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Editorial

This special edition of the journal provides significant coverage of Double Tax Agreements (DTAs) in the East Asia/Australia region. It thereby provides some redress to the overwhelming coverage of DTA issues in Europe and North America that exists in the academic and professional literature. Is there any need to consider the regions differently? Yes, there is. DTAs operate with significant differences in different legal, economic and social environments despite their structural similarities. The region that is the focus of this special edition is also one that is growing rapidly in global economic significance and its needs must be considered by the tax community as much as by other communities. This special edition is also the first of at least two that will collect the papers that are being prepared by authors from various other regional jurisdictions on the topic of DTAs.

In this edition, papers are provided from a variety of jurisdictions and approaches. Overviews of DTA policy and approach in both China and Russia are provided. These are highly significant given the recent emergence and rapid progression of both these transition economies. The authors have done an excellent job of capturing the priorities of China and Russia in establishing their relatively recent DTA networks. It is suggested that more subtle insights into how these two countries view their role in the globalised world may be garnered from a careful contemplation of their treaty policy.

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The occasion saw a group of five Atax academics present in Hong Kong which has proved a successful initiative for further joint research programs.

Nolan Cormac Sharkey and Kathrin Bain (Editors)
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In practice, the Hong Kong Inland Revenue Department assesses tax, in certain circumstances, on income that is attributable to activities occurring outside Hong Kong. For example, if an employee has a Hong Kong resident employer, and the employment contract was negotiated and concluded in Hong Kong, all of the income from the employment will be assessed to tax as Hong Kong-sourced income regardless of where the employee's services were rendered, unless the employee can prove that he or she spent no more than 60 days visiting Hong Kong during the year of assessment.[5] Another example: if a Hong Kong-based company purchases products located in a foreign country and sells them to customers in another foreign country, and the products never enter Hong Kong, the resulting profits will generally be assessed to tax as Hong Kong-sourced profits if the authority to conclude the contracts of purchase and sale was exercised by someone in the home office in Hong Kong.[6]

As international business activity expanded in the Asia-Pacific region in the 1970s and 1980s, Hong Kong-incorporated companies began to be used for tax avoidance purposes by investors based in high-tax countries. The combination of a limited tax system, an English legal system, and low-cost, efficient business and banking services performed by English-speaking staff made Hong Kong an unusually attractive location in which to establish an investment holding company or trading company for international business.

For many years, most of the high-tax countries in the world (with the notable exception of the United States) tolerated their residents' use of companies formed in low-tax business and financial centres, even though domestic tax revenue was certainly being lost, or at least deferred, as a result. This complaisant attitude changed gradually. By 1990, nine high-tax countries had enacted controlled foreign company

Meanwhile, the British and Mainland Chinese governments were negotiating the terms of the handover of Hong Kong on 1 July 1997. Three points that emerged from the negotiations were (1) Hong Kong's legal system would continue for at least 50 years, (2) Hong Kong would be independent in financial and tax matters, and (3) Hong Kong would maintain the low-tax policy that it had followed prior to the handover.[10] These matters were decided against a backdrop of rapid economic growth and legal development in the Mainland during the 1990s. Hong Kong's economy was becoming increasingly integrated with that of southern Guangdong province, particularly the manufacturing towns of Shenzhen and Dongguan, where many Hong Kong manufacturing companies had relocated their manufacturing operations.

In these circumstances, it is not surprising that the Hong Kong and Mainland China governments concluded an agreement in 1998 for the avoidance of double taxation.[11] The agreement—which was called an "arrangement" in order to avoid the implication that the two governments were equals—was limited in scope, dealing only with taxable business presence (ie permanent establishments), transportation income, and income from personal services. But it marked a milestone in Hong Kong's tax history: its first DTA applicable generally to individuals and companies from all sectors of the economy.

At around this time, the Hong Kong government decided to pursue DTAs with other countries in an effort to build a worldwide treaty network. Competition with Singapore was undoubtedly a factor in the decision, given the fact that Singapore had a wide network of DTAs already in place. Potential treaty partners were reluctant, however, to conclude DTAs that did not provide for the exchange of information regardless of a domestic tax interest in the information requested.

Between 2004 and 2009, Hong Kong concluded DTAs with four countries:

- Belgium (2004)
- Thailand (2005)
- Vietnam (2009)
- Luxembourg (2009)

In addition, the double tax "arrangement" with Mainland China was expanded and refined, first in 2006 and again in 2008.

A significant change occurred in April 2009, when the G-20 group of nations threatened to punish countries that fail to cooperate in the effective exchange information on tax matters.[12] Failure was defined as having fewer than twelve agreements in place providing for the exchange of information under the terms of Article 26 of the 2004 OECD Model DTA.[13] In conjunction with the G-20's announcement, the OECD Committee on Fiscal Affairs published a list of

[10] Basic Law of the Hong Kong Special Administrative Re

uncooperative countries. At China's request, Hong Kong and Macau were not in the list but were named in a footnote, which stated that they were committed to compliance with the international standard for information exchange and were in the process of amending their laws to permit full compliance in practice.

