

Documents tabled on 14 May 2008:

National Interest Analysis [2008] ATNIA 17

with attachments on consultation and background information on relevant international tax issues

Protocol Amending the Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of Income of 1999, done at Pretoria on 31 March 2008

[2008] ATNIF 2

NATIONAL INTEREST ANALYSIS: CATEGORY 2 TREATY

SUMMARY PAGE

Protocol Amending the Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 1999, done at Pretoria on 31 March 2008 [2008] ATNIF 2

Nature and timing of proposed treaty action

1. The proposed treaty action is to bring the *Protocol Amending the Agreement between the Government of Australia and the Government of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 1999* (the Protocol) into force. The Protocol will amend the existing *Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income [1999] ATS 34* (the Agreement), signed on 1 July 1999. The Protocol will enter into force upon an exchange of notes confirming that each Party has completed the necessary domestic requirements to bring the Treaty into force (Article 13).

2. The Protocol will have effect with regard to Australian taxes in respect of income earned from 1 July in the calendar year following the date on which the Protocol enters into force. However, in regard to withholding tax (WHT) levied by Australia upon income that is derived by a non-resident, the Protocol will have effect on income derived on or after the first day of the second month following the date on which the Protocol enters into force. In addition, Article 10 of the Protocol (which contains a revised provision relating to the exchange of information) will have effect from the day the Protocol enters into force and Article 11 of the Protocol (which inserts provisions relating to assistance in the collection of taxes) will have effect from a date to be agreed in an Exchange of Notes through the diplomatic channel.

Overview and national interest summary

3. The key objectives of the Protocol are to: (i) meet Australia's most favoured nation (MFN) obligations with South Africa under the existing Agreement; (ii) promote closer economic cooperation between Australia and South Africa; and (iii) upgrade the framework through which the tax administrations of Australia and South Africa can prevent international fiscal evasion.

4. The Protocol aligns WHT rates on dividends, interest and royalties and capital gains tax treatment more closely with the Organisation for Economic Co-operation and Development (OECD) practice and improves integrity measures within the Agreement; in particular, by extending the scope of the existing exchange of information provisions and introducing provisions that provide for the cross-border collection of tax debts.

5. The Protocol is expected to reduce barriers to bilateral trade and investment caused by overlapping taxing jurisdictions of Australia and South Africa. In particular, reduced WHT rates on interest and royalty payments will make it cheaper for Australian businesses to obtain business loans and intellectual property from South Africa.

Reasons for Australia to take the proposed treaty action

Meets Australia's international obligations to South Africa

6. The entry into force in 2003 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* [2003] ATS 22 triggered most favoured nation (MFN) obligations under the Agreement, requiring Australia to enter into negotiations with South Africa with a view to establishing rules to protect nationals and businesses of one country from tax discrimination in the other country. Australia's MFN obligations will be met when the Protocol enters into force.

Reduces barriers to bilateral investment and trade

7. The Protocol is expected to reduce barriers to bilateral trade and investment by reducing WHT rates on interest and royalty payments between the two countries. Rather than taking unilateral action to reduce WHT rates under domestic law, Australia has adopted the approach of agreeing to any such reductions on a reciprocal, bilateral basis. This approach "locks-in" the WHT rate limits in both countries, ensuring a steady financial framework for business between the treaty partner countries. It also means that Australia is able to exclude "tax havens" from accessing these concessions. Please see **Attachment B** for an overview of how Australia's WHT rules work.

8. Reduced WHT rates on interest and royalty payments is expected to make it cheaper for Australian businesses to obtain business loans and intellectual property from South Africa. While a South African company is legally liable for interest and royalty income earned in Australia, contracts are often structured so that the Australian company is required to absorb the tax (this commercial practice is often referred to as a "gross up" clause arrangement). Consequently, lowered WHT rates on interest and royalties are expected to reduce costs for Australian businesses. Please see **Attachment C** for further details.

