



THE TAX INSTITUTE

THE MARK OF EXPERTISE

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Mr Greg Wood
Manager
Tax Treaties Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxtreatiesunit_consultation@treasury.gov.au

Dear Mr Wood,

Australia's Tax Treaty Negotiation Program

The Tax Institute welcomes the opportunity to make a submission to the Treasury in response to the public invitation to comment on Australia's Tax Treaty Negotiation Program issued on 11 July 2014.

Tax treaties are key to enabling Australian taxpayers to participate effectively in the global economy and non-resident taxpayers to participate in our domestic economy. It is therefore desirable that Australia's tax treaty negotiation program be periodically reviewed and updated to reflect current global economic setting.

Summary

The Tax Institute has taken this opportunity to make some suggestions around broader matters, such as negotiation principles and external influential factors, for Treasury to consider in reviewing Australia's tax treaty negotiation program in addition to making some suggestions in respect of particular treaties and treaty partners.

Australia's Tax Treaty Negotiation Framework

1. Negotiation principles

There are fundamental principles that comprise the basic framework with which Australia approaches negotiations with current and potential tax treaty partners. There would also be criteria against which a treaty that is formed can be measured to determine whether it is in Australia's best interests.

Australia adopts the OECD Model Tax Convention upon which to base treaty negotiations. Four main factors are taken into account when determining the countries with which Australia will negotiate a tax treaty. These are:

- the level of trade Australia engages in with the country;
- whether they have a comparable tax system;
- the level of 'exchange of information'; and
- countries with which we have a 'Most Favoured Nation' clause in our bilateral treaty.

However, there would also be political and economic factors that influence the way Australia approaches treaty negotiations. We suggest that the factors used to determine countries with which Australia should negotiate a treaty could be broadened to include factors such as recognising growing trade with particular emerging markets¹ and countries from which high numbers of immigrants come to Australia. As such, Treasury may wish to consider whether these and other factors should also be taken into account in determining what new countries Australia could incorporate into its treaty network.

We note that in July 2013, a scoping paper² was issued by the then Government which adopted the recommendation³ that Australia's bilateral treaties should be reviewed at least once a decade to ensure that they continue to be in the national interest. We support the current Government maintaining this position.

In developing and negotiating treaties, consideration should also be given to how the treaties will work in practice when Australian taxpayers come to apply them. Treasury should bear in mind these practical considerations through the negotiation process to ensure workability.

It might also be useful if some qualitative (and where possible, quantitative) analysis of the 44 bilateral tax treaties Australia currently has in place is carried out to determine the value of those treaties. Such an exercise may be used to determine whether it is appropriate that certain treaties remain in place and may also identify treaties that are ripe for renegotiation.

2. Influence of Domestic Laws

Australia has recently adopted new transfer pricing rules⁴ and rules requiring transparency⁵ of certain taxpayers' tax affairs into its domestic law. These rules would

¹ For example, treaties, or a limited form of treaty, could be negotiated with emerging markets such as Brazil, Peru and Mongolia with whom Australia has increasing trade in the mining sector.

² See the paper entitled *Risks to the Sustainability of Australia's Corporate Tax Base* issued by Treasury (<http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability>)

³ Recommendation 2 per the then Assistant Treasurer's press release No. 139 of 24 July 2013 (<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2013/139.htm&pageID=003&min=djba&Year=&DocType=0>)

⁴ Division 815 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**)

⁵ Section 3C of the *Taxation Administration Act 1953* (Cth) (**TAA**)

affect the position that Australia might take in its negotiations with treaty partner countries, particularly in respect of articles that might be affected by these rules. We note, for example, that proper consideration must be given to the effect of Australia's transfer pricing rules in relation to the interpretation and application of Article 7 (the 'Business Profits' article) and Article 9 (the 'Associated Enterprises' article).

It is also necessary that the explanatory memoranda to the bills that give the force of law to new and renegotiated tax treaties that Australia enters take into account the effect of Australia's current domestic laws. This is particularly relevant where significant changes to Australia's domestic law are made (such as experienced recently with the changes to the transfer pricing rules).

We note the Government is yet to publicly release the Board of Taxation's report/recommendations on Article 7. It would be useful to know what recommendations the Board of Taxation has made and whether the Government plans to adopt them as this will influence Australia's negotiations with respect to future treaties (and renegotiated treaties) in respect of Article 7.