Soon after these events, the Hong Kong government introduced legislation in June 2009 empowering the Inland Revenue Department to obtain information, pursuant to a request under a DTA, in which it has no domestic tax interest.[14]

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4. ISSUES ARISING UNDER THE DTAS

Although Hong Kong continues to have the limited tax system described at the outset of this article, its DTAs contain most of the provisions of the OECD model DTA. In order of importance to Hong Kong, these include:

- Exchange of information on request, regardless of domestic tax interest
- Permanent establishment (PE) provisions
- Reduction of withholding taxes on dividends, interest and royalties
- Provisions relating to individual residents and employment income
- Limitation on benefits provisions
- Allocation of taxing rights on capital gains
- Provisions on transactions between associated enterprises

Issues are already beginning to arise under some of the DTAs. For example, some treaties expressly preserve the right of the parties to apply the anti-avoidance provisions of their domestic tax laws to items of income covered by the treaty.[16] This can cause a problem if, for example, anti-avoidance provisions in domestic law require full withholding tax on deductible payments to a nonresident that is not subject to tax on receipt of the payment under the tax laws of the nonresident's home country. As discussed earlier, Hong Kong profits tax does not apply to income arising outside Hong Kong, under the terms of the Inland Revenue Ordinance. Consequently, Hong Kong-based companies may encounter difficulty in obtaining withholding tax reductions under DTAs with certain countries, Indonesia being one example.

Mainland China has also denied the benefits of the PRC-Hong Kong double tax arrangement to a Hong Kong company in at least one case. The Hong Kong company in question owned 15.6 percent of the shares in a PRC company, and sold some of the shares, realizing substantial gains. The Hong Kong company claimed that it was exempt from taxation in the Mainland under Article 13(5) of the double tax arrangement, which provides a tax exemption for gains on share sales if the recipient of the gains owns less than 25 percent of the company whose shares were sold. The Fujian tax authorities denied the claim on the ground that the "recipient of the gains" was not the Hong Kong company but rather its sole shareholder, an individual who also owned all of the shares of a second Hong Kong company that owned 22.49 percent of the shares of the same PRC company.[17]

Exchange of information will undoubtedly give rise to issues in practice. Under the Inland Revenue (Disclosure of Information) Rules and the sta.169o1.0005 Teic25 -1to tapa(a6

Financial Secretary. It is too early to tell how all of this will play out in practice, but it is reasonable to expect that taxpayers will do all in their power to resist information

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A comparative study of the OECD model, UN model and China's treaties with respect to rights to tax income and capital

Bin Yang[1] and Chun Ping Song[2]

1. INTRODUCTION

As of December 31, 2010, China has signed eighty-nine tax treaties with other countries and two tax arrangements with its own special administrative regions, Hong Kong and Macau. All these tax treaties and internal tax arrangements have come into effect. As the largest developing country with a huge net inflow of foreign investment, it seems quite reasonable for China to stick to the UN model, which gives more weight to the source principle than the OECD model does. However, China's current tax treaties exhibit an opposite pattern. Most of China's tax treaties, especially those with the OECD member states, are very close to the OECD model though somewhat performance of independent personal services. Income from immovable property which is attributable to a permanent establishment (PE for short hereinafter) shall be deemed as business profits, which are subject to different rules. The purpose of this provision is to ensure that the state of the attribution of profits to a PE. The OECD model adopts the economic connection principle in the attribution of profits. It stresses the economic connection of the business profits and the PE's activities, which follows that the state of source may only tax business profits arising from a PE's activities. In contrast, the UN model proposes a restricted force of attraction principle with stipulates that "the profits of an and, in some cases, to resort to simpler methods for calculating the profits attributable

3.2.2 The calculation of profits of mere purchase by a PE

In general, an organisation established solely for purchasing is not a PE. If a PE carries on purchasing in addition to other business activities, there are different views on whether the profits shall be attributed to the PE for purchasing. The UN model proposes clearly that the competent authorities of the Contracting States shall settle the question by mutual agreement.

The 2010 OECD model deleted the provision that "no profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise"[10] for being inconsistent with the arm's length principle. The arm's length principle takes into account all activities of a PE's, which clearly includes purchasing, in determining its profits. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise would require that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the PE, such an exemption would raise administrative problems. The profits from purchasing activities shall be determined by using the arm's length principle. In contrast, the previous OECD model stipulates that no profits shall be attributed to a PE by reason of the mere purchase by that PE of goods or merchandise for the enterprise. It's argued that if purchasing, being not a complete business cycle, is to be included in profit attribution, it will be very difficult to calculate the real profits.

3.2.3 Special methods for calculation of profits of a PE

The best way to determine the profit to be attributed to a PE is by looking into its accounting records on the basis of arm's length profit. If the accounting records don't exist or are unreliable, the total profits of the enterprise can also be apportioned to the PE by reference to various formulae. The UN model and the previous OECD model both clearly stipulate that "in so far as it has been customary in a Contracting State to determine the profits to be attributed to a PE on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article". The profits to be attributed to the PE shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

The 2010 OECD model removed the profits apportionment method. It was necessary to delete the provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle. Since it is not allowed for the application of such fundamentally different methods, the OECD model avoids the need for such a provision.