Accommodates announced changes to South African domestic law, which will benefit Australian investors

9. The existing Agreement provides for a dividend WHT rate of zero for non-portfolio inter-corporate dividends that are paid out of profits that have borne the normal rate of company tax and a rate of 15 per cent for all other dividends. These existing rates reflect the fact that South Africa currently levies no dividend WHT. Instead, South African corporate profits are subject to tax in two parts: a primary company tax; and an additional secondary tax on companies (STC) (currently 12.5 per cent, reducing to 10 per cent from 1 October 2007). The STC is imposed on the company for net dividends distributed (that is, dividends distributed less dividends earned). Significantly, the STC, as a tax borne by resident South African companies, has not been subject to treaty limitations.

10. The South African Government announced in its 2007/08 Budget that the STC will be phased out and replaced by a dividend tax on shareholders, which will be subject to treaty limitations. This is subject to the renegotiation of several tax treaties, including its tax treaty with Australia. To facilitate South Africa's domestic law changes the Protocol provides for dividend WHT at a rate of 5 per cent for non-portfolio inter-corporate dividends and 15 per cent for all other dividends, consistent with the OECD Model Tax Convention.

11. South Africa's proposed domestic law changes, combined with limitations on dividend WHT in the new Protocol, will benefit Australian investors. In the case of non-portfolio inter-corporate dividends, the Australian shareholder company would benefit from a reduction in total South African tax on the corporate profit since the South African dividend WHT is limited to 5 per cent under the Protocol. In the case of all other dividends, the overall South African tax rate would be the same, however, Australian investors would benefit from being able to claim a foreign tax credit in Australia for the dividend WHT. This will reduce their overall tax burden.

Upgrades the frameworks to prevent international fiscal evasion

12. The Protocol enhances the existing framework of the Agreement, which prevents international tax evasion, by updating the exchange of information rules to match the 2005 OECD standard and inserting assistance in collection provisions to help in the recovery of tax debts from those Australian taxpayers who move to South Africa.

13. The upgraded arrangements reflect the Government's desire to provide for more effective exchange of information on a broader range of taxes, for example, GST, and to provide for reciprocal assistance in collection of taxes.

Obligations

14. The Protocol makes a number of minor changes to the taxes covered in the Agreement (Article 1, amending Article 2 of the Agreement) and to the provisions of the Agreement dealing with residents (Article 3, amending Article 4 of the Agreement), permanent establishments (Article 4, amending Article 5 of the Agreement), dividends (Article 5, amending Article 10 of the Agreement), interest (Article 6, Amending Article 11 of the Agreement), royalties (Article 7, amending Article 12 of the Agreement) and the alienation of property (Article 8, amending Article 13 of the Agreement). The Protocol accordingly makes minor alterations to the type of property which Parties may tax and the rate of tax imposable.

15. The Protocol contains a new provision on non-discrimination (Article 9, inserting new Article 23A into the Agreement), requiring each Party, in levying taxes, to treat nationals of the other Party no less favourably than it treats its own nationals in similar circumstances. The article contains several express exceptions; for example, discriminatory taxation laws are permitted to prevent tax evasion and to provide tax deductions for expenditure on research and development. The Parties may also agree on further exemptions through an Exchange of Notes.

16. The Protocol extends obligations for the exchange of information (Article 10, amending Article 25 of the Agreement) between the two Parties, including a specific obligation to gather and provide information upon request. Consistent with the current article 25 in the Agreement, the Protocol imposes a correlative obligation on the Party receiving any such information to treat it in the same manner as information obtained under its domestic laws. It allows either Party to decline to provide requested information on limited grounds, including where to do so would be contrary to law or public policy.

17. The Protocol contains a new provision (Article 11, inserting Article 25A into the Agreement) that obliges each Party to take certain action in its own territory to assist the collection of

taxes owed to the other Party. The mode of application of Article 25A may be decided by mutual agreement between the Parties' taxation authorities. The requirement to provide such assistance is subject to certain conditions and limitations; for example, a Party is not required to provide assistance if the other Party has not pursued all reasonable measures of collection or conservancy available to it, or if the administrative burden to the Party whose assistance is requested is clearly disproportionate to the benefit to be derived by the requesting Party.

