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25 June, 2002

Shelley McInnis
Inquiry Secretary
Joint Standing Committee on Treaties
Parliament of Australia
R1 Suite 116
Parliament House
CANBERRA ACT 2600

Dear Ms McInnis

**AMENDING THE CONVENTION BETWEEN AUSTRALIA AND THE US FOR THE
AVOIDANCE OF DOUBLE TAXATION**

Please find attached the following additional information concerning the broad benefits arising from the proposed amendments to the US-Australia Double Tax Convention:

- Attachment A - a summary of the benefits outlined in the National Interest Analysis and Regulation Impact Statement against each of the key elements of the Protocol;
- Attachment B - an analysis of the comparative static net benefits of the Protocol; and
- Attachment C - a copy of the key submissions to the Review of Business Taxation seeking reductions in foreign withholding taxes.

As previously advised, we have not undertaken any dynamic economic modelling on the benefits of the Protocol, as these are very difficult to quantify. We note that most countries face similar difficulties in quantifying the benefits of tax treaty changes. We are also unable to weight the different elements of the Protocol against trade-investment flows and the loss of revenue.

However, we have provided (Attachment B) for the Committee's information a quantitative analysis of the static benefits that arise, using the same assumptions that were used in costing the measure at \$190m per annum. The analysis supports our conclusions that the Protocol provides a net benefit to Australia.

Please advise if we can be of any further assistance. I have copied this information to Ms Julie Bishop, MP, Chairperson of the Committee.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ken Henry', with a small flourish at the end.

Ken Henry
Secretary to the Treasury

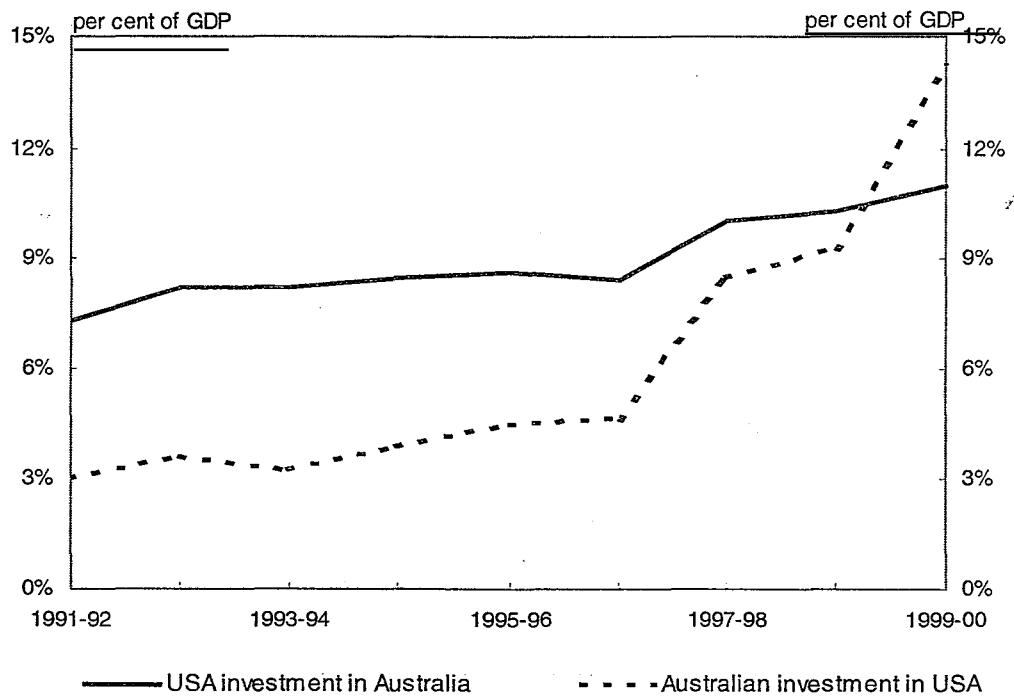
Summary of benefits arising from the proposed amendments to the United States – Australia Double Tax Convention

The National Interest Analysis and Regulation Impact Statement provide a broad outline of the benefits of the US Protocol to amend the US-Australia double tax convention. A summary of the benefits are outlined below against the key elements of the protocol.