3.3 The practices of China's treaties

China follows most of the provisions with respect to PEs and its business profits in the previous OECD model when signing international tax treaties, whilst some UN model clauses are also adopted in a few tax treaties with developing countries, and the

[10] Paragraph 5, Article 7 of the OECD model.

internal tax agreements with Hong Kong and Macao after 2002. For example, China's tax treaties with Nigeria, Algeria, Mexico, Sri Lanka, Morocco, Kyrgyzstan, Bahrain, Tunisia, Oman,[11] Kazakhstan,[12] Venezuela, Moldova,[13] Hong Kong and Macao rule that no deduction shall be allowed in respect of amounts, if any, paid by the PE to the head office of the enterprise, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the PE. The tax treaty between China and Indonesia explicitly states the abandonment of using any force of attraction principle; the tax treaty between China and the Philippines allows an income tax, in addition to the enterprise income tax, not exceeding 10% of the gross amount of the profits repatriated from the branches to its head office.

3.4 An exception to the PE principle-international transportation

International shipping and air transportation usually involve many countries. An enterprise may have branches in different countries and a business activity may involve many countries. Therefore, the PE principle may require that the business profits be taxed in many countries. On the one hand, it is difficult to determine the apportionment of profits to the involved countries (thus the PEs). But on the other hand, the total taxes thus incurred may be too heavy a burden for the enterprise to bear, which in some cases may even outrun its accounting profits. Since it is common knowledge that the international transportation industry earns a relatively low profit, it's reasonable to tackle its international tax, which under the PE principle would be overwhelmingly heavy, in a different way for its better development.[14]

The OECD model states that "Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbor of the ship or boat is situated, or, if there is no such home harbor, in the Contracting State of which the operator of the ship or boat is a resident".

Two alternatives are given in the UN model, namely Article 8 (alternative A) and Article 8 (alternative B). Alternative A is the same as the OECD model. Alternative B has special rules and states "Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by __ per cent. (The percentage is to be established through bilateral negotiations").

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[11] The treaty doesn't mention the exception of the banking or financial institutions with respect to interest.
[12] As above.
[13] As above.
[14] Jin Zhi Liu (translator), Commentaries of UN model Tax Convention between Developed and Developing Countries (China Financial & Economic Publishing House, 1996) 56.

Table 1: An overview of China's tax treaties after 2000

Country	Date of Signature	Tax on Capital?	Withholding Taxes[1] Dividends	Taxation of Capital Gains[2]	Tax Sparing?

Table 1 Notes:

[1] There are a few specialties with respect to investment income of the relative articles of China's treaties. First, the dividends generally don't include the "jouissance" shares or "jouissa

Portugal, Seychelles, Philippines, Ireland, South Africa, Barbados, Azerbaijan, Albania, Sri Lanka, Morocco, Indonesia, Kazakhstan, Kyrgyzstan, Iran, Nigeria and Macau are all of this kind.

The fourth category: a 10% withholding tax rate for all kinds of investment income, while actually a 30%-40% discount in tax payable is given to royalties arising from using industry, commercial and scientific equipment. The treaties with the United States, the United Kingdom, France, Belgium, Germany, Finland, Denmark, Sweden, Italy, Netherlands, Poland, Bulgaria, Switzerland and Spain are all of this kind. The treaty with Israel gives another preference of 7% for the interest paid to a bank or any other financial institutions; while the treaty with Malaysia stipulates a 15% withholding tax rate for royalties arising from the use of cultural copyrights.

The fifth category: a 15% withholding tax rate for dividends and a 10% withholding tax rate for interest and royalties. For example, the treaties with Norway, New Zealand, Australia, Papua New Guinea, Qatar are all of this kind.

The sixth category: a 5% withholding tax rate for dividends and a 10% withholding tax rate for interest and royalties. For example, the treaties with Mongolia, Mauritius, Croatia, Slovenia, Yugoslavia, Sudan, Macedonia, Laos, Saudi Arabia, Mexico, Brunei, Oman Barbados and are all of this kind.

We notice a strong resemblance between China's treaties with the OECD member states and the OECD model, while the other treaties diversify greatly and are difficult to be classified. However, it is worthwhile to note that an anti-avoidance clause was directly added to the articles with respect to investment income in China's newly signed treaties with Singapore and Nigeria. It denies the application of relevant articles if the rights giving rise to the dividend, interest or royalty were created or assigned mainly for the purpose of taking advantage of the treaty and not for bonafide commercial reasons. Although the rules are quite elementary and more observations are needed to determine its application, it is quite evident that China has been giving more concern to combatting international tax evasion and avoidance

5. THE RESPECTIVE RIGHTS TO TAX CAPITAL GAINS

Both the OECD model and the UN model give the exclusive right to tax income from immovable property to the state of source, which is followed by China. However, the two models diverge on the respective right to tax income from the alienation of immovable property.

The four identical aspects are as follows: 1) Gains derived by a resident of a Contracting State from the alienation of immovable property and situated in the other Contracting State may be taxed in that other State. 2) Gains from the alienation of movable property forming part of the business property of a PE which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a PE (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. 3) Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated only in the Contracting State in which the enterprise is a resident.[17] 4) Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.[18]

The differences lie in the taxation of income from alienation of shares or comparable interests. First, the UN model expands the right to tax of the state of source, in that it may tax gains from the alienation of interests in partnerships, trusts and estates which principally own immovable property situated therein. That is to say gains, in whatever form, from the immovable property situated in a Contracting State may be taxed in that State. Secondly, the UN model stipulates that gains from the alienation of shares,

6. CONCLUSION

The dual fundamental purposes of the double taxation treaties are: eliminating international double taxation so as to guarantee that the income from international transactions shall be taxed only once; and reconciling contradictions of sovereign states so as to distribute income tax revenues of international economic activities properly. The prevailing view regarding tax treaties assume that they benefit every country involved. However, under the worldwide tax competition for highly mobilized capital, each country has been driven to take unilateral measures, such as tax credits and tax exemptions for foreign investment, which have eliminated international

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An Australia-Hong Kong double tax agreement: Assessing the costs and benefits

Nolan Cormac Sharkey and Kathrin Bain

relative certainty in DTA principles of revenue jurisdiction in comparison to those employed in Australia and Hong Kong, this article suggests that there is scope for reform of jurisdictional nexus rules in Australia and Hong Kong regardless of DTA completion.

