Regulation impact statement

Background

How tax treaties operate

1.1 Tax treaties facilitate international investment by removing or reducing tax barriers to cross-border movement of people, capital or technology.

1.2 International taxation is based on concepts of residency and source. Countries generally tax their residents on their world wide income. Countries also seek to tax non-residents on the income that is earned (or sourced) within their borders.

1.3 Double taxation can therefore arise when the country of residence and the country where the income is sourced both seek to tax the same income.

1.4 Tax treaties reduce or eliminate double taxation 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. For instance, countries agree to reduce withholding tax imposed on dividends, interest and royalties by the source state. In the absence of rules to relieve the resulting double taxation, international commerce would be seriously inhibited.

1.5 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.

1.6 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.

1.7 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 on Income and on Capital (OECD Model) (Australia being a member of the OECD and involved in the development of that Model). There are however, a few instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model.

Australia's investment and trade relationship with the Republic of Chile

1.8 Chile and Australia share a healthy and growing economic and trade relationship. Chile is Australia's third largest trading partner in Latin America, with two way trade totalling $1.275 billion in 2008-09. Total merchandise trade reached $883 million in 2008-09 (up 14.2 per cent from 2007-08). Major exports to Chile include coal ($136 million in 2008-09), beef, civil engineering equipment, and specialised machinery and parts. Australia's imports from Chile totalled $552 million in 2008-09 and included copper ($295 million), lead ores and concentrates, pulp and waste paper and wood. Two-way trade in services in 2008 totalled $392 million, of which Australian exports of services to Chile were $157 million.

1.9 Australian companies are significant investors in Chile, and its relatively open business environment has made it an ideal base for Australian companies looking to expand into Latin America. There are approximately 120 Australian companies actively trading with Chile. More than half of the Australian or Australian affiliated companies with offices in Chile are related to the mining industry, though this has diversified in recent years. Australian Bureau of Statistics figures show that in 2008, total Australian investment in Chile was $2 billion. Significant Australian private sector investors include BHP Billiton (mining) and Pacific Hydro (power generation).

Policy objective

1.10 The objective of this measure is to:

- promote closer economic cooperation between Australia and Chile by reducing taxation barriers; in particular avoiding double taxation of income arising from overlapping tax jurisdictions; and
- improve the integrity of the tax system by providing the framework through which the tax administrations of Australia and Chile can prevent international fiscal evasion.

Implementation options

1.11 The implementation options for achieving the objectives are:

- no further action – rely on existing unilateral measures; or
- to conclude the tax treaty.

Option 1: No further action – rely on existing unilateral measures

1.12 If nothing was done, existing tax barriers, such as high withholding tax rates and significant compliance costs in meeting source country taxation obligations, will remain. This will constrain international trade and investment and the cross border movement of people, capital and technology. While domestic law measures will generally provide relief from double taxation for Australian residents deriving income from Chile, Australian tax on Chilean investment in Australia is in certain cases only deductible, and not creditable, under Chile's domestic law in the absence of a tax treaty. Tax discrimination will not be prevented and uncertainty with respect to the tax treatment of cross border income flows will remain. Tax administrations will not be able to exchange information necessary for the protection of Australia's tax base and the prevention of international fiscal evasion. Therefore this approach is not practicable in this instance.

Option 2: Conclude the tax treaty

1.13 The internationally accepted approach to meeting the above policy objectives is to conclude a bilateral tax treaty. A new tax treaty would be largely based on the current OECD Model and the United Nations *Model Double Taxation Convention between Developed and Developing Countries,* with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

1.14 For business and investors generally the tax treaty has the advantage of providing some degree of legal and fiscal certainty – unlike domestic laws which can be amended unilaterally.

Assessment of impacts

Difficulties in quantifying the impacts of tax treaties

1.15 Only a partial analysis of costs and benefits can be provided because all of 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 growth gains and losses to Australia that provide estimation problems. Analysis has been conducted to establish offsetting increases in Australian revenue as a result of the other country reducing their taxes under the treaty. The revenue estimates are subject to more uncertainty than the estimates of costs but are best estimates given the technology of estimation, the availability of estimates of behavioural responses, and data.

1.16 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (for example, 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. Tax treaties provide increased certainty and reduce complexity and compliance costs for business.

Impact group identification

1.17 A tax treaty with Chile is likely to have an impact on:

- Australian resident individuals with cross-border dealings in Chile;
- Entities with cross-border dealings in Chile. It is expected that this will comprise large multinationals and Australian companies with foreign shareholdings;
- Tax practitioners who have clients with cross-border dealings in Chile;
- Software developers, financial planners and bookkeepers who have clients with cross-border dealings in Chile;
- the Australian Government; and
- the Australian Taxation Office (ATO).

Analysis of costs/benefits – Option 2: Conclude the tax treaty

Economic benefits

1.18 A new tax treaty with Chile, a country with which Australia does not currently have a treaty, would address business concerns about the lack of competitiveness for Australian investments in Chile in relation to investment in Chile by our competitors. In particular, the treaty would provide for reductions in withholding tax rates.

