

SECOND PROTOCOL AND EXCHANGE OF LETTERS, DONE AT GENTING HIGHLANDS, MALAYSIA ON 28 JULY 2002, AMENDING THE AGREEMENT BETWEEN THE GOVERNMENT OF AUSTRALIA AND THE GOVERNMENT OF MALAYSIA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME OF 20 AUGUST 1980, AS AMENDED BY THE FIRST PROTOCOL OF 2 AUGUST 1999

Documents tabled on 27 August 2002:

- **National Interest Analysis**
- **Text of the proposed treaty action**
- **Associated Exchange of Letters**

Second Protocol and Exchange of Letters, done at Genting Highlands, Malaysia on 28 July 2002, amending the Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 20 August 1980, as amended by the First Protocol of 2 August 1999

NATIONAL INTEREST ANALYSIS

Proposed binding treaty action

1. The Second Protocol and Exchange of Letters will enter into force when the Australian and Malaysian Governments exchange diplomatic notes, advising that the domestic requirements for entry into force have been completed (Article 8 of the Second Protocol). Once in force, they will amend Articles 9 (*Associated Enterprises*), 10 (*Dividends*), 12 (*Royalties*), 21 (*Income of Dual Resident*), 23 (*Methods of Elimination of Double Taxation*), 24 (*Mutual Agreement Procedure*) and 27 (*Limitation of Relief*) of the Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income of 20 August 1980, as amended by the First Protocol of 2 August 1999 (“the Agreement”).

Date of proposed binding treaty action

2. The Second Protocol and Exchange of Letters were signed in Malaysia on 28 July 2002. They will enter into force once both countries have notified each other by an exchange of notes that they have completed their respective domestic requirements for their entry into force. It is proposed that Australia provides such notification to Malaysia before the end of 2002.

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. The Second Protocol and Exchange of Letters ensure that the “tax sparing” (see explanation at paragraph 7) provisions of the Agreement reflect changes made to the Malaysian tax incentives legislation and extend the operation of those provisions to 30 June 2003 at which time they will expire permanently. They include an anti-avoidance rule to limit Australia’s recognition of the tax sparing concessions to active income; exclude from receiving treaty benefits persons who benefit from the Labuan offshore business activity regime; and update the Agreement to reflect Australia’s current treaty practice in relation to a number of existing Articles, including those dealing with Associated Enterprises, Dividends, Royalties and Other Income.

5. The Second Protocol and Exchange of Letters represent a satisfactory outcome for Australia, especially in relation to the exclusion of Malaysia’s tax haven of Labuan, which was one of the main objectives of the negotiations. Having regard to the overall benefits that will accrue to Australia, there was a good case for accepting the 30 June 2003 expiry date for tax sparing. The proposed tax sparing is limited to concessions relating to active income (which will generally be derived by Australian residents in the form of exempt dividends), and, for the most part, relates to activities that have already been undertaken. The revenue cost of extending the tax sparing provisions to 30 June 2003, at which time they will expire permanently, is therefore not likely to be significant.

Reasons for Australia to take the proposed treaty action

Background

6. The Australia-Malaysia double taxation agreement (DTA) was signed in 1980. Tax sparing arrangements under the provisions of that DTA expired on 30 June 1984. The tax sparing arrangements were extended for three years, from 1 July 1984 to 30 June 1987 through an Exchange of Letters and again for another five years from 1 July 1987 to 30 June 1992 by the First Protocol amending the DTA signed on 2 August 1999. That Protocol entered into force on 27 June 2000.

7. Tax sparing refers to the situation where tax foregone (eg. in the form of tax holidays or tax reductions) by a foreign country on the income of an Australian resident taxpayer is *deemed* to have been paid (ie. the tax foregone is credited as if actually paid, under Australia's foreign tax credit system). The typical circumstances in which this arrangement operates is where tax incentives are offered by developing nations seeking to attract foreign investment. The rationale for tax sparing is that, without special provisions which recognise such incentives, they would be negated to the extent that the tax forgone by the source country would be collected by Australia.

8. The Malaysian Government had requested an extension to the tax sparing arrangements in the DTA, as amended by the First Protocol, beyond 30 June 1992. The Malaysian Government had been advised on several occasions of the Australian Government's general reluctance to grant further tax sparing incentives under Australia's DTAs (a position announced in the Government's 1997 Budget Statement) and that the Australian Government would allow existing incentives to generally lapse on expiry.

9. However the Australian Government had considered the Malaysian Government's request for a further extension of the tax sparing arrangements beyond 30 June 1992 and had approved further negotiations between officials in relation to the matter. The Australian Government's approval was given only on the basis that those further negotiations would also deal with the Australian proposal to exclude from receiving treaty benefits persons who benefit from the Labuan offshore business activity regime.

10. Australian Taxation Office (ATO) officials and their Malaysian counterparts met in Canberra on 9-10 May 2001, resulting in a draft Second Protocol and Exchange of Letters being initialled at officials' level. The officials reached agreement on all issues, with the exception of the date of expiry of the tax sparing provisions. The two sides agreed to seek approval from their respective Governments and to advise each other of the outcome by correspondence. Both Governments have now agreed to the 30 June 2003 expiry date for the tax sparing provisions, at which time they will expire permanently.