Part 2 of this article sets the context of the question of a DTA between Australia and Hong Kong by reviewing the treaty policy of both jurisdictions as well as their tax systems and the relationship between them. Part 3 provides a detailed analysis of the impact a DTA would have on the tax claims of both Hong Kong and Australia. It finds that this impact is significant and should be carefully considered by both jurisdictions as to benefits it could bring as well as the revenue loss it may create.

2. BACKGROUND

Australia's history of DTAs dates back 65 years, with the first DTA being signed with the United Kingdom in 1946. In contrast, Hong Kong did not enter into any DTAs until 1998, and until recently, there was little expansion in Hong Kong's DTA network. Since 2010, there has been rapid expansion of Hong Kong's DTA network. As yet, no negotiations have been scheduled between Hong Kong and Australia, despite an indication by Hong Kong that they would like to enter into such negotiations.[2] This part will first compare Australia's and Hong Kong's tax systems, DTA history and policies, as well as discuss the potential usefulness of an Australia-Hong Kong DTA.

2.1 Comparison of Australian and Hong Kong tax systems

One of the relevant considerations before entering into a DTA is the similarity of tax systems. Despite the fact that both the Australian and Hong Kong tax systems were based on United Kingdom tax legislation, there are significant differences between them. The key differences are discussed below.

Australia uses a combination of both residence and source based taxation. Broadly speaking, Australian residents are taxable on their worldwide income, and non-residents are taxable on Australian sourced income.[3] In contrast, Hong Kong uses a purely source based taxation system, with tax only being imposed on income that arises in or is derived from Hong Kong.[4]

The tax bases of both countries are significantly different, with Australia having a much broader tax base. Although income is not comprehensively defined in Australian tax law, it is a wide concept, including both amounts of income (for example, salaries, business profits, income derived from property) and capital.[5] The income tax rates vary based on the type and residency of taxpayer and, for individuals,

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[2] Linda Tsang, 'Tax agreement between Hong Kong and Australia – negotiations', IBFD (online), 24 June 2011 <www.ibfd.org>

[3] Income Tax Assessment Act 1997 (Cth) ss 6-5, 6-10.

[4] Ayesha MacPherson and Garry Laird,

level of income. Companies are currently subject to a flat tax rate of 30 percent.[6] Individuals are subject to progressive taxation, with tax rates for the 2010-11 year ranging from zero percent to 45 percent for residents, and from 29 percent to 45 percent for non-residents.[7]

In terms of income, Hong Kong essentially taxes only business profits, salaries and rent from real property. Profits Tax is imposed at a flat rate (for the 2010-11 year) of either 16.5 percent (for corporations) or 15 percent (non-corporate taxpayers).[8] Salaries Tax is a progressive tax, with rates for the 2010-11 year ranging from 2 percent to 17 percent. The total tax payable is not to exceed a rate of 15 percent. Property Tax imposed under Hong Kong's *Inland Revenue Ordinance* is a flat rate of tax (15 percent for the 2010-11 year) on the net assessable value of property.[9] There is no capital gains tax in Hong Kong.[10]

Hong Kong does not tax dividends. Under s 26(a) of the *Inland Revenue Ordinance*, dividends from corporations that are subject to Profits Tax are specifically excluded from assessable profits. Although the wording of this exemption may imply that dividends paid by a corporation that has not been subject to Profits Tax will not be excluded under s 26(a), the Hong Kong Inland Revenue Department treats all dividends as non-assessable.[11] Interest derived from bank deposits, most Government Bonds and various debt instruments is also excluded from Hong Kong taxation.[12]

Australia's treatment of dividends is rather unique and worthy of discussion. Under the classical system of taxation, company profits are taxed at the company level. When the profits are distributed to shareholders in the form of dividends, the dividends are also taxed. This effectively results in economic double taxation – with the same amount of income being taxed twice, albeit in the hands of different taxpayers. In 1987, Australia introduced what is known as an imputation system[13] in an attempt to eliminate the effect of double taxation. Under this system, tax paid by a company can be attributed ('imputed') to shareholders. When a company pays a dividend out of profits on which tax has already been paid, they can attach a 'franking credit' to the dividend (a dividend with a franking credit attached is a 'franked dividend'). The franking credit reflects the tax that has been paid by the company. If a dividend is paid from profits which have not been subject to tax at the company level (or the company decides not to attach franking credits to the dividend), it is known as an unfranked dividend. When a resident shareholder receives a franked dividend, they are required to include both the dividend received and the franking credit in assessable income. However, this franking credit then becomes a tax offset, which reduces the

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[6] *Income Tax Rates Act 1986* (Cth) s 12(1), Sch 7 Pt 1.

