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International Tax Agreements Amendment Bill (No. 1) 2002

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Contents

International Tax Agreements Amendment Bill (No. 1) 2002

Date Introduced: 21 March 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Royal Assent. The various measures have effect from differing dates often depending on when certain conditions are met. Refer to the brief description of the agreements in the background section of this Digest for further information.

Purpose

To incorporate into Australian law:

- an agreement made with the Russian Federation aimed to avoid double taxation, and
- the recent protocol made with the United States amending the 1982 Australia/United States Double Taxation Agreement.

Background

Australia has agreements with a number of countries, known as Double Tax Agreements, aimed to prevent the double taxation of income where income is received by a resident of one country from activities in the other country. The agreement also aims to help minimise tax avoidance and evasion. The agreements deal with income from a number of specific sources, such as business income, dividends, interest and royalties. The agreements provide for the taxation treatment which is to apply, particularly which country may tax various categories of income and limitations of the amount that may be taxed. Subsection 4(2) of the *Income Tax (International Agreements) Act 1953* provides that agreements are, in most cases, to overrule provisions of the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*, although a specific Australian law can overrule an agreement.

Agreements have a common format but differ to reflect the various tax rules applying in the countries with which Australia has an agreement. Australia currently has agreements with over 41 countries, including:

- China, Japan, Korea, Malaysia and Indonesia
- Singapore, Thailand, India and Vietnam
- most Western and Southern European and Scandinavian countries
- Hungary and Poland
- Ireland and the United Kingdom
- the United States of America, and
- New Zealand.

The aims of Double Tax Agreements are to prevent:

- the double taxation of income received in one country that is a party to an agreement by a resident of the other country that is a party to an agreement. This is achieved by the separation of taxing powers between the parties and, in certain circumstances, the giving of credits for the payment of tax in the other country, and
- tax evasion or avoidance by international tax arrangements. This is aimed to be achieved by the transfer of information between the taxation authorities of the countries that are parties to an agreement.

Agreements tend to have standardised rules for the taxation of various categories of income depending on its source and the place of residence of the person deriving the income, although different limits and variations to the standard rules apply for the various countries. Broadly, income from certain categories is reserved for taxation in the country of residence of the taxpayer while income from other sources may be taxed in its country of source, usually to a maximum percentage of the income (the most important categories covered by the later rule are dividends, royalties and interest). Where the country of residence also taxes these classes of income, it is required to allow a credit for the tax paid in the country of source. Agreements may also have general 'catch all' provisions designed to preserve the operation of Australia tax rules unless specifically excluded by the agreement.

Russia

The Bill reintroduces the provisions contained in the International Tax Agreements Amendment Bill 2001 which were intended to give effect to the Russian Double Taxation

Agreement. That Bill lapsed when Parliament was prorogued with the calling of the 2001 Federal election.

The Russian Double Taxation Agreement falls within the category of a 'standard' double tax agreement in the matters subject to the agreement and the taxing arrangements between the countries.

Date of entry into force

The agreement was signed on 7 September 2000 and will enter into force after notice has been given that the parties have completed the processes necessary to give effect to the incorporation of the agreement in their domestic law (including, for Australia, the passage of this Bill).

Date of effect

In Australia: 1 July in the calendar year following the year in which the Agreement enters into force.

In Russia: 1 January of the calendar year following the year in which the Agreement enters into force.

United States

The current taxation agreement with the United States was signed on 6 August 1982 and had effect from 1 December 1983.

The proposed Protocol would update that agreement in a number of important respects. Subject to certain exceptions, dividends, interest and royalties will generally remain taxable in both countries, but with changed limits on the tax that the source country may charge on residents of the other country who are beneficially entitled to the income.

Dividends

Under the current Double Tax Agreement with the US, subsidiaries of Australian companies that are resident in the US pay 15 per cent withholding tax to the US Government on dividends.[1]

This withholding tax on dividends received media attention last year following the decision of manufacturer James Hardie Industries to move its headquarters to Amsterdam. It was reported that James Hardie management cited the tax penalty it was suffering from having most of its earnings in the US and most of its shareholders in Australia as the reason for the move[2]. The Double Tax Agreement between Australia and the US meant James Hardie had to pay US company tax on its earnings plus an extra 15 per cent on money it repatriated to its Australian investors. As media reports indicated, this tax burden could be significantly reduced by the company moving its headquarters to a country with a more favourable tax treaty with the US.[3]

The Protocol can be seen as an attempt to address the issue of taxation of dividends for Australian companies that have subsidiaries in the US. Under the Protocol, US subsidiaries with more than 80 per cent ownership from an Australian parent company will pay no withholding tax on the US dividends. Subsidiaries with less than 80 per cent holding from a single Australian owner will face a 5 per cent dividend withholding tax. This reduced rate will not apply to dividends derived from certain substantial holdings in US Regulated Investment Companies or Real Estate Investment Trusts.[4]

Royalties

The current Double Tax Agreement, allows both countries to tax royalty flows but limits the tax of the country of source to 10 per cent of the royalties paid to residents of the other country.

