Chapter 4
Regulation impact statement

THE 2006 NORWEGIAN CONVENTION

Background

How tax treaties operate

#.1 Tax treaties reduce or eliminate double taxation caused by the exercise of source and residence country taxing rights on cross border income flows. They do so by treaty partners agreeing (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 exercise their right to tax.

#.2 In addition, tax treaties provide an agreed basis for determining the allocation of profits within a multinational company and whether the profits on related party dealings by members of a multinational group operating in both countries reflect the pricing that would be adopted by independent parties. Tax treaties are therefore an important tool in dealing with international profit shifting through transfer pricing.

#.3 To prevent fiscal evasion, tax treaties include provision for exchange of information held by the respective revenue authorities. Treaties may also provide for cross-border collection of tax debts, and may preclude certain types of tax discrimination. Taxpayers can also avail themselves of the mutual agreement procedures provided for in treaties which allow the two revenue authorities to consult with a view to developing a common interpretation and to resolving differences arising out of application of the treaty.

#.4 Australia seeks an appropriate balance between source and residence country taxing rights. Generally the allocation of taxing rights under Australian tax treaties is similar to international practice as set out in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (Australia being a member of the OECD and involved in the development of that Model). There are, however, a few instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model Tax Convention.

The Norwegian tax treaty

#.5 The existing Australia-Norway tax treaty was signed on 6 May 1982 and has effect from 1 July 1983 (for Australian tax purposes). With the entry into force of the Protocol to the United States (US) tax treaty on 12 May 2003, Australia was obliged, under the existing Norwegian treaty to provide most favoured nation (MFN) treatment in respect of the rates of tax applicable to dividends, interest and royalties. [1]

#.6 While the triggering of the most favoured nation clauses imposes certain obligations on Australia, it also presents an opportunity to update certain aspects of the current treaty including clarifying Australia's rights to apply capital gains tax (CGT).

Australia's investment and trade relationship with the Kingdom of Norway[2]

#.7 Major Australian merchandise exports to Norway (totalling A$121 million in 2005) include alumina, wine, gold, base metal manufactures, and medical instruments. Imports from Norway in 2005 totalled A$276.4 million and included pumps for liquids, telecommunication equipment, paper products, arms and ammunition and cheese/curd. These figures do not include, however, the very strong services trade between Norway and Australia in the education sector. Two-way trade in services was valued at A$354 million in 2005 and marginally (A$32 million) in favour of Australia. In 2005 there were just over 3,300 Norwegian students in Australia, of which 2,641 were undertaking higher education courses, making Australia one of the top destinations for Norwegian students overseas. The number of Norwegian students studying in Australia has declined from a high of 4,789 just two years earlier. This trend has been due to a Norwegian preference for students to remain in Norway to undertake higher education courses.

Investment

#.8 Norway has a significant level of investment in Australia, totalling just over A$2 billion, and ranked 16th. In 2004 Norway was the

[1] Most favoured nation clauses require a country to enter into negotiations with a view to providing similar treatment to its treaty partner if it subsequently agrees with a third country to a certain specified tax treatment.
[2] Source: Department of Foreign Affairs and Trade.

27th largest destination for Australian investment, with A$807 million invested, predominately in the mining sector.

#.9 Norway and Australia share common expertise in various industrial sectors, including oil and gas, mining, chemicals, and marine and shipping. This points to a receptive market for Australian technology and expertise in these sectors. There are a number of significant Norwegian companies with direct investments in Australia. These include the Kvaerner Group (oil and gas), Norsk Hydro (fertilisers/aluminium production) and Dyno Wesfarmers (explosives). In March 2005 the major Norwegian global investor Yara International ASA agreed to acquire a 30 per cent share of the world's largest ammonia plant (under construction) on the Burrup Peninsula in Western Australia, owned by Burrup Holdings Pty Ltd. It is estimated that the investment is in the order of $A100 million. In 2002 Yara had entered into a long term agreement with Burrup to market and sell 100 per cent of the production from the new plant. There is a small amount of direct Australian investment in Norway, largely concentrated in the mining sector.