[7] *Income Tax Rates Act 1986* (Cth), s 23(2). Most Australian resident individuals are also subject to an additional 1.5 percent tax (the Medicare Levy) to help fund Australia's public healthcare scheme. See *Medicare Levy Act 1986* (Cth).

[8] *Inland Revenue Ordinance 1947* (HK) Schs 2, 8.

[9] *Inland Revenue Ordinance 1947*

shareholder's tax liability. When the taxpayer is a resident individual, any excess franking credits are refunded.[14]

Australia does not have a clearly published DTA negotiation policy, with the Review of International Tax Arrangements stating:

> Like many other contracts entered into by governments, DTAs are negotiated largely in secret. To some extent, this is changing: in Australia in recent years the negotiation process has been partly opened to consultation, through the ATO's Tax Treaties Advisory Panel and direct dealing with specific taxpayers on particular issues. But the balance is still very much on the side of secrecy.[42]

In January 2008, the then Assistant Treasurer and Minister for Competition Policy and Consumer Affairs announced that the government was seeking public comment and submissions on Australia's future DTA negotiation program and policy. The announcement included a summary of the main features of Australia's recent tax treaty practice, including the fact that although Australia broadly follows the OECD Model, it would be modified to ensure that Australia retained taxing rights over natural resources. In terms of withholding tax rates, these would generally be limited to five percent for inter-corporate non-portfolio dividends, 15 percent for other dividends, 10 percent for interest and five percent for royalties.[43]

As part of the process of seeking public input, the government was particularly interested in submissions indicating countries that Australia should seek to negotiate or update a DTA. In this regard, the Review of International Tax Arrangements had indicated that updating DTAs with Australia's major trading partners was more important than entering into new DTAs with countries with which Australia has only low levels of trade or investment.[44] The current levels of trade and investment between Australia and Hong Kong will thus be examined in Section 2.4 of this article.

2.3 Hong Kong DTA network

Due to Hong Kong's source-based taxation system, double taxation is less of an issue than in a country such as Australia that utilises concepts of both residency and source. However, the Hong Kong Inland Revenue Department has stated:

> actively engaged our trading partners in negotiating a comprehensive DTA (covering various types of income) with us.[45]

Hong Kong entered into its first DTA with China in 1998.[46] Following this first treaty, Hong Kong's DTA network was very slow to develop. No further DTAs were signed until December 2003, when a DTA was signed with Belgium. From that point until 2009, only three new DTAs were signed: Thailand (2005), Luxembourg (2007) and Vietnam (2008).

The main reason for the slow development of a DTA network was the inability of Hong Kong to meet the OECD Model Exchange of Information article due to their domestic tax legislation. Hong Kong's early DTAs contained a phrase under the Exchange of Information Article that read: "Information received shall not be disclosed to any third jurisdiction for any purpose without the consent of the Contracting Party originally furnishing the information". This was inconsistent with the OECD Model Convention,[47] and significantly restricted Hong Kong's ability to successfully negotiate DTAs.

Hong Kong's Financial Secretary announced in the February 2009 Budget Speech that legislation would be introduced to allow Hong Kong to negotiate DTAs that included the OECD Exchange of Information Article. Specifically, he stated:

> In recent years, our major trading partners have raised the requirements on the exchange of tax information under such agreements. Our existing legislation has not kept pace with this development. To further extend our network of such agreements, we consulted the industry in mid-2008 on liberalising the arrangements for the exchange of tax information. I believe that the business and professional community generally agrees that Hong Kong should align its arrangements for the exchange of tax information with international standards so that we can enter into such agreements with more economies. We plan to put forward relevant legislative proposals by the middle of this year.[48]

Amendments to the *Inland Revenue Ordinance* came into effect in March 2010 as a result of the *Inland Revenue (Amendment) (No. 3) Bill 2009*. The amendments allow Hong Kong's Inland Revenue Department to collect and provide information in any matter that may affect any liability, responsibility or obligation of any person under the laws of a country outside of Hong Kong concerning the tax of that outside country. The amendments also extend the power of the Commissioner of Inland Revenue to issue search warrants for the purposes of collecting such information, and make it an offence for a taxpayer to give false information in relation to tax matters outside of Hong Kong. (These amendments only apply to countries with which Hong Kong has

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[45] Inland Revenue Department, *Policies: Double Taxation* (3 May 2011) Inland Revenue Department <http://www.ird.gov.hk/eng/pol/dta.htm>.

[46] It is well established that although Hong Kong is a Special Administrative Region of China, they operate two separate tax systems. See for example: *The Basic Law of Hong Kong Special Administrative Region of the People's Republic of China* 1990 (HK), Australian Taxation Office Taxation Ruling TR 97/19 *Income tax: tax implications of re*

entered into a DTA).[49] In order to protect taxpayer privacy, the Inland Revenue (Disclosure of Information) Rules came into effect at the same time as the amending legislation that sets out the IRD's practice for dealing with exchange of information requests, procedures to be followed, and safeguards available to taxpayers.

In regards to the amending legislation, the Commissioner of Inland Revenue, Chu Yam-Yuen, stated that "Hong Kong has entered a new phase in supporting the international effort to enhance tax transparency". The Commissioner further stated "Our target is to sign the new comprehensive agreement with all our trade partners.

impact on tax revenue), it is relevant to examine the current levels of trade between Australia and Hong Kong.

