PROTOCOL, DONE AT CANBERRA ON 23 JANUARY 2002, AMENDING THE CONVENTION BETWEEN AUSTRALIA AND CANADA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME, DONE AT CANBERRA ON 21 MAY 1980

Documents tabled on 27 August 2002:

- **National Interest Analysis**
- **Text of the proposed treaty action**
- **Regulation Impact Statement**

Protocol, done at Canberra on 23 January 2002, amending the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, done at Canberra on 21 May 1980

NATIONAL INTEREST ANALYSIS

Proposed binding treaty action

1. It is proposed to bring into force the Protocol. Once in force the Protocol will amend Articles 2 (*Taxes Covered*), 3 (*General Definitions*), 4 (*Residence*), 5 (*Permanent Establishment*), 6 (*Income from Real Property*), 7 (*Business Profits*), 8 (*Shipping and Air Transport*), 10 (*Dividends*), 11 (*Interest*), 12 (*Royalties*), 13 (*Alienation of Property*), 15 (*Dependent Personal Services*), 22 (*Source of Income*), 23 (*Elimination of Double Taxation*), and 24 (*Mutual Agreement Procedure*), of the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, done at Canberra on 21 May 1980 ("the Convention"). A new Article, 26A (*Various Interests of Canadian Residents*), will also be added to the Convention by the Protocol.

Date of proposed binding treaty action

2. The Protocol was signed in Canberra on 23 January 2002. In accordance with Article 17, the Protocol will enter into force on the date of the last notification that the statutory and constitutional requirements of each Party have been met. It is proposed that Australia provide such advice to Canada by the end of 2002. If the Protocol enters into force during the 2002 calendar year, it will have effect in Australia in respect of withholding taxes from 1 January 2003 and for all other taxes from 1 July 2003.

Date of tabling of the proposed treaty action

3. 27 August 2002.

Summary of the purpose of the proposed treaty action and why it is in the national interest

4. A key objective of the Protocol is to update the Convention to align it with current tax treaty policies and practice. Since the Convention was signed in 1980, both Australia and Canada have modified various aspects of their respective tax treaty practices. Such variations have occurred due to changes in the domestic tax law of both countries or to accord with OECD tax treaty practices. For Australia, the main impact of the Protocol (which is to be read as an integral part of the Convention) will be on Australian enterprises investing in and trading with Canada. The Protocol will assist in enhancing the already substantial bilateral framework for trade and investment relations with Canada and is likely to reduce the administration and compliance costs to business and individuals required to deal with the Australian Taxation Office (ATO) and the Canadian Customs and Revenue Agency (CCRA).

5. In particular, the maximum rates of tax allowed to be imposed by the source country on dividends and interest have been reduced and comprehensive *Real Property* and *Alienation of Property* Articles (Articles 6 and 13 respectively) have been included to deal with capital gains tax matters. Latest international practice as set out in the OECD *Model Tax Convention on Income and on Capital* ("the OECD Model") is also incorporated into the Convention. The Protocol amending the Convention does not significantly alter the balance of taxing rights between the two countries.

Reasons for Australia to take the proposed treaty action

Bilateral investment

6. There are approximately 100 Australian companies active in the Canadian market with sizeable investments in breweries, mining, transportation and packaging sectors. Canada now ranks as the 14th largest source of investment in Australia while Australia's reciprocal investment in Canada ranks 11th. Overall, Canada is Australia's 17th largest trading partner with two way trade reaching $A3.6 billion in the 2000-2001 financial year.

Reasons for the Convention and the Protocol

7. As with all double tax treaties, the underlying **objectives of the Convention** are (i) 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 Convention provides a reasonable element of legal and fiscal certainty within which cross-border trade and investment can be carried on; and (ii) to create a framework through which the tax administrations of Australia and Canada can prevent international fiscal evasion.

8. The Convention reduces or eliminates double taxation by requiring Australia and Canada to limit taxing rights over various types of income. For example, the Convention contains the standard tax treaty provision that neither country will tax business profits derived by an enterprise of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment and the income is attributable to that permanent establishment (Article 7). The countries also agree on methods of reducing double taxation where both countries have a right to tax.