Specification of policy objectives

#.10 The objective of the measure is to:

- meet Australia’s MFN obligations;
- promote closer economic cooperation between Australia and the Kingdom of Norway by reducing tax barriers to trade and investment between the two countries; and
- upgrade the framework through which the tax administrations of Australia and the Kingdom of Norway can prevent international fiscal evasion.

Identification of implementation option(s)

#.11 The internationally accepted approach to meeting the policy objectives specified above is to:

- amend the existing treaty to reflect current policies (amending Protocol); or
- conclude a new bilateral tax treaty.

Option 1: Limited amending Protocol (most favoured nation obligations) – rely on the existing tax treaty measures

#.12 In general terms, option 1 relies on the existing tax treaty measures with an amending Protocol covering, at a minimum, Australia's MFN obligations (dividends, interest and royalty withholding tax rates). Australia would also seek to clarify Australia's rights to tax capital gains.

Option 2: Amending Protocol covering most favoured nation obligations and revising the current treaty to the extent possible without entering into a complete renegotiation

#.13 Option 2 is to deal with a number of other issues, in addition to those proposed under Option 1, on which both sides would like to modify and update the existing treaty. Additional areas include for example, improved integrity measures; in particular, updated rules for the exchange of information on tax matters to the 2005 OECD standard and rules to allow for the cross-border collection of tax debts.

Option 3: Conclude a new tax treaty

#.14 Option 3 is to replace the existing treaty with a new bilateral tax treaty that reflects current policies and practice of both countries.

#.15 A new tax treaty would be largely based on the current OECD Model Tax Convention and the United Nations Model Tax Convention, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

#.16 Both countries have particular policy objectives to achieve in updating the tax treaty and the end result ultimately represents compromises necessary to achieve a mutually acceptable agreement. The key changes in a new treaty include:

- a reduction in the maximum royalty withholding tax rates from 10 per cent to 5 per cent;
- a reduction in interest withholding tax from 10 per cent to zero where interest is paid to a financial institution or body performing governmental functions;
- a reduction of dividend withholding tax from 15 per cent to zero for dividends on non-portfolio holdings of more than 80 per cent, subject to certain conditions and to 5 per cent dividend withholding tax for other non-portfolio holdings;

- inclusion of a comprehensive *Alienation of Property* Article which allocates taxing rights over capital gains;

- improved integrity measures; in particular, rules to allow for the cross-border collection of tax debts and updated rules for the exchange of information on tax matters; and

- new rules to prevent tax discrimination against Australian nationals and businesses operating in Norway and vice versa.

Assessment of impacts (costs and benefits) of each option

Difficulties in quantifying the impacts of tax treaties

#.17 Only a partial analysis of costs and benefits can be provided because all the impacts of tax treaties cannot be quantified. While the direct cost to Australian revenue of withholding tax changes can be quantified relatively easily, other cost impacts such as compliance costs are inherently difficult to quantify. There are also efficiency and growth gains and losses to Australia that provide estimation problems. Analysis has been conducted to establish plausible impacts on Australian economic activity and consequent tax revenue flowing from implementation of the tax treaty. The tax revenue estimates are subject to more uncertainty than the estimates of costs but are best estimates given the technology of estimation, the availability of estimates of behavioural responses, and data.

#.18 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (eg, the OECD) and from consultation with business strongly indicates, however, that while the quantum of benefits is very difficult to assess, a modern tax treaty provides a clear positive benefit to trade and investment relationships. Tax treaties provide increased certainty and reduce complexity and compliance costs for business.

