The Senate

Economics Legislation Committee

Provisions of the International Tax Agreements Amendment Bill 2003

November 2003

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CHAPTER 1

INTRODUCTION

Introduction and Referral

1.1 On 17 September 2003, the Senate adopted the Selection of Bills Committee Report No.11 of 2003 and referred the International Tax Agreements Amendment Bill 2003 to the Senate Economics Legislation Committee for consideration and report by 3 November 2003.

1.2 The principal issue identified by the Selection of Bills Committee as needing examination was the costs and benefits of the UK double tax agreement.

Purpose of the bill

1.3 The purpose of the bill is to provide legislative authority for the entering into force of two new comprehensive tax treaties with the United Kingdom and Mexico.[1]

1.4 The bill amends the *International Tax Agreements Act 1953* by incorporating the text of the two treaties into the schedules of the Act. The bill also makes consequential amendments to the *Income Tax Assessment Act 1936* and the *Taxation (Interest on Overpayments and Early Payments) Act 1983*.[2]

Background to the bill

1.5 Australia has tax treaties with a number of countries. Tax treaties are designed primarily to prevent the double taxation of income, described broadly as 'subjecting the same income of a taxpayer to comparable taxes under the taxation laws of two different countries'.[3] Tax treaties also aim to reduce tax avoidance and evasion.

1.6 Tax agreements between countries deal with income derived from a number of specific sources, such as business income, dividends, interest and royalties. The agreements provide for the taxation treatment which is to apply, and in particular specify which country may tax various categories of income and the limitations on the amount that may be taxed.[4]

1.7 The Explanatory Memorandum to the bill states that Australia's tax treaties are designed to:

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1 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.1.

2 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.4.

3 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.4.

4 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.1.

- avoid double taxation and provide certainty about which tax rules apply to international transactions; and
- prevent avoidance and evasion of taxes on various forms of income flows between treaty partners.[5]

1.8 Provisions for achieving these ends include allowing for the exchange of information between respective taxation authorities, allocating taxing rights between countries over different categories of income, and specifying rules to resolve dual claims or disputes.[6]

1.9 The treaties covered by this bill were signed between Australia and Mexico (signed 9 September 2002) and Australia and the United Kingdom (signed 21 August 2003).[7] The treaty with Mexico is an addition to Australia's network of taxation treaties; the treaty with the United Kingdom is the third comprehensive tax treaty between the two countries.[8] This new taxation agreement between Australia and the United Kingdom reflects modern business practices, changes to the respective tax systems and modern tax treaty practice.[9]

1.10 The Government has said that the tax treaties will facilitate trade and investment between Australia and Mexico, and Australia and the United Kingdom.[10] They are consistent with the policy commitments made by the Government as a result of the review of Australia's international taxation arrangements by the Board of Taxation.[11]

Submissions

1.11 The Committee advertised its inquiry into the International Tax Agreements Amendment Bill 2003 on the internet and in *The Australian*. In addition, the Committee contacted a number of individuals and organisations alerting them to the inquiry and inviting them to make a submission. A list of submissions received is at Appendix 1.

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5 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.5.

6 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.5.

7 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.1.

8 Australia has had a tax agreement with the United Kingdom since 1946, with the second comprehensive agreement concluded in 1967.

9 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.3.

10 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.3.

11 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.2.

Hearings and evidence

1.12 The Committee held one public hearing on this inquiry at Parliament House, Canberra, on Monday 13 October 2003. A list of witnesses who appeared is at Appendix 2.

Acknowledgement

1.13 The Committee is grateful to, and wishes to thank, the organisations and individuals who assisted with this inquiry.

CHAPTER 2

THE BILL

Introduction

2.1 This chapter outlines the provisions of the bill and provides an overview of the Government's assessment of its regulatory impact.

The bill

2.2 The *International Tax Agreements Act 1953* gives the force of law in Australia to international tax treaties, which are included as Schedules to the Act. The Schedules are the texts of the international agreements themselves. They are supplemented by subsequent Protocols which amend the main agreement identified in the Schedules.[1]

2.3 The bill amends the *International Tax Agreements Act 1953* to include as Schedules the texts of the new treaties signed between Australia and Mexico, and Australia and the United Kingdom.

