significance of Mexico means that an Australia-Mexico treaty is important for providing the framework for future economic relations between the two countries.²⁶ It further suggests that obstacles to trade and investment will be removed and the international competitiveness of the Australian tax system improved by the treaty's reductions in rate limits of DWT, RWT and its locking-in of limits to IWTs. Also:

The proposed Treaty provisions for clarification and allocation of taxing jurisdiction (including clarification of capital gains taxation) and exchange of information will

20 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 4.

21 NIA, para. 9.

22 NIA, para. 10.

23 NIA, para. 9.

24 NIA, para. 12.

25 NIA, para. 3.

26 NIA, para. 7.

improve tax system integrity and reduce uncertainty for taxpayers. They will also assist in overcoming fiscal evasion, and in this way protect Australian tax revenues.²⁷

Features of the DTA with Mexico

2.19 According to the Regulation Impact Statement (RIS), the proposed tax treaty is based on the OECD model with some influences from the United Nations model. Both countries have also included variations to reflect their economic interests and legal circumstances.²⁸

2.20 Further to those features concerning taxing jurisdictions and exchange of information listed above, Mr David Parker from the Department of the Treasury stated that the proposed treaty:

... will protect Australia's rights to tax profits, income and gains earned by Mexican residents who undertake activities in Australia by giving priority to source tax rights where shared rights are allocated.²⁹

Costs and benefits

2.21 The Committee recognises the difficulties inherent in empirically quantifying benefits, that is:

it is reasonably possible to make a firm estimate of the up-front headline cost of a treaty action. The benefits of the treaty are relatively clear and transparent, being in the form of promotion of commerce between the countries, but again, taking the next step to quantify those benefits is relatively difficult.³⁰

2.22 The RIS explains that:

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.

27 NIA, para. 5.

28 RIS, p. 1.

29 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 5.

30 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 2.

United Kingdom

2.23 A document entitled *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol* was tabled by representatives of the Department of the Treasury at the public hearing on 8 September 2003. The paper outlined the effects of WHT collections with and without a taxation treaty, that is:

a simulation model of the old economy could be constructed that has all the elements of the actual economy aside from the old UK-Australia tax treaty. A comparison could then be made between the size of relevant variables [including tax revenues, trade and investment] in this model economy with the size of the variables in the actual economy at some precise point in time. The differences would be attributable to the presence of the UK-Australia tax treaty.³¹

2.24 The paper recognised that ‘this measure is subject to many influences and it cannot be regarded as definitive’ and that ‘this situation suggests that only more general statements can be made about the relation between the existence of a treaty and investment levels.’³²

2.25 The Committee understands that the expected cost (about A\$100 million per annum) to revenue of the changes to WHT in the proposed UK treaty will be ‘more than offset by a consequential increase in future corporate taxes and GDP-boosted gains to revenue’,³³ whereas the consequences of maintaining an outdated treaty, which ‘does not comprehensively deal with all the income flows and taxes covered by Australia’s modern double tax treaties’ would be deleterious.³⁴

Mexico

2.26 In the case of the proposed DTA with Mexico, the NIA states that the cost to Commonwealth revenue resulting from the WHT reductions (approximately A\$2 million per annum) is likely to be offset by reductions in Australian tax relief claims for Mexican taxes,

31 *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol*, tabled at public hearing on 8 September 2003, para 3.

32 *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol*, paras 9 and 10.

33 NIA, para. 6.

34 *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol*, para. 11.

however, the proposed Treaty also has more general benefits of promoting investment and trade flows.³⁵

Ongoing concerns about costs and benefits of DTAs

2.27 The Committee notes the increasing focus on the importance of the international network of taxation treaties, the broad support from business groups such as the BCA and the CTA for the shift in tax policy internationally, and the increasingly detailed efforts by the Department of the Treasury to supply methodologies on the costs and benefit analyses of taxation agreements.

