Protocol to update Australia's Double Tax Convention (DTC) with Canada

Regulation Impact Statement

1. Specification of policy objective

Two key objectives of the existing Australia-Canada DTC ("the 1980 DTC") are to:

- promote closer economic cooperation between Australia and Canada by eliminating possible barriers to trade and investment caused by the overlapping taxing jurisdictions of the two countries. The existing DTC provides a reasonable element of legal and fiscal certainty within which cross-border trade and investment can be carried on; and

- create a framework through which the tax administrations of Australia and Canada can prevent international fiscal evasion.

The prime objective in *updating* the 1980 DTC is to make a significant advance in providing a competitive tax treaty network for companies located in Australia by reducing the rate of dividend withholding tax on Canadian - based subsidiaries and branches of Australian companies. Important secondary goals are to prevent double taxation of capital gains derived by Canadian residents on the disposal of interests in Australian entities while retaining Australian taxing rights, and to reduce maximum interest withholding tax rates. In other respects, revision of the DTC will align it more closely with developments in taxation law and administration since 1980 and with the modern DTC policies of the two countries.

2. Background

Ralph Review of Business Taxation

The Government agreed in its Stage 2 response to the Ralph Report's Review of Business Taxation recommendations that priority be given to renegotiating Australia's aging DTCs with major trading partners (in particular, with the United States of America, the United Kingdom and Japan) and that Australian investment offshore would significantly benefit from a lowering of dividend withholding tax on non-portfolio dividends (that is, dividends paid on 10% or greater shareholdings) under such DTCs.

The proposed Protocol was substantially negotiated prior to the Ralph Report recommendations, but accords with them. Canada is, as noted below, a significant trading partner, and in the top ten of destinations for Australian investment overseas.

How DTCs operate

Australian tax treaties are usually based on the OECD Model Tax Convention on Income and on Capital (OECD Model) with some influences from the United Nations' Model Double Taxation Convention between Developed and Developing Countries (UN Model). In addition, countries propose variations to these Models to reflect their particular economic interests and legal circumstances.

DTCs reduce or eliminate double taxation caused by the overlapping taxing jurisdictions because treaty partners agree (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 have a right to tax.

Australia seeks an appropriate balance between source and residence country taxing rights. Generally the allocation of taxing rights under Australia's DTCs is similar to international practice as set out in the OECD Model, but (consistent with our practice) there are a number of instances where it leans more towards source country taxing rights and the UN Model.

In addition, DTCs provide an agreed basis for determining whether the income returned or expenses claimed on related party dealings by members of a multinational group operating in both countries can be regarded as acceptable. DTCs are therefore an important tool in dealing with international profit shifting.

To prevent fiscal evasion, DTCs normally include an exchange of information facility. The two tax administrations can also use the mutual agreement procedures to develop a common interpretation and resolve differences of application of the DTC. There is also provision for residents of either country to instigate a mutual agreement procedure.

The 1980 Canada DTC

The Australia-Canada DTC was signed on 21 May 1980 and came into effect in 1981. Negotiations to update the DTC were held in 1996 and 1998, and some remaining issues have recently been settled by correspondence.

Australia's Trade and Investment Relationship with Canada[1]

Investment ties between Australia and Canada are substantial. The stock of Australian investment in Canada was valued at $2.8 billion in mid 1999, our 10th largest. Investment in Canada is chiefly in the mining, transportation and packaging sectors including through such major companies as TNT, Mayne Nickless and Western Mining. In 1998, BHP opened the billion-dollar Ekati diamond mine in the Northwest Territories. Canadian interests also have substantial investments in Australia, principally in mining and energy, food processing, computer software and media and communications. Canadian investment in Australia stood at A$1.75 billion in mid-1999, our 14th largest source of foreign investment.

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[1]Source: Department of Foreign Affairs and Trade, September 2001.

Canada is Australia's 16th-largest trading partner (A$3.6 billion) and 16th-largest market for merchandise exports. Australian exports to Canada were worth $1.8 billion in the year 2000-2001. Australia's principal exports are alumina, sugar and beef. Primary products as a proportion of total trade represent around 80 percent. A number of processed primary products, including wine and cereal preparations, have performed well in the Canadian market.