2003 United Kingdom convention

2.4 The current tax treaty and protocol with the United Kingdom are currently contained in *Volume 1* of the *International Tax Agreements Act 1953* as Schedules 1 and 1A. The key provision of the bill, Schedule 1, Item 14, repeals the existing Agreement and Protocol with the United Kingdom in Schedules 1 and 1A and replaces them as a new Schedule 1 to the Act.[2]

Mexico agreement

2.5 The key provision of the bill, Schedule 2, Item 3, inserts a new Schedule 47 to *Volume 2* of the *International Tax Agreements Act 1953*. Schedule 47 comprises the full text of the Mexican agreement and protocol.[3]

Consequential amendments

2.6 Schedule 3 of the bill makes minor consequential amendments to the *Income Tax Assessment Act 1936*, the *International Tax Agreements Act 1953*, and the

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1 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.3.

2 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.4.

3 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.6.

Taxation (Interest on Overpayments and Early Payments) Act 1983 to update legislative references to the new treaties contained in the bill.[4]

Impact of the bill

2.7 The regulation impact statements prepared by the Treasury specify the policy objectives of the two treaties, and the estimated financial impact of the bill.

Mexico agreement

2.8 The three key objectives of the Australia-Mexico tax treaty are to:

- avoid double taxation of incomes arising from overlapping tax jurisdictions;
- prevent international fiscal evasion; and
- facilitate trade and investment between Mexico and Australia.[5]

2.9 The Treasury notes that if the tax treaty with Mexico were not implemented, it could be argued that these overall policy objectives would still be met through the internal tax laws of both countries. For example, 'unilateral enactment of foreign tax credit measures by Australia already provides substantial relief from juridical double taxation'.[6]

2.10 Nevertheless, the Treasury notes that a tax treaty has the advantage of providing legal and fiscal certainty to business and investors. It regulates the way the two countries would reduce double taxation and also records important bilateral undertakings in relation to exchange of information.[7]

2.11 The overall regulatory impact of the Mexican tax agreement is assessed as low.

2.12 The Treasury estimates that the cost of the Mexican agreement will be approximately $2 million per annum over the forward estimate period (until 2007-2008). The financial benefits of the agreement are not quantified. The Explanatory Memorandum to the bill states that 'indirect revenue benefits may arise from increased trade and investment between Australia and Mexico and reduced tax credit obligations to Mexico'.[8]

2003 United Kingdom convention

2.13 The regulation impact statement notes that the two key objectives of the existing tax treaty between Australia and the United Kingdom are to:

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4 Bills Digest No.41 2003-04, *International Tax Agreements Amendment Bill 2003*, p.6.

5 Submission 3, The Treasury, *Regulation Impact Statement: The Mexican Agreement*.

6 Submission 3, The Treasury, *Regulation Impact Statement: The Mexican Agreement*.

7 Submission 3, The Treasury, *Regulation Impact Statement: The Mexican Agreement*.

8 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.11.

- promote closer economic cooperation between Australia and the UK by eliminating barriers to trade and investment caused by overlapping tax jurisdictions; and
- create a framework through which the tax administrations of Australia and the UK can prevent international fiscal evasion.[9]

2.14 The new tax treaty, which replaces the 1967 tax treaty and 1980 protocol, is intended to advance these objectives by:

- providing enhanced legal and fiscal certainty for cross-border trade and investment;
- improving cooperation between the two tax administrations;
- modernising the tax treaty to reflect the latest tax treaty policies and practices of both countries;
- ensuring broad consistency in the taxation treatment of Australia's major trading partners, particularly in the light of the recently signed protocol to the Australia – USA tax treaty;
- facilitating and promoting future commercial relations between Australia and the United Kingdom; and
- giving effect to the Government's announcement of 11 November 1999 that priority be given to renegotiating Australia's aging tax treaties with major trading partners.[10]

2.15 The regulation impact statement notes that although the stated policy objective of tax treaties is to avoid double taxation and prevent fiscal evasion, their wider function is to facilitate investment, trade, movement of technology, and movement of personnel between countries, and to develop and strengthen bilateral relationships between countries, especially in commercial areas.[11]

2.16 The Treasury argues that a renegotiated tax treaty with the UK is important for our future commercial relations. The United Kingdom is the second largest foreign investor in Australia, the second largest destination for Australia investment overseas and an important gateway for investment flowing both ways between Australia and the European Union.[12]

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9 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

10 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

11 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

12 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

2.17 The overall regulatory impact of the United Kingdom convention is assessed as high.[13]

2.18 The direct cost to revenue from the proposed tax treaty is estimated to be approximately $100 million per annum. The cost is attributed to the following main changes in the revised tax treaty:

- a reduction in dividend withholding tax to nil or 5% on non-portfolio dividends derived by United Kingdom companies, down from 15% for unfranked dividends;
- an interest withholding tax exemption for interest paid to United Kingdom financial institutions (down from 10%); and
- a reduction in the general royalty withholding tax rate to 5% (down from 10%).[14]

2.19 There may also be 'knock-on' revenue costs as other countries seek reductions in withholding tax rates in line with those agreed between Australia and the United States, and Australia and the United Kingdom.[15]

2.20 The financial benefits of the tax convention with the United Kingdom are difficult to quantify.

2.21 The Treasury has said that there is no generally agreed methodology for quantifying the benefits of tax treaties.[16] Tax treaties affect levels of economic activity, efficiency and growth, but it is difficult to directly quantify the extent to which increased revenue can be directly attributed to the tax treaty itself.

2.22 The Treasury, however, has estimated that there is an expected increase in revenue of around $70 million per annum 'as a result of the boost to economic activity sourced in the proposed treaty's downward pressure on interest rates'. Other benefits are estimated to include a reduction of between $5 to $10 million per annum in Australian tax credits claimed for United Kingdom withholding taxes, an increase in GDP following from the more efficient allocation of resources and a small increase in Australia's growth rate. The Explanatory Memorandum concludes that: 'Overall, it is anticipated that the new treaty will produce a positive economic outcome for Australia'.[17]

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13 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.11.

14 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

15 Submission 3, The Treasury, *Regulation Impact Statement: The 2003 United Kingdom Convention*.

16 Submission 3, The Treasury, 'National Interest Analysis: Category A Treaty' [Mexico Agreement].

17 Explanatory Memorandum, International Tax Agreements Amendment Bill 2003, p.11.

CHAPTER 3

EVIDENCE TO THE INQUIRY

Introduction

3.1 All those who gave evidence to the Committee supported the Bill, although two submissions commented on drafting issues.

3.2 The evidence to the inquiry focused on the 2003 United Kingdom Convention. In particular, the evidence focused on the question of the costs and benefits of the agreement with the United Kingdom.

Costs and benefits of the UK agreement

3.3 As noted in Chapter 2, the Treasury has estimated the direct revenue costs of the agreement with the United Kingdom to be $100 million per annum. Although the Treasury has also estimated that that direct cost will be partially off-set by an increase in revenue of $70 million per annum, that off-set has not been included in the budget estimate. Mr Greg Smith, Executive Director, Revenue Group, Department of the Treasury told the Committee that:

> We have included that gross cost … without the offsets, because again that is the first round effect – and it is the first round effect that we have traditionally published. That is for the purpose of providing a costing of the measure … Some of these benefits will no doubt implicitly be included in future revenue forecasts but they are not in the current ones.[1]

3.4 Other evidence indicated, however, that the Treasury's forecast of estimated revenue benefits flowing from the tax treaties is shared by business groups.

3.5 Mr Frank Drenth, Chairman, International Tax Subcommittee, Business Coalition for Tax Reform, drew the Committee's attention to the larger than forecast company income tax collections for 2002-03. He noted that the budget estimate for that year was $28 billion, but that the actual revenue was $33 billion. He said:

> We are strongly of the view – although neither we nor anyone else can actually prove it – that a significant contributor to these higher than expected company tax collections lies in the process of estimating the revenue impacts of the business tax reform measures that have been churning their way through the parliamentary process over the last three or four years.[2]

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1 *Transcript of Evidence*, Smith, p.E11.

2 *Transcript of Evidence*, Drenth, p.E2.

3.6 Mr Drenth suggested that, by analogy, ‘we have a slight suspicion that, when the dust settles on the revenue impact of the UK treaty, it will not turn out to involve significantly high costs to the revenue’.[3]

3.7 In a similar vein, Ms Freya Marsden, Director Policy, Business Council of Australia, argued that the reform of the tax treaty will result over the long term in larger tax revenues for the government.[4]

3.8 Witnesses also drew attention to a number of other significant benefits arising from the agreement with the United Kingdom, including:

- modernisation of UK treaty;
- competitiveness of Australian business;
- clarification of treatment of capital gains; and
- access to Europe.

