

**PROTOCOL, DONE AT CANBERRA ON 27 SEPTEMBER 2001,
AMENDING THE CONVENTION BETWEEN THE GOVERNMENT
OF AUSTRALIA AND THE GOVERNMENT OF THE UNITED
STATES OF AMERICA FOR THE AVOIDANCE OF DOUBLE
TAXATION AND THE PREVENTION OF FISCAL EVASION WITH
RESPECT TO TAXES ON INCOME, DONE AT SYDNDY ON
6 AUGUST 1982**

Documents tabled on 12 March 2002:

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

Protocol, done at Canberra on 27 September 2001, amending the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, done at Sydney on 6 August 1982

NATIONAL INTEREST ANALYSIS

Proposed binding treaty action

1. The Protocol will enter into force when instruments of ratification have been exchanged between Australia and the United States (US). Once in force it will amend Articles 1 (*Personal Scope*), 2 (*Taxes Covered*), 4 (*Residence*), 7 (*Business Profits*), 8 (*Shipping and Air Transport*), 10 (*Dividends*), 11 (*Interest*), 12 (*Royalties*), 13 (*Alienation of Property*), 16 (*Limitation on Benefits*), 21 (*Income Not Expressly Mentioned*) and 22 (*Relief from Double Taxation*) of the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, done at Sydney on 6 August 1982 (“the Convention”).

Date of proposed binding treaty action

2. The Protocol was signed in Canberra on 27 September 2001. It is proposed that Australia provide the instrument of ratification before the end of 2002. If the Protocol enters into force during the 2002 calendar year, it will have effect for taxes in Australia from 1 July 2003.

Date of tabling of the proposed treaty action

3. 12 March 2002.

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

4. The key objective of the Protocol 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 (DWT) on US subsidiaries and branches of Australian companies.

5. This reduction in the rates of DWT in particular, as well as interest withholding tax (IWT) and royalty withholding tax (RWT), will provide significant benefits to Australian business. The Protocol marks a major step forward in providing companies located in Australia with an internationally competitive treaty network and business tax system. It will also facilitate trade and investment between Australia and the US.

6. Another objective of the Protocol is to prevent double taxation of capital gains derived by US residents on the disposal of Australian entities while retaining Australian source country taxing rights. Clarifying Australia’s right to tax US residents in respect of capital gains is an important tax base protection measure.

Reasons for Australia to take the proposed treaty action

7. This Protocol will amend the Convention, Australia's existing tax treaty with the US. The Convention was signed in 1982 but largely reflects positions agreed by both countries in the early 1970's. Changes are required to the Convention to better meet Australia's current economic policy objectives.

8. The purpose of tax treaties is to avoid double taxation and prevent fiscal evasion with respect to taxes on income. Their wider function is to facilitate investment, trade, movement of technology, and movement of personnel between countries. They are widely used to develop and strengthen bilateral relationships between countries, especially in commercial areas. Tax treaties also provide certainty and protection regarding the level of taxation on investments abroad which is a consideration for business when deciding on the location of regional headquarters. The impact of new tax treaties and the amendment of existing tax treaties on tax policy flexibility is minimal because Australia already has a substantial tax treaty network.

9. In negotiating the Protocol both the US and Australia had particular policy objectives to achieve and the end result represents a mutually acceptable agreement. It should be noted that this Protocol includes some major departures from Australia's long standing treaty practice. While these departures involve a reduction in revenue the benefits are widely spread around the economy, with the most direct benefits accruing to business.

10. Under this Protocol, the reduction in rates of DWT in particular, as well as IWT and RWT, will provide significant benefits to Australian business. For many years, major Australian companies have raised concerns about the lack of competitiveness of Australia's tax treaty with the US, especially the high level of US DWT permitted under the Convention. Accordingly, they support the reduction in withholding tax rates under the Protocol. A reduction in US DWT rates would also be consistent with recommendations regarding Australia's tax treaty policy made by the Ralph Review of Business Taxation.