Implementation

18. As the Protocol affects Commonwealth income tax legislation, enabling legislation must be enacted by the Commonwealth to give the proposed Protocol the force of law in Australia. This will be achieved by amending the *International Tax Agreements Act 1953*, which currently gives domestic effect to the Agreement, to include the Protocol as part of the Agreement and inserting the text of the Protocol into a schedule to that Act. No action is required by the States or Territories. There is no change to the existing roles of the Commonwealth, or the States and Territories, in tax matters as a consequence of implementing the Convention.

Costs

19. Australian revenue would be reduced to the extent that Australian WHT is decreased and additional foreign tax credits in respect of South African dividend withholding tax (when introduced) exceed the reductions in foreign tax credits for South African withholding tax on interest and royalties. However, the cost to revenue arising from the Protocol is expected to be negligible.

20. No other material costs have been identified as likely to arise from the implementation of the Protocol. The closer alignment with international treaty practice would generally be expected to reduce compliance costs.

21. There would be a small, unquantifiable cost in administering the changes made by the Protocol, including minor implementation costs to the Australian Taxation Office (ATO) in educating the taxpaying public and ATO staff concerning the new arrangements. There are also 'maintenance' costs to the ATO and the Department of the Treasury in terms of dealing with inquiries, rulings and other interpretative decisions, mutual agreement procedures (including advance pricing arrangements) and OECD representation. However, these costs also apply to the existing Agreement and will continue to be managed within existing agency resources.

Second round impact of the Treaty

22. The costings do not include second round impacts on taxation revenue that arise from the flow on effects of the Protocol. The second round impacts on revenue are the impacts that arise as the change flows through to prices, wages and activity in other areas of the economy, which in turn may affect taxation revenue.

23. Treasury has not estimated the second round impact of the Protocol. This is because Treasury does not quantify the second round impact of minor policy proposals as the benefits are too small to measure with any degree of certainty. However, Treasury expects that the proposed interest WHT rate changes will reduce the effective cost of borrowing as Australian borrowers bear the burden of tax through "gross up" clause arrangements (see paragraph 8).

Regulation Impact Statement

24. The Office of Best Practice Regulation (Productivity Commission) has been consulted and has confirmed that a Regulation Impact Statement is not required.

Future treaty action

25. The Protocol does not provide for the negotiation of future legally binding instruments. Nor does it contain any amendment procedure. However, Article 39 of the *Vienna Convention on the Law of Treaties 1969* makes it clear that a treaty may be amended by agreement between the Parties. Any amendments would be subject to the domestic treaty process, including tabling and consideration by the Joint Standing Committee on Treaties.

Withdrawal or denunciation

26. The Protocol itself does not contain an express provision dealing with withdrawal or denunciation as it merely amends the more comprehensive Agreement. Article 28 of the Agreement has a termination clause which provides for termination by either Party on or before 30 June in any calendar year beginning after the expiration of 5 years from the date of its entry into force. The termination notice needs to be in writing and delivered through the diplomatic channel.

27. The Protocol shall form an integral part of the Agreement (Article 13). Therefore, should the Agreement be terminated, the Protocol will also cease to exist. As the Agreement has been in force for more than five years, pursuant to Article 28 of the Agreement, either Australia or South Africa can give a notice of termination of the Agreement in writing in any calendar year on or before 30 June.

Contact details

Tax Treaties Unit
International Tax & Treaties Division
Department of the Treasury

ATTACHMENT A

**Protocol Amending the Agreement between the Government of Australia
and the Government of the Republic of South Africa for the
Avoidance of Double Taxation and the Prevention of Fiscal Evasion
with Respect to Taxes on Income of 1999,
done at Pretoria on 31 March 2008**

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CONSULTATION

1. Treasury sought comments from the business community regarding the issues that might be raised during negotiations with South Africa through the Tax Treaties Advisory Panel members of which include:

- Business Council of Australia;
- CPA Australia;
- Corporate Tax Association;
- Institute of Chartered Accountants;
- International Fiscal Association;
- Investment and Financial Services Association;
- Law Council of Australia;
- Minerals Council of Australia; and
- Taxation Institute of Australia.