Measure	Benefits
1. Nil or 5% US dividend withholding tax (DWT) rate (down from 15%) for non-portfolio dividends paid to Australian companies	<ul style="list-style-type: none"> • The reduction in the rate of US DWT will improve the competitiveness of Australian companies operating in the US and create opportunities for new entrants and for existing entrants to expand their operations. It will allow Australian companies to bring back profits from their US subsidiaries largely free of US DWT (the current rate is 15%). Approximately \$90 billion Australian direct equity investment in the US could benefit from reduced US DWT – significantly, Australian direct investment into the US now exceeds US direct investment into Australia (see attached chart). • Australian dividends paid to US residents are in general already free of Australian DWT (when franked).
2. Clarification of Australia's right to apply capital gains tax on US investors in Australia while ensuring that the US investors are not double taxed.	<ul style="list-style-type: none"> • Clarification of Australia's right to apply capital gains tax on US investors (and the obligation of the US to provide a credit for Australian CGT paid) in Australia is an important tax base protection measure. The estimated revenue that could be at risk is in the range of \$70m to \$105m per annum. • Prevention of double taxation is important to facilitate investment. Continuing uncertainty regarding the taxation of capital gains and relief from double taxation may harm future US investment into Australia.

<p>3. Nil interest withholding tax on interest paid to US financial institutions.</p>	<ul style="list-style-type: none">• The cost to Australian business of raising capital from US financial institutions is expected to fall making this source of capital more affordable, and improving the international competitiveness of Australian business.
<p>4. Reduction of the royalty withholding tax (RWT) from 10% to 5% and the taxation of equipment royalties as business profits.</p>	<ul style="list-style-type: none">• 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 had indicated that gross-up obligations are commonly imposed (that is, the cost of RWT is paid by the Australian company via an additional charge).
<p>5. Improvement of arrangements for taxing gains accrued on assets held by departing residents.</p>	<ul style="list-style-type: none">• These improvements address widespread business concerns about the potential for double taxation arising from the application of Australia's CGT 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.

Australian and United States cross-border direct investment



Sources: ABS data.

ATTACHMENT B

STATIC ANALYSIS OF THE NET BENEFIT TO AUSTRALIA OF THE PROTOCOL

The ongoing revenue cost to the Commonwealth of the Protocol is estimated to be \$190 million per annum. This is the estimated revenue cost for 2004-05 shown in the published costings (the figures for the earlier years are affected by timing issues, and are not suitable indicators of the ongoing revenue cost).

The \$190 million estimate is a measure of the net revenue loss to the Commonwealth, but it is not a comparative static measure of the net benefit or loss to Australia of the Protocol. A comparative static measure of the net benefit or loss to Australia requires quantifying the immediate benefits for business of reduced costs arising from the agreed reductions in Australian and US withholding taxes and taking account of Australian revenue protected in respect of capital gains tax (CGT).

The attached table sets out the static gains and losses to Australians (both private and public sector) from the Protocol using the same assumptions and estimates used to calculate the revenue loss estimate of \$190 million for 2004-05. The only additional figure is an estimate of the ongoing capital gains tax revenue at risk if the Protocol does not take effect.

The first column in the table shows the gross revenue cost to the Commonwealth of the Protocol in 2004-05. That amount is \$275 million.

The second column shows the immediate benefits to business that are implicit in the revenue costing. Business benefits in two ways. Reductions in Australian royalty and interest withholding tax reduce the need (as discussed in Attachment A) for business to make gross-up payments. The costings assume that Australian business currently bear 50 per cent of the cost of these withholding taxes. Second, business also benefits from reduced US withholding taxes — principally dividend withholding tax.

The third column shows that as Australian business (and shareholders) benefit from reduced costs, that results in offsetting revenue gains for the Commonwealth — estimated to be \$85 million in total. For example, the reduced royalty payments will reduce a company's tax deductions and increase its assessable income. The gross revenue cost (\$275 million) is reduced by these offsetting gains (\$85 million) to give the net cost estimate of \$190 million.

The fourth column shows the Australian revenue protected by the treaty confirming Australia's ability to apply CGT to US residents. It is estimated to be on average in the order of \$85 million.

The net national benefit can then be worked out, and is shown in the fifth column of the table. On the loss side is the initial gross revenue lost (\$275 million). On the gain side, there are the benefits to Australian business and the offsetting revenue gains (in total \$260 million) and revenue protected (\$85 million). In total there is an estimated net benefit to Australia of \$70 million.

