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International Tax Agreements Amendment Bill (No. 2) 2002

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International Tax Agreements Amendment Bill (No. 2) 2002

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International Tax Agreements Amendment Bill (No. 2) 2002

Date Introduced: 19 September 2002

House: House of Representatives

Portfolio: Treasury

Commencement: Mainly on Royal Assent. The various measures have effect from differing dates. These are set out in the background section of this Digest.

Purpose

To incorporate into Australian law the recent Protocols made with Canada and Malaysia amending the 1980 Australia/Canada Double Taxation Agreement and the 1980 Australia/Malaysia Double Taxation Agreement.

Background

Australia has bilateral 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.

Canada

The Australia/Canada Double Taxation Agreement was signed on 21 May 1980 and came into effect in 1981. Negotiations to update the Agreement were held in 1996 and 1998, and some remaining issues have recently been settled by correspondence.[1]

The Protocol would update the Canadian Double Taxation Agreement in a number of respects:

- the Dividends Article would be amended so to introduce a maximum of 5% rate of dividend withholding tax for non-portfolio dividends, and 15% for all other dividends [Article 8][2]
- the interest withholding tax rate limitation would be reduced from the current treaty rate of 15% to 10% [Article 9]

- the definition of royalties would be expanded [Article 10]
- the Canadian branch profits taxation rate would be reduced to 5% [Article 8]
- several new or revised definitions including 'Australia', 'international traffic', and 'residence' would be added
- several articles would be replaced including the Alienation of Property Articles [Article 11], the Source of Income Article [Article 13] and the Methods of Elimination of Double Taxation Article [Article 14], and
- there would be new rules to assist in removing double taxation of capital gains in the case of departing residents [Article 11].

Date of entry into force

The Protocol will enter into force when instruments of ratification have been exchanged between Australia and the Canada.

Date of effect

In Australia: The provisions relating to withholding tax imposed on income derived by a resident of Canada will take effect from 1 January in the calendar year following the year in which the Protocol enters into force. 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.

In Canada: 1 January of the calendar year following the year in which the Protocol enters into force.

Financial impact

Yearly revenue cost of $ 1 million.[3]

Malaysia

The current Double Taxation Agreement between Australia and Malaysia has been in force since 1980. The Second Protocol would update that Agreement in a number of respects, the most significant being the amendments affecting the Lubuan tax haven and tax sparing arrangements.

Labuan tax haven

In 1990 the Malaysian Government set up a tax haven in the island of Labuan, off the coast of the State of Sabah, called the Labuan Offshore Financial Centre. It is regulated by the Labuan Offshore Financial Services Authority. Passive investments done through Labuan are not subject to tax whilst trading activities are subject to a 3% tax although the tax payer may opt to pay a flat tax of RM20,000 for any year of assessment.

As Labuan is technically part of Malaysia, companies based in Labuan still receive advantages under the country's network of tax treaties with other nations. Malaysia's double tax agreements do not exclude the territory of Labuan, and generally do not exclude Labuan offshore companies from status as Malaysian residents for the purposes of those agreements. At present, of 53 Malaysian double tax treaties, only three exclude Labuan companies carrying on offshore trading business subject to subsection 2(1) of the Labuan Offshore Business Activity Tax Act 1990.[4]

The 2002 Protocol (or the Second Protocol as it is referred to in the Bill) would deny Labuan offshore companies the benefit of protection from Australian tax on income sourced in Australia. The denial of protection by the double tax treaty means the Labuan company would become assessable in Australia on its Australian "business profits" and would be denied the lower rates of withholding tax on Australian unfranked dividends, interest and royalties provided by the double tax treaty.

Tax sparing

Tax sparing refers to the situation where tax forgone (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. The typical circumstance 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 in Australia.