Impact group identification

#.19 A revised tax treaty with the Kingdom of Norway is likely to have an impact on:

- Australian residents doing business with the Norway, including principally:

  - Australian residents investing directly in the Kingdom of Norway (either by way of a subsidiary or a branch);
  - Australians borrowing from Norwegian banks;
  - Australian residents using technology and know-how supplied by Norwegian residents;
  - Australian residents supplying consultancy services to the Kingdom of Norway; and
  - Australian residents exporting to the Kingdom of Norway;

- Australian employees working in the Kingdom of Norway;
- Australian residents receiving pensions from the Kingdom of Norway;
- the Australian Government; and
- the ATO.

Assessment of benefits

#.20 All options would address long term business concerns about the lack of competitiveness of Australia's tax treaty network with business particularly seeking reductions in withholding tax rates.

#.21 These issues were addressed in the 2003 Convention with the United Kingdom (UK) and the 2001 Protocol amending the Convention with the US. Extending similar treatment to Norway aligns treatment, where possible, in Australia's recent tax treaties, maintains the integrity of Australia's treaty network and discourages treaty shopping (and the consequent degradation of the tax base of countries where the costs of capital and intellectual property are higher under their treaties as a result of the higher withholding tax rates). While a reduction in maximum withholding tax rates will involve a cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

Economic benefits common to all options

#.22 The economic benefits of the expected major changes from the existing tax treaty are summarised in paragraphs #.23 to #.29.

Dividends

#.23 An outcome such as that provided to the US and UK (no withholding tax on dividends paid to a company with an 80 per cent or greater voting interest in a listed company in the other jurisdiction; 5 per cent withholding tax where the interest is at least 10% of the voting power and 15 per cent in other cases) would remove distortions in the raising of capital that results from the more favourable terms that currently apply bilaterally in the case of the US and the UK.

Interest

#.24 A nil Australian interest withholding tax rate on interest derived by Norwegian financial institutions will be consistent with the exemption currently provided under domestic law for interest derived from widely distributed arm's length debenture issues. It also recognises that a 10 per cent interest withholding tax rate on gross interest derived by financial institutions may be excessive given their cost of funds. It should, accordingly, lower the costs of borrowing in those cases where the financial institution can pass the cost represented by the withholding tax on to the Australian borrower.

#.25 Although Norway does not currently impose interest withholding tax on payments to Australian residents, locking in the rates will benefit Australian residents should Norway introduce such a tax in the future.

Royalties

#.26 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to Norwegian residents would benefit from a reduced royalty withholding tax rate. Commercial practice indicates that, as with interest, the cost represented by the royalty withholding tax is commonly passed on to the payer of the royalty. This means that they may bear the cost of higher rates of withholding tax and place them at a competitive disadvantage in competing with businesses from other countries with lower rates. The effect of lowering the cost of new technology and intellectual property may encourage the development of Australia's economy through use of the most up to date technology and processes.

#.27 Although Norway does not currently impose a royalty withholding tax on payments to Australian residents, locking in the reduced royalty withholding tax rate will benefit Australian residents should Norway introduce such a tax in the future.

Alienation of property

#.28 The updating of the Alienation of Property Article to address taxing rights over capital gains would provide certainty to taxpayers and reduce the risk of double taxation. Australia's source country taxing rights over capital gains on real property, land-rich companies and assets which form the business property of a permanent establishment in Australia would be retained. More generally, the changes bring into line Australia's treaty practice with international practice. This will encourage investment in Australia and result in generally lower compliance costs.

Compliance and administrative cost reduction benefits

#.29 Tax exemptions in respect of withholding taxes are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax.

Comparative advantage of option 1

#.30 Option 1 involves minimal changes to the existing treaty.

Comparative advantages of option 2

#.31 The advantage of option 2 is that Australia, in addition to addressing its MFN obligations, would be able to achieve improved integrity measures; in particular, rules to allow for the cross-border collection of tax debts, updated rules for the exchange of information on tax matters and rules to prevent tax discrimination against Australian nationals and businesses operating in Norway and vice versa.