11. Indirect revenue benefits may arise from increased trade and investment between Australia and the US, as well as from a reduction in US tax payable by Australian residents thus reducing Australia's obligation to provide a credit for this tax. Further, clarifying Australia's right to tax US residents in respect of capital gains is an important tax base protection measure. The Protocol will also improve arrangements for taxing gains accrued on assets held by departing Australian residents by reducing compliance difficulties and providing relief from double taxation. This will address business concerns about the potential for double taxation arising from the application of capital gains tax to expatriates departing Australia. These concerns have hindered the ability of Australian companies to attract and retain skilled expatriate staff. Such concerns may also have affected headquarters location decisions to Australia's detriment.

12. It is difficult to determine the net benefit that would accrue from changes made by the Protocol because their impact cannot be meaningfully quantified in a number of important areas. Estimates of the expected growth in trade and investment tend to be speculative because of a lack of information and difficulties in determining, with any certainty, the range and impact of behavioural responses. Benefits that flow to business are generally equally difficult to quantify. Some impacts can be determined with greater authority, for instance, the direct revenue impact of reducing rates of withholding tax. As discussed later, the net yearly loss of revenue as a result of the Protocol is estimated to be \$A190 million. However, the overall economic benefits of the Protocol are considered on balance to outweigh this cost.

Key Features of the Protocol

13. The Protocol will remove DWT on certain dividends (down from 15 percent) thereby enabling major Australian public companies to bring profits made by their US subsidiaries back to Australia without further tax being payable. Australia operates an imputation system that already exempts most dividends. Dividends derived by companies from other shareholdings of 10 percent or more will be subject to 5 percent DWT (also down from 15 percent).

14. Consistent with established tax treaty practice, Australia will exempt dividends paid by US companies out of profits derived from sources in Australia. The Convention is the only tax treaty that allows Australia to tax these dividends and this exemption will place US companies on an equal footing with companies from other tax treaty countries. Dividend equivalent taxation on distributions of branch profits will be permitted but a nil rate will apply for most Australian public companies and the maximum rate will be 5 percent (reduced from 15 percent).

15. No DWT rate limit will apply in the US for dividends paid on certain substantial holdings in US real estate investment trusts (REITs). These dividends may therefore be taxed at the US domestic law rate which is currently 30 percent for companies (up from 15 percent). The impact of this increase is significantly reduced, however, because REIT dividends derived by certain publicly listed Australian unit trusts (the main group affected by these changes) would generally continue to qualify for the 15 percent DWT rate limit. Other affected groups will have until at least 1 July 2003 to reduce their holding in a REIT.

16. Exemptions from the standard IWT rate of 10 percent will apply for interest paid to:

- financial institutions of the other country (subject to certain safeguards) thereby improving Australia's standing as a financial centre; and
- government bodies of the other country (including a body exercising governmental functions or a bank performing central banking functions).

17. Rules consistent with US tax treaty practice will allow:

- interest calculated by reference to the profits of the payer to be taxed at a higher 15 percent rate (ie, at the same rate that generally applies to dividends); and
- tax to be charged on intra-entity interest payments taken to arise between a branch and its head office.

18. RWT on royalties will be reduced from 10 percent to 5 percent making the cost of US technology and knowhow more affordable to Australian business. In addition, exclusive residence country taxation will apply to amounts derived from the leasing of containers used for international transport. Amounts derived from other types of equipment leasing will be treated as business profits rather than royalties.

19. The Protocol will also prevent the double taxation of capital gains derived by US residents on the disposal of Australian entities while retaining Australian source country taxing rights. New rules will remove double taxation of capital gains in the case of departing residents and ensure that foreign tax credit rules operate effectively for them.

20. The Protocol will update the existing Convention in various respects in line with Australia's current tax law and tax treaty policies and practice. Among the changes are a revised list of taxes covered by the Convention; a clause to ensure US trust beneficiaries can be taxed on business profits derived through a permanent establishment in Australia; a revised article on shipping and air transport; and a revised article on other income. The

Protocol also updates the *Limitation on Benefits Article* of the Convention to prevent residents of third countries from inappropriately accessing treaty benefits.