Key Features of the Second Protocol and the Exchange of Letters

11. The tax sparing provisions of the Agreement have been updated to reflect changes to the relevant Malaysian tax incentives legislation and the existing tax sparing provisions relating to passive income have been deleted. The operation of the tax sparing provisions have been extended from 1 July 1992 to 30 June 2003, at which time they will expire permanently.

12. Persons who benefit from the preferential tax treatment under the Labuan offshore business activity regime, and other substantially similar regimes are excluded from receiving treaty benefits (eg. reduced withholding tax rates on dividends, interest and royalties).

13. For Australia, nil dividend withholding tax (DWT) is to apply to Malaysian residents in receipt of franked dividends where they hold at least 10% voting power of the Australian company and 15% limit for all others. Malaysia currently does not impose DWT. The Agreement provides that, in the event of Malaysia subsequently introducing such a tax, the rate of DWT would not exceed 15%. The Second Protocol continues to preclude Malaysia from imposing DWT, but provides, in accordance with our treaty practice, that in the event of a significant change of the relevant law in either country, Australia and Malaysia would consult with a view to agreeing an appropriate amendment to that provision.

14. The definition of "royalties" is amended to take into account modern communications methods, and to include payments for spectrum licences.

15. A new paragraph is included in the *Associated Enterprises* Article (Article 9 of the Agreement) to provide for correlative relief where there is an adjustment of profits by the revenue authority of one of the two countries. The Article is aimed at preventing tax avoidance by multi-nationals not operating at arm's length. Where a reallocation of profits is made so that the profits of an enterprise of one country are adjusted upwards, a form of double taxation would arise if the profits so reallocated continued to be subject to tax in the hands of an associated enterprise in the other country. To avoid this result, the other country is required to make an appropriate compensatory adjustment to the amount of tax charged on the profits involved to relieve any such double taxation. The new paragraph replaces the former relief mechanism in the *Methods of Elimination of Double Taxation* Article (Article 23 of the Agreement) that requires Australia to give a credit to the resident company for the extra tax chargeable on the amount of adjusted profits of the associated foreign company.

16. The existing Article dealing with third country income of dual residents is replaced with an *Other Income* Article based on the Australian Model Double Tax Agreement which provides for source country taxation of income not otherwise dealt within the Agreement.

17. A provision is included, for the purposes of the General Agreement on Trade in Services, in accordance with Australian treaty practice, to deal with disputes which may be brought before the Council for Trade in Services.

Investment and Trade Relationship¹

18. Malaysia's rapid economic development, location and active participation in our immediate region, and its long-standing relationship with Australia in many spheres, makes Malaysia an important bilateral partner.

19. The bilateral relationship is diverse, with active and cooperative relations across a broad range of sectors. These include trade and investment, defence, education, tourism, sports cooperation, science and technology, narcotic control, aviation and newly emerging areas such as electronic commerce and cooperation on rural firefighting capacities.

20. In 2000, Australian exports to Malaysia totalled \$A2,363 million (major items being copper, milk and cream, non-monetary gold, aluminium, medicaments, wheat and sugar). In the same year Australian exports of services to Malaysia totalled \$A866 million. In 2000, Australian imports from Malaysia totalled \$A4,266 million (major items being computers, crude petroleum, telecommunications equipment, integrated circuits and furniture). In the same year, Australian imports of services from Malaysia totalled \$A841 million. In 2000,

¹Source: Department of Foreign Affairs and Trade

Australia was Malaysia's 12th largest trading partner whilst Malaysia was Australia's second largest trading partner in ASEAN and our 10th largest trading partner overall.

21. In 1999-2000, Australian investment in Malaysia totalled \$A389 million. In 2000, Australian investment in Malaysia in the manufacturing sector totalled \$A70 million. Investments from Australia for the period 1999 to 30 June 2001 in the manufacturing sector were mainly concentrated in machinery manufacturing, fabricated metal products, chemicals and chemical products. There are 115 non-manufacturing Australian companies registered with AUSTRADE, Kuala Lumpur concentrated mainly in information technology, import or distribution, building and construction, engineering, education and management services.

22. In 2000, Malaysian investment in Australia totalled \$A1,731 million. Malaysia is the second largest ASEAN investor, after Singapore, in Australia. There are 56 companies with Malaysian interest operating in Australia, concentrated mainly in food, tourism, hospitality, property investment and manufacturing.

Obligations

23. The Agreement requires the two Governments to notify each other of any significant changes to their tax law (Article 2) and to relieve double taxation of cross-border income in accordance with its terms (Article 23). The Agreement also establishes procedures for mutual agreement of issues (Article 24) that may arise under the Agreement and for the exchange of information (Article 25).

24. The Second Protocol lists the Malaysian tax incentives to be tax spared (Article 5 of the Second Protocol). Listed incentives are targeted at fostering genuine economic development and relate to active business income (eg. reinvestment allowance in relation to capital expenditure on a factory, plant or machinery and pioneer companies).