Canadian tax treaty practices

As at August 2001, Canada had entered into 71 bilateral tax agreements (with approximately 8 more finalised but not yet in force) and is engaged in negotiations with approximately 22 countries. In general, Canada adheres to the OECD Model.

Canadian tax system/rates (as modified by the 1980 DTC)

Under the unamended1980 DTC, Canada's domestic withholding tax rates for dividend and interest payments to non-residents (currently 25% for each in the absence of the DTC), are limited to 15%. The DTC restricts withholding tax rates on royalty payments (currently 25% under Canadian law, subject to a lower DTC rate) to 10%.

An Australian resident's business profits will only be taxable in Canada if the Australian resident has a permanent establishment in Canada and those business profits are attributable to that permanent establishment, following the OECD Model. In the absence of the 1980 DTC, such business profits would be subject to Canada's domestic income tax if the taxpayer is an individual (currently between 17-29% plus provincial tax) and Canada's branch tax where applicable (currently 25%).

The 1980 DTC also provides that Australian residents receiving income from professional services will only be taxable in Australia (and therefore will not be subject to Canada's domestic individual tax) unless they have a fixed base in Canada. Australian residents deriving professional services income through their fixed bases in Canada may be taxed in Canada on that income at Canada's domestic individual rates.

The 1980 DTC also provides that employees are generally only taxable in the country where the services are performed, although Australian employees on certain short visits to Canada will be exempt in relation to their employment income in Canada.

Amendments anticipated as a result of revising the 1980 DTC

One of the most significant changes resulting from revising the 1980 DTC would be the adoption of a split rate dividend withholding tax. The practical result of implementing a change of this kind, is that certain non-portfolio dividends (those which are also fully franked, in the case of dividends flowing from Australia to Canada) would be taxed at a maximum rate of 5% as opposed to the current DTC rate of 15%. While each country would be allowed to impose a Branch Profits Tax, the limit would be reduced to 5%, rather than the 15% allowed under the 1980 DTC. Only Canada currently has such a tax, which would be levied at 25% without a DTC reduction.

Other changes to be made in the proposed revision of the 1980 DTC include:

- making **definitional changes** to reflect current practices. Specifically, the definitions of "Australia" and "residence" as well as the meaning of 'substantial equipment' permanent establishments;

- revising the ***Income from Real Property*** Article to conform to modern Australian drafting practice, ensuring the Article will cover leases and exploration for natural resources;

- inserting a new provision dealing with **interposed trusts** in relation to permanent establishments, consistent with Australia tax treaty practice;

- reducing the **interest withholding tax** rate limitation from 15% to Australia's usual treaty rate of 10%;

- expanding the **definition of royalty** in conformity with current Australian tax treaty practice to expressly include technological advances in relation to satellite and cable broadcasting as well as reproduction techniques in connection with television, in order to remove any doubt as to whether they are covered by the current definition;

- clarifying the operation of the **royalties** provision in the case of use of software;

- revising the ***Alienation of Property*** Article in line with current Australian tax treaty practice, including ensuring that the coverage extends to real property owned through corporate or other entities, and helping to avoid double taxation when a resident of one of the Contracting States departs to become a resident of the other;

- modifying the treatment of employment income in the ***Dependent Personal Services*** Article by removing the current monetary limits;

- updating the ***Source*** Article to reflect current Australian tax treaty practice;

- provision of **credits for underlying taxes** on a reciprocal basis;

- a provision clarifying the relationship of the amended DTC with the **General Agreement on Trade in Services**, in accordance with current Australian (and wider OECD) treaty practice;

- A provision required by Canadian tax treaty practice to confirm that the amended DTC does not prevent the operation of certain **Canadian legislation applying to interests of Canadian residents**.

3. Identification of implementation option(s)

The implementation options for achieving the policy objectives are:

1. no further action - rely on the existing DTC; or

2. negotiate an amending Protocol to the 1980 DTC; or

3. renegotiate the 1980 DTC in its entirety.