#.32 This option represents an advance on Option 1 and recognises that the rates of withholding tax negotiated in the US Protocol were agreed as part of an overall package of measures (including CGT coverage). It would allow Australia to seek a more balanced update of the existing treaty.

Comparative advantages of option 3

#.33 The advantages of Option 2 are also common to Option 3.

Renegotiation provides a better outcome for all stakeholders

#.34 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it has become outdated (no coverage of CGT, for example) and no longer adequately reflects current tax treaty policies and practices of either Australia or Norway.

#.35 A new tax treaty would provide benefits to Australian business and to the Australian revenue by ensuring certainty of legislative outcomes based on the treaty. It would be another step forward in providing Australian business with an internationally competitive tax treaty network and business tax system.

#.36 A renegotiated treaty will provide a better outcome for all stakeholders. Given the long-term nature of such arrangements, a revised tax treaty is expected to promote greater certainty than the existing tax treaty. It would also be consistent with the Government's decision in response to the *Review of International Taxation Arrangement*, to move towards a more residence-based tax treaty policy, and would contribute to the updating of Australia's ageing treaty network.

Other benefits

#.37 Where Australians carry on business activities in Norway, the existing treaty prevents Norway from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment in Norway. A new tax treaty would further refine the concept of when a permanent establishment should be taken to exist and the level of activity that would constitute a permanent establishment. This principle also applies where a Norwegian carries on business activities in Australia. Other benefits also include:

- The clarification of the residency rules;
- Coverage of royalties from Australian spectrum licences;
- Clarifying the treatment of income derived through trusts; and
- The inclusion of anti-avoidance rules.

Revenue benefits

#.38 New treaty arrangements with Norway would represent another step in facilitating a competitive and modern treaty network for Australian companies and would help to maintain Australia's status as an attractive place for business and investment. While a reduction in maximum withholding tax rates will involve a small cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

#.39 Small revenue benefits should also result from enhanced tax integrity measures over a broader range of taxes.

Compliance and administration cost reduction benefits

#.40 The closer alignment with more recent Australian and international treaty practice would generally be expected to reduce compliance costs. In particular, interpretative issues relating to the extent Australia can tax capital gains under the existing treaty arrangements has resulted in considerable uncertainty and the risk of costly legal arguments.

#.41 Administrative costs in explaining the ATO view and responding to legal arguments would also be significantly reduced. Clarifying other areas of uncertainty, such as tax treaty tests of 'residency' and updating the treaty text, should also decrease compliance costs and uncertainty.

Improved international relationships

#.42 New treaty arrangements with Norway will also assist the bilateral relationship by updating an important treaty in the existing network of commercial treaties between the two countries. It would also promote greater cooperation between taxation authorities to prevent fiscal evasion and tax avoidance. Updating the tax treaty to take account of changes to the OECD Model Tax Convention would also help to maintain Australia's status as an active OECD member, which in turn would maintain Australia's position in the international tax community.

Assessment of costs

Costs common to all options

Revenue costs

#.43 Treasury has estimated the impact of the first round effects on forward estimates as unquantifiable but probably negligible. The three options do not present material differences in estimated direct cost to revenue as the only identifiable costs to revenue are associated with the reductions in dividend, interest and royalty withholding tax rates.

Administration costs

#.44 The administrative impacts on the ATO from the changes made by any new treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example, private binding rulings, concerning the application of the new treaty arrangements. ATO staff, clients and tax professionals will need to be made aware of the entry into force and changes from previous treaty. Therefore a number of ATO information products will need to be updated

#.45 The costs of negotiation and enactment of new tax treaty arrangements with Norway are minimal and have mostly been borne by the Treasury and the ATO. There will also be an unquantified but small cost in terms of parliamentary time and drafting resources in enacting the proposed new tax treaty arrangements.