1.19 It is only in the context of a tax treaty that Chile would agree to limit domestic withholding tax rates on certain interest and royalties. The new treaty provides for similar rates of withholding on interest and royalties to those provided for under Chile’s other tax treaties. It also includes ‘most favoured nation' obligations with respect to Chilean withholding tax rates on dividends, interest and royalties. This will assist in maintaining the competiveness of Australian business and their dealings in Chile into the future.

1.20 While a reduction in maximum withholding tax rates, insofar as those reductions affect Australian withholding taxes, will involve a cost to Government 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.

Other benefits

1.21 Where Australians carry on business activities in Chile, the new treaty would prevent Chile from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment (such as a branch) in Chile. The tax treaty would establish an arm's length basis for allocation of profits to that permanent establishment. This principle also applies where a Chilean enterprise carries on business activities in Australia. In addition to reducing Chilean income tax payable by Australians, the treaty would limit the circumstances in which Chile could impose tax on capital gains.

1.22 Other benefits also include:

- clarifying the residency rules;
- clarifying the treatment of profits derived through trusts from business activities;
- establishing specific rules for taxation of shipping and airline profits and income from real property;
- providing anti-profit shifting (transfer pricing) rules, including time limits for initiating audit activity;
- establishing non-discrimination rules to prevent tax discrimination against Australian nationals and companies operating in Chile and vice versa;
- establishing a framework to allow the tax administrations to exchange taxpayer information. These rules meet the internationally agreed tax standard for exchange of information. Furthermore they will further enhance Australia's efforts to combat tax avoidance and evasion, and will support global action on improving information exchange and transparency;
- protecting Australia's tax base by including anti-avoidance and limitation of benefits rules; and

- special rules to preserve the application of existing tax arrangements between Chile and Australian companies under the provisions of the Chilean legislation DL 600 (Foreign Investment Statute).

Revenue benefits

1.23 While a reduction in source taxation generally involves a cost to revenue, there are expected to be benefits to revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

1.24 Including exchange of information provisions in the new treaty with Chile will often result in an expansion of taxpayer information available to the Commissioner of Taxation in relation to these countries. This is expected to increase taxpayer compliance and tax revenue.

Compliance and administrative cost reduction benefits

1.25 The establishment of a treaty between Australia and Chile which is broadly consistent with international norms would generally be expected to reduce compliance costs.

Revenue costs

1.26 Treasury has estimated the impact of the first round effects on forward estimates as ‘not zero but rounded to zero’.

Administration costs

1.27 The administrative impacts on the ATO from the changes made by the new treaty are considered to be minimal.

1.28 The administrative impacts on the ATO from the changes made by any new treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example, private binding rulings, concerning the application of the treaty. Staff from the ATO, 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.

1.29 The cost of negotiation and enactment of new tax treaty arrangements with Chile is minimal and have mostly been borne by Treasury. 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.

1.30 There are also ‘maintenance’ costs to the ATO associated with tax treaties and mutual agreement procedures (including advance pricing arrangements). Given that treaties are deals struck between the two countries that reflect specific features of the bilateral relationship, some level of differential treatment or wording between Australia's normal practice and the proposed new treaty with Chile, which may require interpretation or explanation by the ATO, is inevitable.

Consultation

1.31 The then Prime Minister and Chilean President issued a joint communiqué announcing the commencement of negotiations for a tax treaty between Australia and Chile on 14 July 2005. Following this announcement Treasury invited interested parties to make submissions on the proposed tax treaty. Four submissions were received from the public with further submissions endorsing the conclusion of a tax treaty being received in response to the Government's review of Australia's tax treaty negotiation policy and program announced in the then Assistant Treasurer's Press release No. 4 of 2008.

1.32 Confidential consultation with peak industry and professional bodies is carried out on an on-going basis through the Tax Treaties Advisory Panel.

Conclusion and recommended option

1.33 While the existing unilateral rules go some way to satisfying the policy objectives of this measure by providing a measure of protection against double taxation of Australian investments in Chile, they are unable to resolve all areas of difference. For example, differences could arise over fundamental matters such as the source of the income and residence of taxpayers. Unilateral measures are also unable to remove tax barriers, such as limited or no double tax relief in the other country, high withholding tax rates and significant compliance costs in meeting source country taxation obligations. These barriers can only be addressed by a tax treaty.

1.34 By establishing an internationally accepted framework for the taxation of cross-border transactions the proposed new treaty would also reduce investor risk. In addition, a tax treaty, would address business concerns about the lack of competitiveness for their Chilean investments. The tax treaty is unlikely to result in increased compliance costs for business.

1.35 There would also be benefits to both Australia and Chile in terms of bilateral relationships and information exchange.

1.36 On balance the benefits of the proposed tax treaty outweigh the costs. The tax treaty should be enacted.