In a 2008 speech entitled "The Australia Hong Kong Connection", Stephen Smith (the then Australian Minister for Foreign Affairs and Trade) highlighted the relationship between the two countries, stating: "Australia and Hong Kong have long shared a special relationship in Asia, underpinned by strong people-to-people links and a highly complementary trading and investment partnership. As one of the world's freest economies, Hong Kong plays a significant role in this region's, and Australia's, prosperity".[53] At the time the speech was given, Hong Kong represented Australia's second largest expatriate community.[54] Further, in the same year (2008), Hong Kong was Australia's fourth largest source of foreign investment.[55] In terms of trade, Hong Kong was Australia's 20th largest trading partner, 15th largest export market and 27th largest source of imports.[56]

More recent figures are available from Hong Kong's perspective. In 2010, Australia was Hong Kong's 17th largest trading partner, 13th largest domestic export market, 11th largest re-export market, and the 21st largest source of imports. In terms of bilateral investment, in 2009 Australia was the 16th largest source of inward direct investment into Hong Kong, and the 10th major destination of outward direct investment from Hong Kong.[57] More detailed figures regarding the amount of trade and investment between Hong Kong and Australia (from Hong Kong's perspective) is shown in the table below.

Table 1: Hong Kong's trade and investment with Australia[58]

Type of trade / investment	Amount ($HK million)	Year
Domestic Exports (HK into AU)	1,148	2010
Re-exports (HK into AU)	36,926	2010
Total Exports (HK into AU)	38,074	2010
Total Imports (AU into HK)	16,064	2010
Total Trade	54,138	2010
Inward Direct Investment (AU into HK)	19,100	2009
Outward Direct Investment (HK into AU)	34,100	2009

[53] Stephen Smith (Australian Minister for Foreign Affairs and Trade), 'The Australia Hong Kong Connection' (Speech delivered at the Australian Chamber of Commerce, Hong Kong and Macau, 6 May 2008) <http://www.foreignminister.gov.au/speeches/2008/080506_austcham_hong_kong.html>.

[54] Ibid.

[55] Department of Parliamentary Services, Foreign Investment in Australia: Recent Developments (1 April 2011) Parliament of Australia <http://www.aph.gov.au/library/pubs/bn/eco/AustForeignInvestment.pdf>.

[56] Hong Kong Regional Cooperation Division, Trade and Industry Department, Hong Kong Australia Trade Relations (April 2011) Hong Kong Economic and Trade Office Sydney <http://www.hketosydney.gov.hk/hkaustraderel.php>.

[57] Ibid.

[58] Sourced from Hong Kong Regional Cooperation Division, Trade and Industry Department, above n 56.

By way of comparison, it is noted that Hong Kong and New Zealand signed a tax treaty in December 2010, which entered into force in November 2011. On the one hand, the existence of a Hong Kong-New Zealand DTA may be considered irrelevant from Australia's point of view. On the ot

The significance of trading relationship that currently exists between Australia and Hong Kong lends support to the argument that Australia should consider entering into DTA negotiations. As cross-border trade and investment increases, so too does the potential for double taxation. However, the strength of the existing relationship is just one factor that is relevant in determining whether a DTA should be entered into between Australia and Hong Kong. Also of relevance is the impact a DTA would have on each country's tax system and associated effect on taxation revenue, the focus of Part 3 of this article.

3. IMPACT OF A DTA ON AUSTRALIAN AND HONG KONG TAX OUTCOMES

Part 3 provides an analysis of how the signing of a DTA by Australia and Hong Kong would impact tax outcomes in both jurisdictions. As discussed in Part 2, there may be various reasons why two jurisdictions would conclude a DTA that go beyond altering technical tax outcomes. A treaty may simply be viewed as symbolic of the two jurisdictions willingness to bind themselves in respect of their taxing jurisdictions and therefore show that they have a good cooperative relationship. There may also be taxation related reasons that don't actually impact the manner in which the taxes operate. These would include using the DTA to allow cooperation between revenue and other government authorities. However, ultimately DTAs are meant to prevent double taxation and share revenue jurisdiction between two countries. It would be expected that a DTA would only be needed when it actually makes a material difference to taxation outcomes. The question that arises is what difference to tax outcomes would a DTA between Hong Kong and Australia make? If these are negligible, a DTA may not be considered necessary. On the other hand, if the differences are material, then Australia and Hong Kong would need to consider such differences and whether they are desirable or undesirable in how they impact both taxpayers and the revenue claims of the countries themselves.

On the face of it, it may be expected that given Hong Kong's limited source based tax jurisdiction, the signing of a DTA would make little difference to tax outcomes. In Australia as well, the tax claim against non-residents is generally consistent with that allowed under DTA principles. However, detailed analysis of how the tax laws of the two jurisdictions operate and how DTAs operate to shape tax laws often reveals unexpected outcomes. Therefore it is necessary to conduct a thorough and detailed analysis of the tax claims that both Australia and Hong Kong make under domestic laws and the manner in which DTAs operate. The following analysis does this by considering the major categories of income dealt with by DTAs in turn as well as the critical areas of residence. As DTAs all differ, the nature of any future DTA between Australia and Hong Kong is anticipated by the developing practice of Hong Kong and Australia. Reference has been made to recent DTAs of both jurisdictions as well as international models. As will be demonstrated, a DTA between Australia and Hong Kong would have a significant impact on both jurisdictions. As such, both countries should carefully consider the benefits it may bring against the potential loss of revenue.