3.9 The following sections briefly outline the evidence in relation to these matters.

Modernisation of UK treaty

3.10 The joint submission from the Business Council of Australia (BCA) and the Corporate Tax Association (CTA) argued that it is ‘essential’ to update the current tax treaty between the Australia and the United Kingdom to reflect changes to Australian and UK treaty policy, tax systems and business practices. It expressed the view that the proposed new treaty with the United Kingdom will be aligned with modern business practices, the tax systems in each country and contemporary treaty policy, and will therefore facilitate trade and investment between the UK and Australia.[5]

3.11 The submission also noted that the new UK tax treaty extends to the UK the outcomes of the recently re-negotiated and ratified US protocol. It continued:

> It would be regarded as inequitable treatment not to extend similar withholding tax outcomes to an important treaty partner. The BCA and CTA believe it is important to ensure consisten treatment in Australian tax treaties to maintain integrity of Australia’s treaty network. This is important not only for diplomatic reasons but also to ensure that our international tax law is not inefficient or distortionary.[6]

3.12 The Business Coalition for Tax Reform similarly argued both that the revised tax treaty is desirable because it reflects changes in treaty policies and business

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3 *Transcript of Evidence*, Drenth, p.E3.

4 *Transcript of Evidence*, Marsden, p.E4. See also the same point argued by Mr Alfonso Capito, Partner, Taxation, Ernst and Young: *Transcript of Evidence*, Capito, p.E5.

5 Submission 1, Business Council of Australia and Corporate Tax Association, p.2.

6 Submission 1, Business Council of Australia and Corporate Tax Association, pp.2-3.

practices in both countries, and ensures the 'important' fact that 'the benefits arising from the US/Australia Protocol should equally apply to Australian companies investing in and trading with the UK'.[7]

Competitiveness of Australian business

3.13 Ms Marsden told the Committee that the new treaty will remove barriers to investment by ensuring lower withholding tax rates overall. She pointed particularly to provision for zero taxation for interest withholding for financial institutions, which will reduce the cost of capital. Ms Marsden said that this reduction in the cost of capital will benefit not only the BCA's larger members, but also small to medium sized enterprises.[8]

3.14 Ms Marsden also noted that the lowering of royalty withholding taxes will make it cheaper for Australian companies to use overseas technology, and will help Australian companies to grow. It will also mean, on the reverse side, 'that anyone who is trying to sell their know-how overseas in the UK will not be at such a competitive disadvantage'.[9]

3.15 Mr Capito also discussed the benefits of the lower cost of withholding taxes on dividends, interest and royalties. He said:

> In short, the lower you tax the import of capital in the form of equity and debt capital, and the lower you tax the import of technology by way of lower withholding tax costs, the cheaper it is for Australian companies to import the capital and the technology. Therefore, the more efficient Australian companies are, the more competitive they will be against foreign competition.[10]

Clarification of treatment of capital gains

3.16 A number of witnesses commented on the benefits arising from clarifying the taxation treatment of capital gains. Mr Capito noted that, under the existing treaty with the UK, there is doubt about whether Australia can tax non-residents when they sell shares in Australian companies. He said:

> If you have a non-resident with more than a 10 per cent holding in an Australian company, there is some doubt under the existing treaty whether that is taxable. This treaty makes it very clear that we can tax it. I have seen transactions where you would easily recoup $100 million of tax on just one

7 Submission 2, Business Coalition for Tax Reform, p.3. See similar arguments in Submission 5, Institute of Chartered Accountants in Australia, p.3.

8 *Transcript of Evidence*, Marsden, p.E4. See also, *Transcript of Evidence*, Drenth, p.E3.

9 *Transcript of Evidence*, Marsden, p.E4.

10 *Transcript of Evidence*, Capito, p.E5.

> transaction … From an Australian point of view, this is a very favourable treaty.[11]

3.17 The BCA and CTA commented that clarifying the treatment of capital gains will also facilitate investment, because it reduces uncertainty. Their submission notes that the new agreeement addresses the potential for double taxation arising from the application of Australia's capital gains tax to temporary workers departing Australia. This will assist Australian companies to attract and retain a skilled temporary work force, needed to help Australian businesses to expand.[12]

Access to Europe

3.18 Witnesses, finally, commented on the way in which the new agreement with the United Kingdom would facilitate trade and investment, not only with the UK, but with Europe generally.

3.19 Mr Capito said that the European Union (EU) directives are 'all about making sure that there are no withholding taxes within the EU'. Because of that, he noted, Australian companies use the UK as their base for investment into Europe and 'take their royalties, their interest and their dividend flows out of the European countries into the UK without any European tax'.