Please include the following information, in addition to who has been consulted;

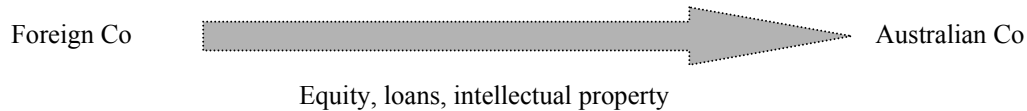
- at what stage they were consulted;
- what form the consultations took;
- what contributions were made, including support, concerns, suggestions and criticisms;
- how the feedback from consultations has been incorporated into the negotiations or text, and if feedback has not been integrated, why.

2. The State and Territory Governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information regarding the negotiation of the Protocol was included in the Schedules of Treaties to State and Territory representatives on 12 February 2007.

ATTACHMENT B

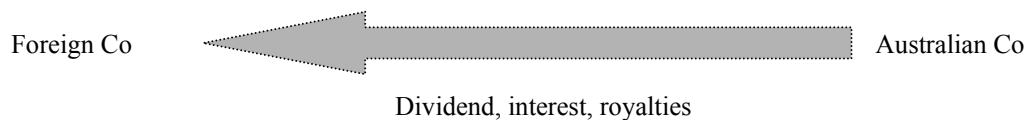
How do Withholding Taxes Work?

Step 1



An Australian company (Australian Co) obtains equity, loans, and intellectual property from a Foreign company (Foreign Co).

Step 2



In return for equity, loans, and intellectual property, Australian Co pays dividends (for equity), interest (for loans), and royalties (for intellectual property) to Foreign Co.

Step 3



Foreign Co earned dividend, interest, and royalties from Australia, so it is liable to pay Australian tax on that amount.

However, it is difficult for the Australian Taxation Office to collect tax from Foreign Co, since it is located outside Australia. Rather than requiring Foreign Co to lodge an Australian tax return, Australian Co is instead required to collect tax, by “withholding” an amount from its payment of dividend, interest, and royalties to Foreign Co. This amount of tax is referred to as a “withholding tax” (WHT).

ATTACHMENT C

The Effect of Lower Interest and Royalty Withholding Taxes

The South African recipients of outbound interest and royalty payments have the legal liability for withholding tax (WHT) on those payments. However, in commercial practice, those taxes will often be borne by the Australian payers. This is because:

- International lenders often have low profit margins. Consequently, they would not have an incentive to lend to Australian borrowers if those lenders had to bear the burden of interest WHT.
- An international owner of a unique intellectual property (for example, know-how, technology, etc) may be in a sufficiently strong bargaining position to demand that the Australian payer of the royalty also bear the cost of royalty WHT.

Under those circumstances, WHT on outbound interest and royalty payments will be borne by Australian businesses, effectively increasing their business costs.

Reduced Withholding Taxes under the Proposed Protocol

While interest WHT rates will continue to be 10 per cent, the proposed Protocol does provide an exemption (that is, a zero rate of WHT) for interest derived by South African financial institutions engaged in lending activities.

The general limit for royalties will be reduced from 10 to 5 per cent.

Expected Economic Benefits of Lowered Withholding Taxes

Lowered interest WHT rates are expected to reduce the burden of repayment placed on the Australian borrowers of South African debt, since they often have to bear the burden of the interest WHT:

- This is expected to make it cheaper for Australian businesses to borrow from South African lenders.
- Other things being equal, this should lead to increased economic activity.
- In turn, this is expected to result in an increase in the annual tax revenue, which should offset the cost of the interest WHT component of the proposed Protocol.

Similarly, lowered royalty WHT rates are expected to reduce the cost to Australian businesses that make royalty payments to foreign owners, since they often have to bear the burden of the royalty WHT:

- This is expected to make it cheaper for Australian businesses to obtain intellectual property from South Africa.

- Other things being equal, the cheaper cost of intellectual property should lead to increased economic activity.
- In turn, this is expected to result in an increase in the annual tax revenue, which should offset the revenue cost of the royalty WHT component of the proposed Protocol.