3.1 Residency

3.1.1 Residence of individuals

Prior to Australia's introduction of a temporary resident regime in 2006, a DTA between Australia and Hong Kong would have made a very significant impact on the

Australian taxation of Hong Kong people who came to Australia for relatively short periods of time. This is because Australia's multiple tests of residency for tax purposes and the way they have been administered are very wide and verge on the aggressive. For example, based on TR 98/17,[63] a person who spends very little time in Australia may be regarded as a resident for tax purposes if they are working in Australia. Given the very significant numbers of people from Hong Kong who come to Australia for a variety of work, study and leisure activities, this approach would certainly have been a

from many other tax jurisdictions. A resident of Hong Kong for DTA purposes can be a person who ordinarily resides in Hong Kong, who spends more than half a year in Hong Kong or more than 300 days in two years.[77] It is clear that it would be far easier for expatriate workers to meet these Hong Kong residency tests than it would be to escape Australian residence rules. They would therefore become dual residents and under the tie breaker rules discussed above, may be allocated to Hong Kong. While not all persons would end up with this outcome, there will be far more certainty in the Australian tax treatment of Australian workers in Hong Kong. In addition, of concern to Australia would be the certain loss of tax revenue due to losing a significant number of tax residents if a DTA was concluded with Hong Kong.

3.1.2 Corporate residence

As with individuals, the introduction of a Hong Kong DTA results in the introduction of a corporate residence concept for Hong Kong tax purposes that is not generally categories of income derived by such residents would be impacted by a DTA. The following will assume a clear residency status of taxpayers as either Hong Kong or Australian.

3.2 Active income

3.2.1 Employment income

As noted in Parts 2.4 and 3.2.1, there are significant numbers of Australians working in Hong Kong and Hong Kong people working in Australia, making the impact a DTA would have on employment income very relevant. A DTA based on the anticipated model would make notable changes in relation to Australian and Hong Kong residents who earn employment income that has a connection with the other jurisdiction. As will be seen with several other instances below, one of the key changes that a DTA would bring about is a significant increase in certainty in relation to taxing rights in both Australia and Hong Kong. This is primarily the result of the continued reliance of both jurisdictions on uncertain common law tests to determine their taxing rights rather than mechanical and predictable rules.

As noted in Section 2.1, Australia will generally only tax non-residents on their Australian sourced income.[83] Common law principles determine whether a non-resident's employment income has an Australian source.[84] Australian case law has developed a significant focus on the place where work is done as being the source of employment income,[85] which is consistent with DTAs that also focus on where work is performed as the key taxing nexus.[86] However, Australian law is not certain on this nexus with precedents establishing that the place that work is done is not always the source of employment income. In the facts of *FCT v Mitchum*[87] for example, there was a clear finding that the place where the work was done was not significant in determining the source of employment income. However, the case did not clearly articulate what the other relevant factors are. It is therefore submitted that DTAs provide a significant increase in certainty to non-resident employees whose work has some connection to Australia in that it ensures that the test is one that looks to where the work is performed as the sole relevant nexus.

In addition to providing certainty in relation to the source of employment income, a DTA will also impact Australian taxing rights in relation to work done in Australia by non-residents. It will do this by restricting Australia's taxing rights in relation to persons who do short term work in Australia. Under current Australian law, non-residents will be taxed on their Australian sourced employment income even if they worked in Australia for a very short time.

significant difference to their tax outcomes in Australia in that they will not be taxed at all in relation to this income. At present all such income is subject to Australian taxation.

As with Australia, a DTA prima-facie makes little difference to the taxation of employment income by Hong Kong as Hong Kong generally only taxes employment income sourced in Hong Kong.[90] However, a more detailed analysis demonstrates that a DTA significantly alters the concepts that Hong Kong employs in taxing signing of the DTA would have been a major benefit to many Australians working in Hong Kong for period of greater than 90 days and less than 180 days in particular, as determined in accordance with common law precedents and is, by its nature, something that evolves over time and can be difficult to determine with certainty given the array of possible business activities.[95] Thus, precedent indicates that the place of contracting may be important in trade while the place of manufacture may be highly significant in cases of manufacturing.[96] However, there is always the possibility that in a particular case, a particular factor may be held to be highly significant to the generation of a particular business profit and the location of this factor may be used as a major indicator of source. Precedent also indicates that the source of business profits may be apportioned between different territories where different factors are located in different territories.[97]

Given the above, it is not surprising that the source of a business profit in accordance with common law principles can be difficult to predict with certainty. Up until recently, Australia partially addressed these difficulties with deemed source rules contained in the *Income Tax Assessment Act 1936* (Cth).[98] However, these provisions were unexpectedly repealed as part of the Australian government's process of repealing redundant provisions from the 1936 Act. It is submitted that the only way that these could be held to be redundant was on the assumption that a DTA existed in

Under its Profits Tax, Hong Kong will seek to tax a business profit when a trade, business or profession is carried on in Hong Kong and then to the extent that the profit arises in Hong Kong.[101] The concept of a profit arising in Hong Kong is very similar to the concept of an Austrian sourced business profit in Australia and courts in both jurisdictions have looked to similar precedents in deciding on these matters. Consideration of when a trade, business or profession is carried on in Hong Kong has major benefit of the DTA is the predictability it creates in relation to tax claims over business profits in both jurisdictions. Thus, the merit of the conclusion of a DTA between Hong Kong and Australia will need to be evaluated through a balancing of the reduced tax claims with the desired increase in certainty in tax claims.