2.28 The Committee also understands the point illustrated by Mr Parker that:

At the very broadest level, if you tax something you tend to depress the level of activity. What tax treaties do, by removing double taxation, is reduce the level of tax on international trade and investment between countries and, therefore, you would expect there to be more of it.³⁶

2.29 The Committee has continuing concerns, however, at the broad claims as to the benefits of taxation agreements without demonstration of clear quantifiable reasons as to their success. The Committee expects that the Department of the Treasury will continue with the development of methodologies to demonstrate the costs and benefits of tax treaties more clearly, so that the Australian public are able to clearly see their relevance and importance to increasing Australia's economic prosperity.

Consultation

2.30 The Committee notes that information was provided regarding both proposed taxation agreements to State and Territory governments through the Commonwealth-State Standing Committee on Treaties' Schedule of Treaty Action, although the proposed treaty applies only to federal taxation.

2.31 Annexure 1 to the proposed agreement with the UK claims that since the Government's acceptance of the Review of Business Taxation

35 NIA, para. 6.

36 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 10.

(RBT - the Ralph Review), the wider business community has been aware that Australia would renegotiate with its major treaty partners, including the United Kingdom. The Committee understands that:

In general, business and industry groups supported the recent US Protocol and encouraged the Government to pursue a similar result in the proposed treaty with the United Kingdom. While some of those consulted recommended going further than the changes negotiated with the recent US Protocol, most recognised the need for both a consistent treaty policy and a degree of moderation in the extent to which Australia can afford to concede taxing rights.³⁷

- 2.32 Annexure 1 to the proposed agreement with Mexico states that the treaty was submitted for consideration and review by the Australian Tax Office's advisory panel, comprising industry representatives and tax practitioners. The panel's concerns were addressed and the panel had no objections to the signature of the Agreement.³⁸
- 2.33 The Committee was satisfied with the range and outcomes of the consultation processes undertaken by the Department of the Treasury in relation to both of the proposed treaty actions.

Timing of introduction of legislation

- 2.34 As noted in recent reports by the Committee, the introduction of legislation to allow the provisions of the proposed treaty action to be met has continued to cause concern. The Committee has stated on several occasions that the introduction of legislation prior to the conclusion of the Committee's review has the potential to undermine the operation of the review process for treaties.
- 2.35 The BCA notes in its submission that the relevant legislation, the *International Tax Agreements Amendment Bill 2003*, contains a number of start dates which are relevant to the 2003/04 business cycle. In this instance, while the Committee appreciates that Australian businesses 'need to be given the opportunity to prepare for the changes that come with the treaty and to adjust their systems'³⁹, the timing of the

37 NIA Annexure – Consultations (UK).

38 NIA Annexure – Consultations (Mexico).

39 BCA, *Submission*, p. 2.

tabling of proposed treaty actions and their entry into force should be considered during the negotiation process.

Concluding observations and recommendations

2.36 The Committee agrees with the conclusion of the Department of the Treasury that the operation of the existing UK tax treaty appears to have had a positive benefit on bilateral investment, but that the treaty has not kept pace with emerging business and tax policy trends, necessitating its renegotiation.⁴⁰ The Committee also concurs with the opinion expressed by Mr David Parker that:

The proposed new treaty achieves a balance of outcomes that will provide Australia with a competitive tax framework for international trade and investment while ensuring the Australian revenue base is sustainable and suitably protected.⁴¹

Recommendation 1

The Committee supports the *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, done at Canberra on 21 August 2003, and an Associated Exchange of Notes* and recommends that binding treaty action be taken.

2.37 The Committee also concurs with the view expressed by Mr Parker that:

The proposed Mexican treaty will only have a very small impact on the forward estimates that is likely to be much more than offset by gains to tax revenues from the improved profitability of Australian companies with operations in Mexico.⁴²

40 *The Costs and Benefits of the Previous Australia-UK Tax Treaty and Protocol*, para. 17.

41 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 3.

42 Mr David Parker, *Transcript of Evidence*, 8 September 2003, p. 5.

Recommendation 2

The Committee supports the *Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and Protocol, done at Mexico City on 9 September 2002* and recommends that binding treaty action be taken.

Recommendation 3

Further to comments made at paragraphs 2.34 and 2.35, the Committee recommends that the Government give greater consideration to the timing of the introduction of legislation to bring proposed treaty actions into force, so that the incidence of enabling legislation being introduced prior to the conclusion of the Committee's review is reduced.