Tax sparing has been a traditional feature of Australia's double taxation agreements, however in May 1997, the Government announced the abandonment of Australia's longstanding commitment to tax sparing.[5] The last expiring tax sparing provisions are contained in the double tax agreement with Vietnam and these are due to expire on 30 June 2003.[6]

The Double Tax Agreement with Malaysia was signed in 1980. Tax sparing arrangements under the original provisions of the Agreement expired on 30 June 1984. The arrangements were later extended for 3 years from 1 July 1984 to 30 June 1987 through an Exchange of Letters and again for another 5 years from 1 July 1987 to 30 June 1992 by a First Protocol amending the Double Tax Agreement signed on 2 August 1999. The Second Protocol will extend the operation of the tax sparing provisions from 1 July 1992 to 30 June 2003, at which time they will permanently expire. The Protocol will also update the tax sparing provisions in the Double Tax Agreement to reflect changes to the Malaysian tax incentives legislation[7]

The Explanatory Memorandum to the Bill states that one of the Government's main objectives in the negotiations leading to the Second Protocol was the exclusion of Malaysia's tax haven of Labuan from the treaty.[8] The Explanatory Memorandum further suggests that in order to obtain the Malaysian Government's agreement to the exclusion of

the Labuan preferential tax regime, the continuation of the tax sparing measures was an essential part of the bargaining.[9]

Date of entry into force

The Second Protocol will enter into force when instruments of ratification have been exchanged between Australia and Malaysia.

Date of effect

In Australia: The provisions relating to tax sparing will take effect for any year of income beginning on or after 1 July 1992. 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.

In Malaysia: The provisions relating to tax sparing will take effect for any year of income beginning on or after 1 July 1993. In all other cases, the Protocol will have effect from 1 January in the calendar year following the year in which the Protocol enters into force.

Financial impact

Revenue cost of $1 million to $2 million in 2002-2003.[10]

Main Provisions

Schedule 1 - Protocol to the Convention with Canada

Item 1 amends the term 'the Canadian convention' currently in the list of definitions contained in existing subsection 3(1) of the *International Tax Agreements Act 1953* (ITAA53). The amended definition includes reference to the recent Protocol.

Item 2 inserts the term 'the Canadian protocol' into the list of definitions contained in existing subsection 3(1) of the ITAA53.

Item 4 inserts a **new section 6AB** into the ITAA53 to make it clear that the Protocol will have the force of law.

Item 5 inserts the text of the new Canadian Protocol into the ITAA53 by adding a **new Schedule 3A** to that Act.

Schedule 2 - Second Protocol to the Agreement with Malaysia

Item 1 inserts the term 'the first Malaysian protocol' into the list of definitions contained in existing subsection 3(1) of the ITAA53. The definition refers to the Protocol signed on 2 August 1999, amending the 1980 Malaysian Agreement.

Item 2 repeals and replaces the term 'the Malaysian agreement' currently in the list of definitions contained in existing subsection 3(1) of the ITAA53. The new definition includes reference to the First and Second Protocols.

Item 4 inserts the term 'the second Malaysian protocol' into the list of definitions contained in existing subsection 3(1) of the ITAA53. The definition refers to the recent Protocol.

Items 3, 5, 6 and 7 are consequential amendments to take account of the new definitions of 'first Malaysian protocol' and 'second Malaysian protocol'.

Item 8 inserts a **new section 11FB** into the ITAA53 to make it clear that the Second Protocol will have the force of law.

Item 9 inserts the text of the Second Malaysian Protocol into the ITAA53 by adding a **new Schedule 16B** to that Act.

Schedule 3

Schedule 3 makes minor amendments to the double tax agreements with the United States, Greece, Romania and Vietnam.

Endnotes

1 *Explanatory Memorandum*, p. 51.

2 Article numbers refer to the Protocol, not to the original Agreement.

3 *Explanatory Memorandum*, p. 9.

4 They are the 1997 United Kingdom treaty, the 1998 Netherlands treaty, and the 1999 Protocol to the 1999 Japanese treaty. *See* Peter Searle and Robert Gordon, *Permanent establishments and controlled foreign corporation*, 2002.

5 Treasurer, *Press release*, 'Budget 1997: Taxation of foreign source income'.

6 *Explanatory Memorandum*, p. 68.

7 Examples of these changes are set out in the *Explanatory Memorandum* at page 37. Certain activities and sectors are specifically excluded from the tax sparing provisions

8 *Explanatory Memorandum*, p. 68.

9 ibid., p. 66.

10 ibid., p. 9.