Option 1: No further action - rely on the existing DTC

The implementation of this option requires no further action on the part of the ATO or any other organisation. The policy objectives would not be achieved.

Option 2: Negotiate an amending Protocol to the 1980 DTC.

The proposed Protocol would update the DTC to:

- reduce the rate of dividend withholding tax on Canadian-based subsidiaries and branches of Australian companies;
- reduce the rate at which Canada could impose Branch Profits Tax from 15% to 5%;
- prevent the double taxation of capital gains derived by Canadian residents on the disposal of Australian entities, while retaining Australian source country taxing rights;
- reduce maximum interest withholding tax rates; and
- achieve the other policy outcomes noted above.

Implementation of this option is achieved by negotiating only those Articles of the 1980 DTC which are considered to be pivotal to achieving the policy objectives of the revision. This limits the scope of negotiations, potentially avoiding contentious areas, resulting in shorter negotiations.

Option 3: Renegotiate the 1980 DTC in its entirety

Renegotiation of the 1980 DTC in its entirety would allow for a general overhaul of the 1980 DTC to ensure that its original objectives are being adequately met. Every area of the 1980 DTC would be examined and negotiated. Under this option, a lengthier period of negotiations would be required, with little more being achieved of in terms of achieving the policy objectives.

4. Assessment of impacts (costs and benefits) of option

Impact group identification

A revised DTC is likely to impact on Australian residents who derive amounts from Canada and on Canadian residents who derive amounts from Australia, particularly the former. The extent of this impact will depend in particular on the advantage taken of the reduced rates in repatriating dividends back to Australia from Canada.

The main groups initially affected by a reduction in the rate of Canadian dividend withholding tax and from comprehensively covering the taxation of capital gains in the DTC are likely to be the at least 38 major Australian companies with investments in Canada and publicly listed Canadian companies with investments in Australia. Persons affected by changes in investment flows between the countries would also be impacted. Any Australian banks lending to Canadian residents should also benefit from reduced Canadian interest withholding taxes. The small number of mining companies operating between the two countries may be affected by the changes to the 'substantial equipment' provisions.

The Australian Taxation Office (ATO) will need to administer the changes to the DTC and Government policy in relation to taxation of Canadian residents could be constrained by changes to treaty obligations, but as those changes closely accord with our other modern DTCs, that is not likely to be significant.

Australian employees working in Canada and vice versa may also be impacted by the amendments to the Dependent Personal Services Article, but the changes are not likely to have any significant impact, since the monetary limits under which the country where the work is performed may currently not tax the income, and which the Protocol would remove, are very low in current conditions.

Assessment of costs

Option 1: No further action - rely on existing DTC

As this option represents a continuance of the current position, it would be expected that the administration and compliance costs of this option would be minimal. Because the current treaty is not in line with international best practice, there may in fact be a slight increase in the administration costs of retaining the 1980 DTC, however, due to issues arising from the interpretation and application of the outdated provisions contained in the DTC. There is a clear cost to those investing in Canada as the terms of the 1980 DTC disadvantage Australian investors in Canada in comparison to those from many other countries.

Option 2: Negotiate an amending Protocol to the 1980 DTC

Revision of the 1980 DTC is not expected to result in increased administration or compliance costs for the ATO. In fact, the modernisation of the terms of the DTC could be expected to lead to a reduction in costs. An example is that the removal of the money limits in the Dependent Personal Services Article allows the ATO to apply the same general approach to the application of this Article as in most of our DTCs, and is not required to address updating the monetary limits (which was provided for as a possibility in the 1980 DTC but never occurred). Similar issues arise in the many other areas where the DTC is being aligned with modern tax treaties practice. A major example is the clear coverage of capital gains generally. This avoids the risk of double taxation of such gains, which may have some compliance costs from the ATO perspective, such as engaging in a mutual agreement procedure.

