THE TAX INSTITUTE

29 August 2019

Ms Ronita Ram
Manager – Corporate and International Tax Division
Revenue Group
The Treasury
Langton Crescent
PARKES ACT 2600

By email: ronita.ram@treasury.gov.au

Dear Ms Ram,

Tax Treaty between Australia and Israel

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to *Treasury Laws Amendment (International Tax Agreements) Bill 2019 Exposure Draft* (**ED**) and associated Explanatory Materials (**EM**).

Summary

The Tax Institute has numerous concerns with the Double Tax Agreement (**DTA**) and associated EM. However, we are mainly concerned with the hasty introduction of a new general source rule. A general source rule is a fundamental feature of the international tax rules in Australia. The Tax Institute believes a short two week consultation is both insufficient and inappropriate to allow for due consideration of such a key concept in the Australian international tax law framework. This measure was not announced and therefore stakeholders were not aware of its pending introduction until the ED was released for consultation on 7 August 2019. The Tax Institute believes the revision of the current source rule should not proceed until it has been subject to further and more considered public consultation.

Also, we are led to believe from inquiries which have been made with Treasury directly that there may be errors in the DTA itself (at Articles 7(9) and 9(4)). It would be preferable to have the DTA amended as soon as practicable rather than having to amend the DTA soon after it comes into force.

Our detailed comments in relation to the ED and EM are below.

Discussion

Australia – Israel Double Tax Agreement

1. Comments on the Double Tax Agreement

a) **Dual Residency disputes** – Unfortunately, despite the existence of a tie-breaker test, the DTA in some circumstances does not provide a way of resolving dual residency disputes. Ultimately the

Contracting States only need to 'endeavor to resolve' dual residency issues by mutual agreement so there is no obligation on them to do so. If they fail to agree, the taxpayer shall not be considered a resident of either Contracting State for the purposes of enjoying benefits under DTA. This outcome is consistent with Australia's reservation to Article 4 in the Multi-Lateral Convention as there is no provision for this to be resolved by arbitration. This means not only that the competent authorities have no incentive to reach any agreement for dual residents but that they both have a positive incentive *not* to reach an agreement as this preserves their full taxing rights.

This will arise in the most difficult cases where a person has an habitual abode in both states, is a national of both states and does not have a centre of vital interests in either state. In a modern setting in which these issues are more and more likely to arise, we consider that Treasury should be discouraged from entering into treaties on such a basis which actively encourages double taxation.

However, it would be more useful to have a mechanism in the DTA that can resolve double taxation arising from a dual residency dispute. In the absence of such a mechanism, we anticipate a negative impact on the revenue to Australia given Australia will probably choose to resolve these disputes by providing a foreign income tax offset for the tax paid in the other Contracting State (except where imposed because the taxpayer is a resident of the other state on income from sources outside that state). This is not a preferred outcome. We are taking this opportunity to suggest Treasury be mindful of this issue when negotiating future treaties.

b) **Errors in the DTA** – We are led to believe from inquiries which have been made with Treasury directly that the DTA may contain two errors: Articles 7(9) and 9(4) provide time limitations on adjustments to profits with each saying that an adjustment cannot be made 'after the expiration of seven years' from the end of the relevant tax year unless there is fraud, etc, or 'within that period of ten years' where an audit has been initiated by either state. We encourage Treasury to rectify this error in the DTA by entering a further protocol with Israel as soon as practicable rather than having to amend the DTA soon after it comes into force. Until this can be done, we recommend that an acknowledgment be inserted in the EM of the errors together with a comment on what was intended or the way in which it should be administered.

We seek confirmation that 'audit' for the purpose of these Articles would also include a review initiated by the taxpayer (for example if the taxpayer lodges an objection with the relevant 7 or 10 year time limit (as applicable)), the time limit will not preclude the objection from being dealt with. This should be included in the EM. If, however, this is not intended, we would urge Treasury to reopen negotiations with Israel to ensure there is a common understanding.