9. In addition, the Convention provides 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 (Articles 7 and 9) and in doing so addresses fiscal evasion by means of international profit shifting. Another feature of the Convention that assists in the prevention of fiscal evasion is the exchange of information facility (Article 25). The two tax administrations can also use the mutual agreement procedures to develop a common interpretation and resolve differences of application of the Convention.

10. The **objective of the Protocol** is to modernise the text of the Convention to reflect the latest tax treaty policies and practices of Australia and Canada. The Protocol negotiations were not intended to be a comprehensive review of the 1980 Convention, rather the approach was to modify and update the Convention where possible, in areas where both Parties felt there was the most need.

11. The Convention as amended by the Protocol has an impact on – (i) the Governments of Australia and Canada; (ii) Australians and Canadians investing in and trading with the other country; and (iii) Australians and Canadians working in or supplying services to the other country.

12. The Protocol will substantially reduce Canadian taxation on interest and dividends flowing to Australians. It also restricts the circumstances in which Australians trading with Canada will be taxed by requiring the existence of a permanent establishment in Canada before Canadian taxation will take place (although in practice Canada's domestic taxing rules adopt a similar approach). Modernising the text of the Convention will assist Australian investors by increasing the certainty of the taxation rules applying to the cross-border investment. Therefore it is likely to reduce compliance costs not only for the ATO and the CCRA, but for Australian investors also.

Overview of the Protocol

13. The Convention applies to residents of either Australia or Canada (Article 1). The taxes to which it applies are to be modified by the Protocol, reflecting Australia's abolition of its undistributed profits tax and the separate introduction of a resource rent tax. As amended, the Convention applies to the following taxes – (i) income taxes imposed under the Canadian Income Tax Act; and (ii) the Australian federal income tax, including the resource rent tax (Article 2).

14. The **definition of Australia** has been revised to conform with Australia's current drafting approach by formally including the Territory of Heard and MacDonald Islands (Article 3(1)). Also a **definition of international traffic** has been included for the purposes of the *Alienation of Property* Article (Article 13) and the *Dependent Personal Services* Article (Article 15) of the Convention, as amended by the Protocol.

15. A redundant provision (Article 3(1)(k)) which deemed words in the singular to include the plural meaning (and vice versa), has been deleted from the Convention as it is considered to be implicit, and **Article 3(3)** of the Convention, which allows recourse to definitions prescribed by domestic law where a term has not been defined in the Convention, has been revised to accord with recent changes to the OECD Model.

16. The **definition of residence** has been revised to conform with the latest OECD Model, which now specifically includes the Governments within the definition.

17. The scope of the "**substantial equipment**" provision in Article 5(4)(b) of the permanent establishment definition has been widened. Amendments made by the Protocol mean the substantial equipment test is no longer confined by a 12 month time test or the application to natural resources. Substantial equipment being used in a State, "in connection with a building site or construction, installation or assembly project" will now be explicitly excluded from being deemed a permanent establishment. This provision has been included to ensure that building sites, which would not otherwise constitute a PE, are not caught under Article 5(4)(b) of the Amended Convention.

18. The Protocol completely revises the ***Income from Real Property* Article** (Article 6) to conform to current Australian drafting practice by enabling the Article to cover leases and exploration for natural resources.

19. **Article 7(6)** of the Convention, which sets out the **relationship between the *Business Profits* Article and other provisions** dealing with business profits, has been revised consistently with the latest OECD Model, and a new paragraph (8) dealing with **interposed trusts** in relation to permanent establishments has also been added to Article 7 to maintain consistency with Australian tax treaty practice.

20. A minor modification to Article 8 of the Convention, which deals with **shipping and air transport,** has ensured that internal transport includes journeys which return to the port of origin, such as certain cruise ship operations.