#.46 There are also ‘maintenance’ costs to the ATO associated with tax treaties in terms of dealing with enquiries, rulings and other interpretive decisions and mutual agreement procedures (including advance pricing arrangements). These costs also apply to the existing arrangements. By bringing the Norwegian treaty into basic conformity with modern treaty practice these costs would be reduced. However, as treaties are deals struck between the two countries that reflect specific features of the bilateral relationship, some level of differential treatment or wording between treaties, which may require interpretation or explanation by the ATO, is inevitable.

Other costs

#.47 Government policy flexibility in relation to taxation of Norwegian residents would be further constrained by changes to treaty obligations, eg with respect to taxation of capital gains. However, as the more significant changes accord with the Government’s tax treaty policy the cost of such constraints are outweighed by the benefits. Ultimately, the tax treaty could be terminated if it became out of step with Government policy. Such termination is very rare in international tax treaty practice, however, and could be expected to be resisted by the business community and others who benefit from the treaty.

#.48 The impact of new tax treaty arrangements on tax policy flexibility is generally quite minimal as tax treaties are based on broad and generally accepted taxation principles.

Costs associated with Option 1

#.49 Option 1 primarily represents a continuation of the current treaty position subject to adjustment to withholding tax rates. Accordingly, administration and compliance costs that apply to the existing tax treaty would not change materially.

Costs associated with Options 2 and 3

Taxpayer costs

#.50 No material additional costs to taxpayers have been identified as likely to arise from the renegotiation of the Norwegian treaty.

Administration costs

#.51 The requirement on the ATO to exchange information on a broader range of taxes and to provide assistance in the collection of tax debts are also considered to be of minimal impact. In most cases the ATO will already have the required information in its possession, and safeguards in the treaty which limit the obligations to provide collection assistance will limit the related administrative costs.

Consultation

#.52 The Board of Tax consulted widely during the *Review of International Taxation Arrangements* on the direction of Australia's tax treaty policy. The Board's recommendations supported a move towards a more residence-based treaty policy in substitution for treaty policies (reflected in most of Australia's treaties, including the existing Norway treaty) based on the source taxation of income.

#.53 The Minister for Revenue and Assistant Treasurer's Press Release No. C101 of 6 November 2003 announced proposed tax treaty negotiations, and invited submissions from stakeholders and the wider community in relation to issues that might be raised during negotiations with MFN countries such as Norway. Prior to this announcement, Treasury had already sought comments from the business community through the Tax Treaties Advisory Panel.

#.54 In general, business and industry groups supported similar outcomes to those in the 2003 UK Convention and the updated Australia-US tax treaty.

#.55 The State and Territory Governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information on the negotiation of this treaty was included in the schedules of treaties to State and Territory representatives from October 2003.

#.56 The proposed treaty arrangements will also be considered by Commonwealth Joint Standing Committee on Treaties, which provides for public consultation in its hearings.

Conclusion and recommended option

#.57 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or Norway, nor modern international norms.

#.58 All options would address long term business concerns about the lack of competitiveness of Australia's tax treaty network with respect to withholding tax rates. They also address Australia's MFN obligation in the existing treaty.

#.59 However, developments in both countries' domestic law, commercial practices, and treaty policies and practices support a full revision of the treaty (Option 3). This option also provides an opportunity to update the text in accordance with modern OECD practice.

#.60 The proposed new treaty arrangements with Norway are consistent with the Government's response to the *Review of International Taxation Arrangements*, moving towards a more residence-based tax treaty policy and contributing to the updating of Australia's ageing treaty network. It would bring Australia's arrangements with Norway more into line with international norms, as set out in the OECD Model Tax Convention and would provide outcomes similar to Australia's treaties with the US and the UK.

#.61 There is a direct cost to revenue common to all options, largely sourced in reduced withholding tax collections. The compliance costs associated with Option 3 are considered to be minimal. On balance, the benefits of concluding a new treaty outweigh the cost to revenue.

#.62 Option 3 is therefore recommended as the preferred option.