Under the Protocol the limit on source country taxation of royalties will be reduced from 10 to 5 per cent. According to media reports this is a necessary concession to the US in return for the changes in dividend withholding tax.[5]

In addition, payments for the use of industrial, commercial or scientific equipment will cease to be treated as royalties for the purposes of the Agreement.

Interest

Article 11 of the Double Tax Agreement provides for interest income to be taxed by both countries but requires the country of source to generally limit its tax to 10 per cent where a resident of the other country is beneficially entitled to the interest.

Under the Protocol, source country tax on interest will continue to be limited to 10 per cent. However, no tax will be charged in the source country on interest derived by:

- a government body of the other country; or
- a financial institution resident in the other country.

Other changes

The Protocol also:

- contains new rules to remove double taxation of capital gains in the case of departing residents
- contains a comprehensive Alienation of Property Articles consistent with Australia's current treaty practice

- amends the Shipping and Air Transport Article
- amends Article 2 in order to update the list of taxes covered by the Convention
- insert a new Limitation on Benefits Article to prevent 'treaty shopping'.

Date of entry into force

The Protocol was signed on 27 September 2001 and will enter into force when instruments of ratification have been exchanged between Australia and the United States.

Date of effect

The provisions relating to withholding tax on dividends, interest and royalties, will take effect from either 1 July 2003 or one month after the Protocol comes into force, (which ever is the later). For other Australian tax, the Protocol will have effect from 1 July in the calendar year following the year in which the Protocol enters into force.

Financial impact

Yearly revenue cost of $190 million.[6]

Main Provisions

Schedule 1 - Agreement with Russia

Item 1 inserts the term "the Russian agreement' into the list of definitions contained in existing subsection 3(1) of the *International Tax Agreements Act 1953*.

Item 2 inserts a **new section 11ZK** into the *International Tax Agreements Act 1953* to make it clear that the Double Taxation Agreement will have the force of law.

Item 3 inserts the text of the Double Taxation Agreement into the *International Tax Agreements Act 1953* by adding a **new Schedule 46** to that Act.

Schedule 2 - Protocol to the Convention with the United States

Item 1 amends the term 'the United States convention' currently in the list of definitions contained in existing subsection 3(1) of the *International Tax Agreements Act 1953*. The amended definition includes reference to the amending protocol.

Item 2 inserts the term 'the United States protocol' into the list of definitions contained in existing subsection 3(1) of the *International Tax Agreements Act 1953*.

Item 3 inserts a **new section 6AA** into the *International Tax Agreements Act 1953* to make it clear that the Protocol will have the force of law.

Items 4-5 makes consequential amendments to section 17A following changes to the treatment of equipment royalties paid to US residents arising from the Protocol[7] to exclude domestic law royalty payments from the scope of the royalty withholding tax provisions in tax treaties in cases where the payments are not treated as royalties under the Royalties Article of a tax treaty.

Item 6 inserts the text of the Protocol into the *International Tax Agreements Act 1953* by adding a **new Schedule 2A** to that Act.

Endnotes

1 There is considerable variation in dividend withholding taxes negotiated in the various Double Tax Agreements. For example the South African treaty rate is zero, the Czech Republic is 5 per cent, the Taiwan rate is 10 per cent and the current US rate is 15 per cent.

2 The *Canberra Times* on 26 July 2001 reported that this would reduce the tax bill by $30 million. 'Business urges tax overhaul' A similar report in: 'Hardie leads way in tax shift offshore', *Australian Financial Review*, 25 July 2001.

3 According to the terms of the US/Netherlands Double Taxation Treaty, US subsidiaries of Hardie would pay only 5 per cent withholding tax on dividends to the US Government.

4 These will either be taxed at the standard treaty rate of 15 per cent or according to the US domestic law rate which is currently 30 per cent for companies.

5 'Costello blames US for dual tax stand-off', *Australian*, 26 July 2001.

6 *Explanatory Memorandum*, p. 9.

7 See above at p. 4.