21. The **taxation of dividends** provisions (Article 10) have undergone three changes. The first change involves a "split rate" formula being adopted similar to the formula incorporated in Australia's most recent tax treaties (Article 10(2)). Here a split rate of 5% for non-portfolio dividends and 15% for all other dividends has been implemented. Generally, a reciprocal reduction in dividend withholding tax rate limits has been achieved. The rules for the lower 5% have been customised for the internal laws of the two Contracting States. Canada and Australia use a slightly different test for defining a "non-portfolio" shareholding. Canada uses a "voting power" test, while Australia adopts a "control" test.

22. Canada excludes non-resident owned investment corporations ("NRO's") from the reduced withholding tax rate (Article 10(2)(a)(ii)). Income of NROs is subject to a 25% refundable tax when the dividend is paid by the NRO to its foreign parent, at which time a dividend withholding tax becomes payable. It is Canadian policy in its tax treaties to retain the higher 15% tax rate on such dividends.

23. The second change modernises the definition of the term ‘dividends’ (Article 10(4)).

24. The third change is a reduction to the limitation on Canadian and Australian branch profits taxation to 5%, consistent with the reduced dividend withholding tax rate limits (Articles 10(6) and (7)). Non-resident corporations carrying on business in Canada are subject to normal domestic tax rates in Canada, plus an additional branch tax. Under Canadian domestic law, the rate of branch tax (25%) is reduced to the tax treaty rate of withholding tax on dividends paid to non-residents (5%). This provision is in line with Canada's reservation to the OECD Model's Dividend Article.

25. The use of specific provisions to authorise the imposition of a branch profits tax are not strictly necessary because Article 7(1) of the 1980 Convention authorises unlimited source country taxation of the profits of permanent establishments. However, in view of Canada's branch profits tax it was thought desirable to include such a provision because this would expressly limit the exposure of Australian companies to such a tax, to the agreed treaty rate.

26. The **interest withholding tax** rate limitation has been reduced from 15% to 10% by the Protocol (Article 11(2)).

27. The **definition of royalties** has been expanded in conformity with current Australian tax treaty practice (Article 12). The definition now specifically includes payments for the reception or use of transmissions by satellite, cable, fibre optic or similar technology (Article 12(8)), as well as reproduction techniques in connection with television (Article 12(3)). These were inserted in order to remove any doubt as to whether they were covered by the previous definition. The definition also specifically excludes payments for the use or acquisition of source code of software that is granted purely to enable effective operation of the program by the user.

28. The amended Convention will clearly address the **taxation of capital gains** based on modern Australian tax treaty practice (Article 13). To further counter the avoidance of taxation of real property income by the country in which the real property is situated, a specific provision dealing with **land rich entities** is contained in the Protocol (Article 13(4)). Under the provision, profits arising from the sale of shares or other interests in land rich companies or other entities, whether the land is held directly or indirectly, also give rise to taxation in the country in which the real property is situated.

29. The treatment of employment income (**dependent personal services**) has been substantially modified by the Protocol including the deletion of the former monetary limits (Article 15). Existing arrangements for taxation by the Contracting State in which employment is exercised have been modified to conform with modern Australian and OECD tax treaty practice.

30. The **source rule** contained in Article 22 has been revised to conform with modern Australian tax treaty practice.

31. The method by which **relief from double taxation** (Article 23) was provided by Australia and Canada in the Convention has been revised in the Protocol to reflect their respective current treaty practice, although Australia has not substantively altered its current practices. Australia will still apply its foreign tax credit system to allow a credit for Canadian tax paid in respect of the corresponding foreign income.

32. Canada will also allow credit for Australian tax paid in a manner similar to that utilised by Australia but with one minor difference. Whereas Australia considers that 'exemption with progression' is implicit in its credit provision, Canada formally provides for exemption with progression within its credit rules, so this has been explicitly expressed in subparagraph 2(c). "Exemption with progression" means that the country of residence may take into account income over which the country of residence does not have a taxing right for the purposes of calculating tax on the income over which it does have taxing rights.

33. The credits to be provided by both Australia and Canada will include a credit on underlying tax payed by a company in the other Contracting State, where that company controls at least 10% of the voting power in the company to which it paid the dividend.