The negotiation of an amending Protocol (involving one round of formal negotiations in Australia) and the subsequent enactment of any resulting amendments has been at a cost of approximately $46,000. Most of these costs have been borne by the ATO, although other agencies, such as Treasury and the Department of Foreign Affairs and Trade would bear some of these costs. There would also be an unquantified cost in terms of Parliamentary time and drafting resources in enacting any amendments to the 1980 DTC, though these would not be large, based on similar agreements in the past.

There is already a small unquantified "maintenance" cost to the ATO associated with the administration of the 1980 DTC in terms of dealing with enquiries, mutual agreement procedures and Advance Pricing Agreements, OECD representation, etc. Any changes to the 1980 DTC would result in further minor implementation costs to the ATO.

A revised DTC is not expected to result in increased compliance costs for taxpayers. The closer alignment with more recent treaty practice would probably reduce them. The reduced dividend and interest withholding rates, will for example, give those investing in Canada greater freedom in structuring their investments and repatriating dividends and interest. Likewise the clear coverage of capital gains means that the difficult issues of the applicable law in such cases, and the issue of how double taxation of such gains can be avoided, brings the situation into line with most of our DTCs and with most tax treaties, which address capital gains tax where it is levied and seek to avoid double taxation on the gains.

The removal of the monetary amounts under which employment in a country during a visit of less than 183 days would not be taxed would possibly disadvantage some taxpayers, however the figures are so low ($Can 3,000; $Aus 2,600) since they have never been increased under the 1980 DTC that this is likely to have little or no practical impact.

There might be some reduction in Australian Government revenue from taxation of Canadian investments and other business activities in Australia, but in view of the enhanced anti-avoidance aspects of the DTC, and that the dividend and interest reductions only reflect Australian domestic law reductions already applying, any reduction is likely to be minimal.

On the other hand, further limitation of Canadian taxation rights in circumstances where Australia may have given credit for Canadian taxation may lead to increased Australian tax revenue. The main areas in this respect are the imposition of Canadian royalty withholding taxes and interest withholding taxes. Canadian withholding taxes are generally imposed at a 25% rate subject to the reduction by a DTC. By reducing the maximum rate of dividend withholding tax from 15% to 5% in most cases and of interest withholding tax from 15% to 10% the amount of tax effectively paid by Australian residents to the Canadian revenue is likely to be reduced. As both the unamended 1980 DTC and the treaty in its amended form require Australia to give a tax credit for such taxes paid on dividends and interest flowing from Canada to an Australian resident, the lower withholding tax rates would reduce the amount of such required credit in cases where the Australian resident was able to use the credit. The effect is likely to be somewhat balanced by the increased likelihood of repatriation under the lower rates. As to dividends flowing from Australia to Canada and interest

flowing in the same direction, the lower rates only reflect our domestic law anyway, so the situation of Canadian investors in Australia is not affected.

It should also be recognised that DTCs generally limit the flexibility of treaty countries' policy in relation to cross-border taxation. However, given the existence of the 1980 DTC, and the fact that most changes align the DTC to Australia's recent treaty practice, the effect of revising the DTC, in terms of reduced policy flexibility, will only be very marginal.

Option 3: Renegotiate the 1980 DTC in its entirety

The costs associated with this option are generally the same as for Option 2, with the exception that the actual administrative costs associated with meeting for negotiations may be greater if some of the issues become difficult to agree on. Although occasionally an agreed text can be settled in a single week of negotiations, substantial renegotiation of an existing DTC often takes at least 2 rounds of negotiations. There may also be additional unquantified costs in terms of Parliamentary time and drafting resources in enacting additional amendments to the 1980 DTC. Based on the experience of previous DTCs, that is only likely to be minimal.

Assessment of benefits

Option 1: No further action - rely on existing DTC

This option represents the *status quo*. By adopting this option there would be no need for further action and resources could be devoted to other issues.

Option 2: Negotiate an amending Protocol to the 1980 DTC.

It is anticipated that the proposed amending Protocol would result in the clarification of the operation of the DTC and bring it into line with current domestic law and treaty practice. Consequently, such a revision would further assist the development of trade and economic cooperation between Australia and Canada, and would be likely to reduce the administration and compliance costs of the ATO and the Canadian tax authority.