3. Influence of current global economic setting

The current global economic setting also influences treaty negotiations. The outcomes of the activity being undertaken by the OECD in relation to base erosion and profit shifting (**BEPS**) are likely to be adopted by Australia.

Tax is also on the agenda for the G20 this year. There is particular emphasis on BEPS tax avoidance and tax transparency as well as promoting information sharing. These are all likely to shape Australia's future treaty negotiations and impact on the key outcomes that Australia should seek in its treaty negotiations.

There are action items arising from the OECD's work stemming from the BEPS Action Plan that will result in a variety of recommendations being made in respect of treaty abuse measures and other matters, such as the development of a multilateral instrument, among other things. Given Australia's likely propensity to adopt these recommendations, the recommendations would both directly and indirectly influence negotiation of future treaties and may cause Australia to renegotiate existing treaties.

As these recommendations will be made in accordance with the BEPS Action Plan timeline (that is, between now and December 2015), it may be useful if Australia's treaty negotiation program is revisited after December 2015 and further consulted on at this time.

4. Policy in respect of anti-avoidance articles

We request clarification of Treasury's current position on the use of anti-avoidance articles in treaties such as:

- Limitation on Benefits (**LoB**) articles; or

- ‘Main Purpose⁶’ articles;

as these articles may impose significant costs on some Australian businesses - in particular, small and medium enterprises (**SMEs**).

Tax treaties play a critical role in removing barriers to cross-border trade and investment by SMEs. Any rules that create uncertainty and unpredictability for SME taxpayers about whether they are eligible for the benefits of a treaty will undermine this role.

Australia already has one of the broadest general anti-avoidance regimes in the world in its domestic law, Part IVA⁷. If Australian businesses need to contend with treaty anti-avoidance articles as well as Part IVA, this may significantly increase barriers to trade for Australian businesses by increasing:

- the compliance costs of cross border business;
- the uncertainty associated with cross border business; and
- the opportunity for disputes with foreign revenue authorities.

Such increases in disputes, uncertainty and cost can disproportionately disadvantage SMEs on the basis that:

- compliance costs do not scale in proportion to the amount of tax at stake;
- due to their reduced resources, SMEs are more likely than larger taxpayers to ‘get it wrong’ resulting in substantial penalties;
- SMEs are economically disadvantaged in any dispute with revenue authorities.

In addition, as most SMEs are ultimately held by discretionary trusts, their ability to access benefits under a LoB article is far more limited than for larger taxpayers.

At a certain point, the additional cost, additional tax and additional risk associated with cross border business may result in SME business owners, who are likely to have only a limited understanding of international tax issues, deciding that it is too hard to do business internationally and that they should limit their business to the confines of the Australian domestic market.

Clearly it is not in Australia’s national interest to discourage SMEs from expanding globally. What is in Australia’s national interest is to encourage international entrepreneurship and ensure unnecessary barriers to trade are not put in place via our treaty arrangements.

Given Australia already has a strong anti-avoidance regime within its domestic law and the inclusion of anti-avoidance clauses in treaties may increase compliance costs (and

⁶ Refer to the *Public Discussion Draft BEPS Action 6: Preventing the granting of treaty benefits in inappropriate circumstances* Paper issued by the OECD March - April 2014 at pp10 – 14. For current examples of a ‘main purpose’ article, see for example sub-Articles 10(11), 11(10) and 12(8) of the Japanese Convention.

⁷ Part IVA of the *Income Tax Assessment Act 1936* (Cth)

decrease certainty) for certain taxpayers, we suggest that a strong case supporting the inclusion of anti-avoidance clauses in future treaties should be formed before clauses of this nature are included.

Comments on treaties with specific countries

1. Tax Treaties with Canada, Germany and China

Australia's tax treaties with Canada, Germany and China are over ten years old.

In relation to the treaties with Canada and Germany, we believe they should be updated to be in line with treaties agreed with our major OECD trading partners. Particular areas that should be addressed include a full exemption for dividend withholding tax on substantial shareholdings, a full exemption from interest withholding tax for interest paid to unrelated financial institutions and protection from taxation of disposals of portfolio interests in non-land rich companies.