34. As suggested in the OECD Model Commentary, the Protocol includes a provision requiring the consent of both Canada and Australia before the World Trade Organisation General Agreement on Trade in Services (GATS) process for **dispute resolution** can be utilised (Article 24(6)). This requirement has been implemented to prevent a single country from unilaterally initiating the dispute resolution proceedings in the jurisdiction of their choice.

35. The majority of OECD member countries accept that anti-abuse measures, such as the controlled foreign corporation (CFC) rules, are a necessary means of attaining equity and neutrality of international tax laws. Australia considers that its CFC regime is consistent with the requirements of the Convention, as amended by this Protocol. In particular, Australia considers there is no conflict between the CFC rules and Articles 7 and 10(5) of the Convention. Australia's CFC regime does not tax foreign companies, it taxes residents based on the profits of CFCs. However, it is Canadian treaty practice to **expressly preserve the operation of its CFC rules** in its double tax treaties. This has been achieved by the insertion of Article 26A into the convention.

Obligations

36. The Protocol requires the two Governments to relieve double taxation of cross-border income in accordance with its terms. The Protocol does not impose any greater obligations on residents of Australia than Australia's domestic tax laws would otherwise require.

37. The Convention also establishes procedures for mutual agreement of issues that may arise under the Convention (Article 24), for the exchange of information (Article 25), and the notification of substantial changes in the respective laws of each country that affect the taxes covered by the Convention (Article 2).

Implementation

38. As the Protocol affects Commonwealth income tax legislation, enabling legislation must be enacted by the Commonwealth to give it the force of law in Australia. This will be achieved by incorporating the text of the Protocol as a schedule to the *International Tax Agreements Act 1953*. No action is required by the States or Territories and no change to the existing roles of the Commonwealth or the States or Territories will arise as a consequence of implementing the Protocol.

Costs

39. The Protocol is not expected to result in increased administration or compliance costs. In fact, modernisation of the terms of the Convention may actually 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 double taxation treaties.

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

41. 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 Convention as amended by the Protocol, and that the dividend and interest reductions only reflect Australian domestic law reductions already applying, any reduction is likely to be minimal.

Consultation

42. In February 1998 the Protocol was submitted for consideration by the ATO's Tax Treaties Advisory Panel (TTAP), which consists of private sector representatives and tax practitioners who review proposed treaty action. As advice on tax treaty matters is largely provided to industry through specialist and tax professional firms, membership of the TTAP is composed of tax professional specialists, industry representatives and officials from the ATO, the Commonwealth Treasury and the Department of Foreign Affairs and Trade. The Panel includes representatives from the Australia Bankers' Association, Law Council of Australia, Taxation Institute of Australia, Institute of Chartered Accountants, Australian Society of Certified Practising Accountants, Corporate Tax Association, Business Council of Australia, Minerals Council of Australia, International Fiscal Association, and the Australian Industry Group. The Investment and Financial Services Association and the Australian Stock Exchange Limited became members of the TTAP in 2001.

43. The Panel supported the signature of the Protocol subject to further work on the "land-rich entities" provision – which had been revised following the decision in *Lamesa Holdings BV v FC of T* 97 ATC 4752. The ATO has now reached agreement with the Canadian tax authorities on a revised provision which it considers addresses the issues raised in this case.

44. Information in relation to the Protocol has been provided to the States and Territories through the Commonwealth-State-Territories Standing Committee on Treaties' Schedule of Treaty Action. To date there have been no requests for further information.

Regulation Impact Statement

45. A Regulation Impact Statement is attached.

Future treaty action: amendments, protocols, annexes or other legally binding instruments

46. The Protocol and the Convention do not provide for the negotiation of future legally binding instruments (although this does not preclude the two Governments from agreeing in the future to further amend the Convention).

Withdrawal or denunciation

47. The Protocol itself does not contain express provisions dealing with withdrawal or denunciation. The Convention, under Article 28 (*Termination*), provides for termination by either Government by giving a written notice to the other Government through the diplomatic channel. The termination becomes effective in Australia as from the start of the next income tax year. The termination shall become effective in Canada as from the start of the next calendar year.

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