*Investment and Trade Relationship*¹

21. As at 1999-2000 the US was Australia's second largest merchandise trading partner after Japan and our second largest export destination. Two-way trade between the countries totalled \$A33.0 billion or 16 percent of total trade.

22. Exports to the US in 1999-2000 totalled \$A9.68 billion. The US remains Australia's largest market for services. The major services exports were transportation and travel.

23. Australia's imports from the US amounted to \$A23.34 billion in 1999-2000.

24. As at 1999-2000 the US was the largest foreign investor in Australia. US investment in Australia is diversifying and many US firms are establishing regional headquarters and other operations here. The US is the largest investment destination for Australian investment abroad, with investment of \$A156.7 billion as at 1999-2000. \$A90 billion of this is direct equity investment that would benefit from reduced US DWT.

Obligations

25. The Convention requires the two Governments to relieve double taxation of cross-border income (Article 22). Australia is also generally required to avoid enacting tax measures which discriminate against US entities (Article 23).

26. 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).

27. The Protocol generally does not add further to treaty obligations that arise from the Convention. The *Limitation on Benefits Article* under the Protocol creates some administrative obligations to consider applications for treaty benefits from certain US residents.

Implementation

28. Enabling legislation will need to be enacted to give the Protocol 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*. Some consequential amendments to the Act itself will also be necessary.

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 Protocol.

Costs

30. The net yearly loss of revenue as a result of the Protocol is estimated to be \$A190 million. Over time the lower withholding tax rates may be extended to other countries because of most favoured nation (MFN) clauses in some existing tax treaties. These clauses

¹Source: Department of Foreign Affairs and Trade

are typically entered into at the time a tax treaty is negotiated, and provide that if one of the treaty partner countries subsequently agrees in a treaty with a third state to certain specified tax treatment or provisions, the treaty partner country will enter into negotiations to provide similar treatment to the other treaty partner. There are MFN clauses on rates of withholding tax in Australia's tax treaties with the Netherlands, France, Switzerland, Italy, Norway, Finland, Austria and Korea. A reduction in withholding tax rates would mean a loss of revenue but would also lower the cost of capital for Australian businesses seeking funding in these countries.

31. There will be a small unquantifiable cost in administering the changes made by the Protocol. This includes minor implementation costs for the Australian Taxation Office (ATO) in educating the taxpaying public and ATO staff about the new arrangements. On the other hand, there will be a significant reduction in compliance costs as a result of clarifying taxing rights over capital gains derived by US persons from the disposal of an Australian entity. Administrative costs would also be significantly reduced in these cases.

32. Some additional administrative costs may arise for the ATO in considering applications for treaty benefits from persons who do not qualify based on the general tests in the *Limitation on Benefits Article*. The need to make such an application would also increase compliance costs for the applicant.

Consultation

33. In 1997 the ATO established a Tax Treaties Advisory Panel (TTAP) to review proposed tax treaty actions. As advice on tax treaty 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.

34. The TTAP and the American Chamber of Commerce were consulted about this Protocol before negotiations commenced (May 2000) and during negotiations (May 2001). They were also briefed just before the signature of the Protocol (September 2001). Both bodies supported the signature of the Protocol. Industry representatives of parties potentially affected by the changes to the taxation of REIT dividends were also consulted and indicated that they were satisfied with the REIT provision in the Protocol.

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

Regulation Impact Statement

36. A Regulation Impact Statement is attached.

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

37. The Protocol does not provide for the negotiation of future legally binding instruments. However, the Protocol provides that the US and Australia are to consult on amendments to the *Dividends Article* if there are significant changes to either country's rules for taxing dividends.

Withdrawal or denunciation

38. The Protocol itself does not contain express provisions dealing with withdrawal or denunciation as it amends the Convention. However, under Article 29 of the Convention either country may terminate the Convention by giving at least six months prior notice through the diplomatic channel.

39. If such notice is given the Convention, as amended, would cease to have effect in both countries for all income derived on or after 1 January following the expiration of the six month period.

Contact details

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