In relation to the treaty with China, a key area of focus for Australian financial institutions is ensuring this treaty reflects recent Chinese treaties that offer protection from Chinese capital gains tax on the disposal of portfolio interests in non 'land-rich' Chinese companies. Given Australia does not seek to tax such disposals in domestic corporations, the reciprocal extension of this policy to Australian treaties generally would level the playing field for Australia's outbound funds management industry.

2. Tax Treaty with Israel

In light of the fact that Israel is an OECD country with which Australia has growing trade, Treasury may like to consider whether Australia should negotiate a tax treaty with Israel. Other stakeholders are better placed to comment in detail about the costs and benefits of forming a treaty with Israel, though we consider that this could be explored by Treasury.

3. Tax Treaty with Hong Kong

In addition to its role as a major financial services hub, Hong Kong is a country with which Australia has growing trade and as such Treasury may wish to consider whether Australia should negotiate a treaty with Hong Kong. We refer to comments included on the Australian Department of Foreign Affairs and Trade website under the heading 'Bilateral Economic and Trade Relationship' (which have been extracted and included in Appendix A) in support of this. A treaty with Hong Kong would likely enhance Australia's already significant inbound and outbound trade and investment with Hong Kong.

Hong Kong is one of the major financial services hubs in the world and plays an important role in Asia - in particular, for investment into and from China. We note that not only have both Canada and New Zealand recently signed tax treaties with Hong Kong but the majority of the tax treaties that Hong Kong has entered into are with countries that Australia also has tax treaties with - including France, Japan, Indonesia, Malaysia and the United Kingdom.

On the one hand, for Australia to maintain a level playing field with its other treaty partners ((a) in terms of also being able to access investment capital coming indirectly from China; or (b) doing business in Hong Kong, for example in the funds management industry), it may wish to consider forming a treaty with Hong Kong.

However, this should be weighed against broader concerns that have been raised in commentary concerning treaties with Hong Kong⁸ and whether such a treaty will overall be beneficial for the Australian financial sector. We suggest that Treasury needs to weigh all the relevant costs and benefits of entering into a treaty with Hong Kong against each other to assist Treasury to determine whether forming a treaty with Hong Kong may overall be beneficial to Australia. In this regard, Treasury should engage with relevant stakeholders to assist in this process.

If you would like to discuss any of the above, please contact either me or Tax Counsel, Stephanie Caredes, on 02 8223 0059.

Yours sincerely

A handwritten signature in black ink, appearing to read 'M. Flynn', followed by a long horizontal flourish line.

Michael Flynn
President

⁸ Concerns have been raised in the context of the New Zealand – Hong Kong Double Tax Agreement that Hong Kong treaties seem to ‘reward’ treaty shopping even more so than other treaties – see Littlewood, A.M. and Rainsford, K. [2014] *“Hong Kong’s Treaty Network: Are the US, Germany and Australia Sensibly Standing Aloof? Or Sadly Missing Out?”* *British Tax Review* (1) pp72 - 99. These are concerns that Treasury should take heed of in considering whether negotiating a treaty with Hong Kong is right for Australia.

Appendix A

Extract from Australian Government Department of Foreign Affairs and Trade website re Hong Kong:

Bilateral Economic and Trade Relationship

Hong Kong is an important source of foreign investment for Australia, our fifth-largest, with a stock of \$51.3 billion at the end of 2013. Investment sectors include electricity supply, natural gas, mining, transport, vineyards, food processing, port infrastructure, light industry, insurance, engineering, telecommunications and biotechnology. Hong Kong is also an attractive investment destination for Australia, our eleventh-largest, with a stock of \$30 billion at the end of 2013. Sectors of interest include banking and finance; construction and engineering; health and medical services; telecommunications; insurance; legal services; education; information technology; consulting; logistics; and transport.

Australia and Hong Kong have an established trade relationship. Hong Kong was Australia's 14th most important destination for merchandise exports (\$2.6 billion) in 2013 and eighth-largest services market (\$1.8 billion) in 2012-13. Two-way trade in goods and services amounted to \$7.7 billion in 2012-13. Australia's major merchandise exports were crustaceans, gold and telecommunications equipment and parts. Australia's major imports from Hong Kong were telecommunications equipment and parts, clothing and optical goods. Bilateral services trade is centred on travel (including education exports) and transport.⁹

⁹ See the Australian Government Department of Foreign Affairs and Trade website https://www.dfat.gov.au/geo/hong_kong/hong_kong_brief.html