25. The tax sparing provisions in the Agreement expired on 30 June 1992. The Second Protocol extends the operation of those provisions to 30 June 2003, at which time they will expire permanently.

26. The Agreement contains a most favoured nation provision (paragraph 8 of Article 23). It provides that if Australia should subsequently conclude an agreement with a third country granting more favourable treatment in relation to underlying tax on dividends and tax sparing concessions, the Governments of Australia and Malaysia will enter into negotiations with a view to providing similar treatment to Malaysia.

27. The Second Protocol and Exchange of Letters generally do not add further to treaty obligations that arise from the Agreement.

Implementation

28. Enabling legislation will need to be enacted to give the Second Protocol the force of law in Australia. This will be achieved by incorporating the text of the Second Protocol as a schedule to the *International Tax Agreements Act 1953*. Legislation is not required for the Exchange of Letters.

29. No action is required by the States or Territories and no change to the existing roles of the Commonwealth, or the States or Territories in tax matters will arise as a consequence of implementing the Second Protocol and the Exchange of Letters.

Costs

30. The Second Protocol and Exchange of Letters are not expected to result in increased administration costs for the ATO because they further clarify the taxing rights of Australia and Malaysia under the Agreement.

31. The Second Protocol and Exchange of Letters are unlikely to result in increased compliance costs for business because no extra burden to comply is placed on them.

32. It is not possible to quantify with any degree of precision the tax likely to be forgone by the Australian Revenue in providing tax sparing credits for the Malaysian tax incentives. Much is dependent on the amount of the income subject to tax sparing, the amount of the Malaysian tax reduction or exemption applicable in respect of the particular income, the nature of the investment income, the legal structures used by Australians to make these investments, their need to remit or reinvest the income and their ability to utilise the tax spared foreign tax credits. The presently available information and statistics are of little help in this regard.

33. The proposed tax sparing is limited to concessions relating to active income (which will generally be derived by Australian residents in the form of exempt dividends), and, for the most part, related to activities that have already been undertaken. The revenue cost of extending the operation of the tax sparing provisions to 30 June 2003, at which time they will expire permanently, is therefore likely to be insignificant.

34. A further complication relates to the fact that the tax sparing provisions of the Second Protocol relate only to tax sparing granted by Malaysia for years of income up to and including the Australian year ended 30 June 2003. The amount of likely revenue forgone will to some extent be subject to taxpayers making a claim for amendment of tax assessments issued several years ago. The taxpayers that are likely to do this cannot be determined with any great certainty.

35. Subject to the above qualifications, an annual cost to Australian Revenue of around \$A2 million is estimated, with the greatest cost likely to occur towards the end of the period covered by the tax sparing provisions (ie. 30 June 2003).

36. It is relevant that the tax sparing measures in the proposed Second Protocol were found necessary during negotiations to secure its agreement to other measures in the Second Protocol and Exchange of Letters. These include updating the Agreement to reflect Australia's current treaty practice in a number of areas and in particular to the carve-out of the Labuan preferential tax regime, which represented a significant potential threat to the Australian tax base.

Consultation

37. In 1997 the ATO established a Tax Treaties Advisory Panel (TTAP) to review proposed tax treaty actions. As advice on double tax agreement matters is largely provided to industry through specialist tax professional firms, membership of the TTAP is composed of tax professional specialists, industry representatives and officials from the ATO, Commonwealth Treasury and Department of Foreign Affairs and Trade. The TTAP includes representatives from the Australian Bankers' Association, Certified Practising Accountants of Australia, Business Council of Australia, Corporate Tax Association, Institute of Chartered Accountants, International Fiscal Association, Law Council of Australia, Australian Industry Group, Minerals Council of Australia and Taxation Institute of Australia. The Investment and Financial Services Association and the Australian Stock Exchange Limited became members of the TTAP in 2001.

38. The TTAP was consulted on the Second Protocol and Exchange of Letters in May 2001 and February 2002 and supports their signature. The Australia-Malaysia Business Council (a member of the Australian Business Council who in turn is a member of the TTAP) has also been informed of the Second Protocol and Exchange of Letters.

39. Information on the Second Protocol and Exchange of Letters 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

40. A Regulation Impact Statement will accompany implementing legislation.

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

41. The Second Protocol and the Exchange of Letters do not provide for the negotiation of future legally binding instruments. However the Second Protocol provides that Australia and Malaysia are to consult on amendments to the *Dividends* Article if there are significant changes to either country's rules for taxing dividends. The Second Protocol also provides that Australia and Malaysia are to consult each other if laws subsequently established either in Australia or Malaysia grant preferential treatment to certain persons, with a view to deny treaty benefits to such persons in an Exchange of Letters.

Withdrawal or denunciation

42. The Second Protocol and Exchange of Letters do not contain express provisions dealing with withdrawal or denunciation as they amend the Agreement. The Agreement provides for termination by either of the Contracting States on or before 30 June in any calendar year after 1982 (Article 29). This means that either Contracting State can now give written notice of termination any time. If notice is given, the Agreement as amended would cease to have effect in Australia for income tax purposes for the year of income beginning on or after 1 July in the calendar year next following the year in which the notice of termination is given.

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