The table is a comparative static exercise, and not economic modelling. It does not attempt to trace through the consequences of the Protocol in terms of cross-border investment levels, technology access, reduced cost of capital and economic growth and jobs. The table does however illustrate that the assumptions underlying the \$190 million revenue estimate support a conclusion that Australia has a static net gain from the Protocol. The expected increase in cross-border trade and investment should add significantly to that gain.

Static gains and losses to Australia of the Protocol to the Australia - United States double tax convention, 2004-05 (a)

<i>Australian tax changes</i>	Gross revenue cost	Business cost reductions (b)	Offsetting revenue gains (c)	Revenue protected (d)	Net national benefit
	(1)	(2)	(e)	(3)	(1) + (2) + (3)
	\$m	\$m	\$m	\$m	\$m
Reduced Australia dividend withholding tax	-45	0	0	na	-45
Reduced Australia interest withholding tax	-90	45	15	na	-45
Reduced Australian royalty withholding tax	-140	70	20	na	-70
Affirmation of Australian CGT rights	0	na	na	85	85
<i>sub-total</i>	<i>-275</i>	<i>115</i>	<i>35</i>	<i>85</i>	<i>-75</i>
<i>United States tax changes</i>	Gross revenue cost	Business cost reductions (f)	Offsetting revenue gains (c)	Revenue protected	Net national benefit
	(1)	(2)	(e)	(3)	(1) + (2) + (3)
	\$m	\$m	\$m	\$m	\$m
Reduced United States dividend withholding tax	na	140	50	na	140
Reduced United States interest withholding tax	na	(g)	(g)	na	(g)
Reduced United States royalty withholding tax	na	5	-	na	5
<i>sub-total</i>	<i>na</i>	<i>145</i>	<i>50</i>	<i>na</i>	<i>145</i>
Total (h)	-275	260	85	85	70

- (a) This table is based (except for the CGT figure) on the assumptions underlying the revenue estimates in the 2001-02 MYEFO, 2001 PEFO and 2002-03 Budget Papers.
- (b) It was estimated that 50 per cent of the benefit of the reduced royalty and interest withholding tax was derived by business in reduced costs.
- (c) Offsetting revenue gains as a result of reduced costs for Australian business. Potential CGT gains from increased market value of companies with United States operations and of company tax gain from improved opportunities to thinly capitalise United States operations are unquantifiable and are not reflected in these estimates.
- (d) Estimate of average revenue at risk if Australia's taxing rights not confirmed (current treaty does not directly address position of CGT).
- (e) Offsetting revenue gains do not impact on net national benefit as they represent a reallocation within Australia of the benefits of reduced business costs.
- (f) Estimated reduction in United States dividend withholding tax.
- (g) Not estimated.
- (h) The gross revenue cost plus the offsetting revenue gains gives the cost shown in the forward estimates of \$190 million.

ATTACHMENT C

THE REVIEW OF BUSINESS TAXATION AND DIVIDEND WITHHOLDING TAX (DWT)

- The Review of Business Taxation noted that several submissions had stressed the importance of Double Taxation Agreement issues, particularly relating to seeking a reduction in foreign DWT rates. Copies of the key submissions are attached:
 - PricewaterhouseCoopers;
 - Arthur Andersen;
 - The Minerals Council of Australia;
 - The Business Council of Australia and the Corporate Tax Association;
 - James Hardie Industries Limited;
 - KPMG; and
 - Lend Lease.
- The Review concurred with the views expressed in the submissions but noted that it is necessary to reach an outcome that provides net benefits to both countries.
- The Review argued that reducing foreign DWT would benefit Australia since more income would be returned to Australia and be subject to Australian tax.
- The Review recommended (recommendation 22.21) that Australia should press strenuously to have foreign tax on dividends on non-portfolio investment reduced in future treaties. The Review went on to note that this would significantly benefit Australian investment offshore, particularly into the United States which currently levies 15 per cent in the current DTA with Australia, but not in many of its other DTAs. The Review also noted that its recommendation had received strong support in submissions and consultations.
- Since the Review, consultations with the business community have been conducted on the US Protocol. This includes consultations through the Tax Treaties Advisory Panel (TTAP), and discussions with representatives of the financial services sector.