> If we enable a lower set of withholding taxes to apply between Australia and the UK, we are effectively putting in place a European treaty, which is a very important treaty for us – almost as important as and perhaps more important than the US treaty.[13]

3.20 Mr Richard Atkinson, Head of Taxation Australia, Rio Tinto Ltd, saw similar benefits arising from the UK agreement. He said:

> There is currently a European directive which covers withholding tax across the European Union. Basically, that allows zero withholding tax on dividends, interest and royalties, so there is a free flow of those three across the European Union. This treaty between Australia and the UK will allow the leg between Australia and the UK to be effectively withholding tax free. By default, if an Australian entity sets up a subsidiary in the UK it will allow that subsidiary to access the European Union.[14]

Other issues

3.21 Two submissions raised concerns about the drafting of the treaty in relation to the treatment of interest.

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11 *Transcript of Evidence*, Capito, p.E5.

12 Submission 1, Business Council of Australia and Corporate Tax Association, p.3.

13 *Transcript of Evidence*, Capito, p.E5. See also Submission 2, Business Coalition for Tax Reform, pp..2-3.

14 *Transcript of Evidence*, Atkinson, p.E7.

3.22 The Taxation Institute of Australia expressed concern about the interpretation of the scope of the 'interest article' which, it claimed, 'creates some confusion over the extent of the exemption from Australian withholding tax on interest payments in respect of a range of financial instruments held by United Kingdom financial institutions'.[15]

3.23 Deloitte Touche Tohmatsu specified its concern in more detail. It noted that the definition of 'financial institution' in article 11(3)(b) is given as:

> a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.[16]

3.24 The submission argued that the definition should be extended to include a wholly-owned subsidiary of a 'financial institution' as defined. This would ensure that the interest withholding tax exemption will apply where a financial institution conducts some of its business through a subsidiary.

3.25 Deloitte Touche Tohmatsu submitted that if the definition is not extended in this way, then there are circumstances under which the exemption from interest withholding tax would be denied 'merely because the UK financial institution provides finance to the Australian borrower via a wholly-owned subsidiary, rather than directly'.[17]

3.26 While recognising the 'impracticality' of amending the treaty itself, Deloitte Touche Tohmatsu suggested an amendment to the *International Tax Agreements Act 1953* along the following lines:

> A reference in an agreement to a financial institution shall be taken to include a reference to an entity that is a wholly-owned subsidiary of a financial institution (as defined in section 995-1 of the *Income Tax Assessment Act 1997*).[18]

Conclusion

3.27 The International Tax Agreements Amendment Bill 2003 will provide legislative authority for the entering into force of two new comprehensive tax treaties with the United Kingdom and Mexico.

3.28 The Committee notes that all those who gave evidence to the inquiry supported the passage of the bill.

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15 Submission 4, Taxation Institute of Australia, p.1.

16 Submission 6, Deloitte Touche Tohmatsu, p.1.

17 Submission 6, Deloitte Touche Tohmatsu, p.2.

18 Submission 6, Deloitte Touche Tohmatsu, p.2.

Recommendation

The Committee recommends that the bill be agreed to.

SENATOR GEORGE BRANDIS

Chairman

Appendix 1

Submissions Received

Submission Number	Submittor
1	Business Council of Australia
2	Business Coalition for Tax Reform
3	The Treasury
4	Taxation Institute of Australia
5	The Institute of Chartered Accountants in Australia
6	Deloitte Touche Tohmatsu

Appendix 2

Public Hearing and Witnesses

Monday, 13 October 2003 Canberra

ATKINSON, Mr Richard Duncan, Head of Taxation Australia, Rio Tinto Ltd

BERNFIELD, Mr Harry, Regional Manager Taxation, Asia Pacific, Brambles Industries Ltd

CAPITO, Mr Alfonso Joseph, Partner, Taxation, Ernst and Young

DRENTH, Mr Frank, Chairman, International Tax Subcommittee, Business Coalition for Tax Reform

MARSDEN, Ms Freya Verity, Director Policy, Business Council of Australia

McBRIDE, Mr Paul David, Manager, Tax Treaties Unit, International Tax and Treaties Division, Department of the Treasury

MYTTON, Mr Alistair Robert, Tax Manager, Corporate and Business Development, BHP Billiton Ltd

PARTINGTON, Mr Allan John, Senior Adviser, Tax Analysis Division, Department of the Treasury

PICKERING, Mrs Ariane Robin, Principal Adviser, Treaties, Department of the Treasury

SMITH, Mr Greg, Executive Director, Revenue Group, Department of the Treasury