2. Comments on the EM to the DTA

a) **Paragraph 1.16** – consistent with sections 4 and 4AA of the *International Tax Agreements Act 1953* (Cth) (**Agreements Act**), paragraph 1.16 should be rephrased to reflect the view that the provisions of the Assessment Acts and FBT Act are incorporated into the Agreements Act. The EM expresses the opposite, and incorrect, position.

b) **Paragraph 1.125** – paragraph 1.125 should include further clarification on the origins of Article 4 in the DTA. We suggest including the following wording (similar to the wording included in paragraph 1.114):

'This provision is based on the wording recommended in paragraph 39 of the BEPS Action 14 2015 Final Report as an alternative provision for inclusion in the OECD Model Commentary on Article 9 of the OECD Model. The seven year period is broadly consistent with the general limitation period that applies for transfer pricing adjustments in respect of separate legal entities under Subdivision 815-B of the ITAA 1997.'

c) **General** - We believe overall that the EM would benefit from including a larger portion of the negotiator's notes as has been done for the 2009 New Zealand Treaty and 2015 Germany Treaty.

Australia's Deemed Source Rule

a) **Section 764-5** - The proposed section 764-5 has no practical effect. It provides that income is from an "Australian source" if it is "from a source in Australia" or if a provision of the Act provides that it is derived from, attributable to or otherwise has a source in Australia. Therefore, this provision does not add anything helpful. To be of some use, the section could at least include a table referring to the other provisions which affect source.

However, given that neither the 28 March 2019 joint media release by the Treasurer and Assistant Treasurer nor the 2 April 2019 Budget announcement referred to the introduction of a new general source rule, and the resultant unrealistic consultation period (two weeks) in respect of an unannounced measure that this fundamental to the international tax rules in Australia, The Tax Institute believes the revision of the current source rule should not proceed until it has been subject to further and more considered public consultation.

We do not understand why this particular rule has been introduced with such haste as it is not crucial to the enactment of section 764-10 and the circular definition in section 995-1 of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**) would continue uninterrupted. As stated in paragraph 2.33 of the EM, these rules (section 764-5) "do not alter the meaning or scope of the existing definition … do not disturb or disrupt any provision that includes an amount in assessable income on a basis other than source ...".

It may explain why the table on page 46 of the EM which compares the key features of the new law and the current law only considers the introduction on the new tax treaty source rule in proposed section 764-10, without also considering the introduction of the new general source rule in proposed section 764-5. However, this provision duplicates existing rules in at least two places, paragraphs 6-5(3)(b) and 6-10(5)(b) of the 1997 Act. It would be better to have that qualification only in the source rule, not duplicated throughout the 1997 Act. Leaving that duplication in place only reinforces the argument for not altering it at all. So, sections 6-5 and 6-10 should be amended now (not over time as suggested in para 2.31 as there is unlikely to be a project on those sections in any foreseeable timeframe) to remove the duplication. As this duplication does not give rise to a change to the existing law, the comparison table in EM should also show there has been no change even though section 764-5 is being introduced.

Further clarity is required in paragraph 2.36 (and repeated in paragraph 2.39) of the EM in respect of the discussion of 'derived' or attributable to a source in Australia. Could Treasury please confirm if it is intended to pick up the origin based rules in the 1936 Act (withholding tax rules that impose tax on payments (interest, dividends and royalties) that have an Australian origin rather than source (Part III, Div 11A)) and the deeming rules (in the overseas shipping payments (Div 12) and certain insurance

premiums (Div 15)). Either way, appropriate examples should be used rather than the existing lack of clarity.

b) **Section 764-10** - The proposed section 764-10 provides a general rule that, where a double tax agreement allows Australia to tax income of a resident of a foreign country, that income will be taken to be derived from an Australian source. This is the clearest expression yet of Australia's intention to use double tax agreements to expand its tax base at the expense of its treaty partners. We acknowledge the purpose of the section is made clear in the EM, even though it would seem to go against the spirit of treaty-making. It also is consistent with the decision in *Satyam*[1] last year but broader as that decision was only about a situation in which the treaty had provided a specific source rule. However, paragraph 2.7 of the EM does not explain why, as a matter of tax policy, it is considered a desirable and appropriate outcome that a tax treaty can result in a tax disadvantage to a treaty resident, relative to a non-resident not affected by a treaty.

   We query whether the deemed source rule is intended to apply in all cases where Australian source matters in the Australian tax legislation (for example for the purpose of, section 770-10(3)(b) could the deemed source rule deem a source to be outside the treaty partner). Does the deemed source rule also affect what is taken into account under section 770-75(4)(a)(ii)? If this is not the case, consistent with our view above, the introduction of the deemed source rule should be deferred until proper consideration of the required consequential amendments have been identified following more thorough consultation.

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

Yours faithfully,

Tim Neilson
President

[1] Satyam Computer Services Limited v Commissioner of Taxation [2018] FCAFC 172