Specifically, it is expected that revision of the 1980 DTC would result in the reduction of Canadian taxation on dividends and interest and therefore be of direct benefit to Australian investors in Canada. The cost of Australian investment in doing business in Canada and the international competitiveness of those seeking to lend to Canadian enterprises would be enhanced by those lower rates, and there would be greater freedom as to how such activities are structured, which should itself reduce the costs of such enterprises.

In the broader sense, DTCs play a role in 'growing' investment and trade between countries. As indicated above, reducing the cost of our residents doing business abroad and promoting international investment would increase the returns on Australian capital and maximise gross national product, so that the Australian tax revenue would be increased.

These benefits are expressed in broad terms. This is because the ATO has not been able to precisely define the costs and benefits to the revenue of DTCs. The specific reasons why it has not been possible to forecast the costs and benefits of a DTA in more than a general sense include:

- the range of income covered by a DTA;
- the time period for which a DTA will operate (usually 15 or more years);
- the difficulty of obtaining adequate data;
- the fact that domestic tax rules may already provide relief for foreign taxes;
- the relationship with increased trade and investment flows; and
- the prospective nature of such flows as well as the time lag which will be involved in 'growing' trade and investment.

This has been a difficulty internationally. A 1991 OECD study[2], indicates, however, that there is a slight improvement in the required rate of return on the cost of capital when there is a DTC in existence as compared to where there is no DTC. The OECD study concluded that 'it is possible to be relatively positive about the effects of the current network of double tax treaties, since they both lower the average required return and they reduce the variance in required returns between alternative locations'[3].

In 1993-4, the OECD considered the feasibility of a study specifically assessing the impact of DTAs on investment flows between countries, but it was concluded that no further work could usefully be done by it on the subject at that time. The main reason was that it found almost no empirical work has been undertaken in this area, largely because of the difficulty of obtaining adequate data.

By extending taxing rights in relation to the *Permanent Establishments* Article and the *Income from Real Property* Article, in line with the changes proposed to be made as a consequence of revision of the 1980 DTC to include the exploration of natural resources, it is anticipated that the Australian revenue may benefit, due to the size of Canadian activity in the area.

Option 3: Renegotiate the 1980 DTC in its entirety.

This option offers the same benefits as Option 2. In addition, it allows for a more general updating of the 1980 DTC, which in turn provides for the text of the resulting DTC to be in one document with consistent language.

Consultation

Information has been provided to the States and Territories through the Commonwealth-State Standing Committee on Treaties' Schedule of Treaty Action.

[2] See OECD, *Taxing Profits in a Global Economy: Domestic and International Issues*, Paris 1991. p.143.

[3] At p 144.

The amending Protocol has been be considered by the ATO's Tax Treaties Advisory Panel of industry representatives and tax practitioners. That Panel has been notified of developments in the renegotiation since 1998 and has been supportive of the package of proposed changes. The Protocol will be considered by the Parliamentary Joint Standing Committee on Treaties prior to treaty action, and that Protocol is likely to provide for public consultation in its hearings.

5. Conclusion

Revision of the 1980 DTC is desirable to ensure that the objectives of the 1980 DTC are advanced and reflected in the modern business and taxation environment. Based upon a cost benefit analysis, Option 2 is considered to be the preferable option for implementing the revision. Negotiating an amending Protocol will maximise the objectives of revision whilst limiting costs. Such an amending Protocol can be viewed as a necessary part of the general maintenance work associated with Australia's existing DTC network.

By modernising the 1980 DTC to reflect international best practice, ease and efficiency of the administration of the treaty will be enhanced, thereby reducing both administration costs as well as compliance costs. Proposed reduction of dividend and interest withholding taxes payable by Australian investors in Canada, and those lending to Canadian entities, will benefit such investors. It will also specifically address the taxation of Australian capital gains, rendering that issue more certain.

The Treasury and the ATO would monitor the amending Protocol, as part of the whole taxation system, on an ongoing basis. In addition, the ATO has consultative arrangements in place to obtain feedback from professional and small business associations and through other taxpayer consultation forums.