3.3 Passive income

3.3.1 Interest income

The taxation of interest income in both jurisdictions would remain largely unchanged by the conclusion of a DTA but there are some notable points for consideration. Australia's tax claim on interest through its withholding tax regime is structurally very similar to that allowed by a DTA. In Australia, interest derived by non-residents is taxed at 10 percent (withholding on gross) unless it is connected to a PE in Australia.[106] If it is, then it is taxed by assessment. This is little different to what occurs under most DTAs except that there may be minor differences as to what constitutes a PE.[107] In these unusual circumstances the DTA may alter outcomes. One area in which a DTA may make a significant difference is when interest is sourced in Australia under common law principles but not subject to the withholding tax regime because it is not paid by an Australian or non-resident's Australian establishment.

3.3.2 Royalties

The analysis of how a DTA would impact the taxation of royalties by Australia and Hong Kong has some similarities to the analysis in respect of interest. In Australia, royalties paid to a non-resident are generally taxed through a final withholding tax.[110] Unlike with interest, there is no exclusion from withholding when the royalty is derived through a PE. Also, the withholding tax rate is a very significant 30 percent of the gross royalty. The alteration of these two features would be the most significant impact that the signing of a DTA would have on taxation of royalties by Australia. A DTA would ensure that when dividends are derived by a Hong Kong resident through a PE in Australia, they will be subject to taxation by assessment rather than withholding.[111] This is a very significant change and would provide a notable incentive for Hong Kong residents to carry on royalty generating business in Australia as they would get the benefit of having business expenditure as a tax deduction against their royalty income. For royalties that are not connected to a PE, the DTA should reduce the withholding tax rate from 30 percent of the gross to 15 percent or lower on the gross. This again is a major reduction to the Australian tax claim over Hong Kong residents.

Finally, as was discussed with interest, a DTA would clarify Australia's residual taxing rights over royalties based on the source concepts. At present, there remains the possibility that royalties derived by Hong Kong residents but that are not paid by an Australian or a non-resident with a PE in Australia may remain taxable if the source of the royalty can be found to be in Australia. This is because as with interest, s 128D only excludes from assessment royalties that fall into the withholding tax regime. As the common law source of royalty income is not related to the location of the payer,[112] such situations may arise. However, the actual common law source rules are again very unclear. A DTA would prevent Australia from taxing any royalty of a Hong Kong resident that is not either paid by an Australian or effectively connected to an Australian PE. In doing this it will create significant certainty in relation to Australia's tax jurisdiction over royalties and also reduce Australia's jurisdiction. This would be a notable benefit to Hong Kong residents as it is unlikely that Hong Kong would impose taxation in Australia's place.

The final point above is something that Australia should consider carefully if it is going to conclude a DTA with Hong Kong and offer a low rate of withholding tax for royalties unconnected to Australian PEs. The reduced tax claim together with Hong Kong's narrow tax base means that a DTA with Hong Kong may create significant treaty shopping possibilities for residents of third countries who can structure their Australian involvement through Hong Kong.

have to curtail its claims in relation to royalties derived by Australian residents if it concludes a DTA with Australia. Under s 15 of the *Inland Revenue Ordinance*, royalties as well as rents for moveable property are deemed to be business profits and sourced in Hong Kong if the property they relate to is used in Hong Kong. However, as outlined above, a DTA would restrict Hong Kong taxation of royalties derived by are connected with Australia. Hong Kong would not collect the tax saved through Australia's reduced claim.

Income from real property and from the alienation of real property should be minimally impacted by the conclusion of a DTA between Australia and Hong Kong. A DTA is likely to allow the country where the real property is situated to retain full primary taxation rights over both rents and gains on disposal. As both Australia and Hong Kong are unlikely to exceed this jurisdiction under their domestic rules, this would not be a constraint. Australia generally only taxes gains made on Australian real property and rents from real property in Australia when these are derived by a non-

DTA as well. However, the tax that is no longer payable to Hong Kong may simply be collected by Australia under its worldwide tax base. Hong Kong should therefore consider the desirability of this outcome of a DTA. On the other hand, tax given up by Australia under a DTA would not be likely to be subsequently collected by Hong Kong due to its narrow tax base. Hong Kong residents under the DTA therefore stand to significantly benefit from it. This may be a concern for Australia in that it will create the possibility that persons from third countries will structure their Australian business through Hong Kong to take advantage of its benefits together with Hong Kong's minimal tax base. Australia should therefore pay careful attention to the inclusion of anti-treaty shopping and limitation of benefits clauses in any DTA that is contemplated with Hong Kong. It is submitted that Australia should determine the rates of withholding tax granted to royalties and dividends under any DTA very carefully to determine whether a low rate is in its interests.

Hong Kong has indicated a desire to enter into DTA negotiations with Australia. Due to the significant relationship between the two countries, Australia should genuinely consider entering into such negotiations. However, also of concern to Australia will be the potential loss of taxation revenue, which, as indicated in Part 3, is likely to be significant. This will affect Australia's willingness to enter into treaty negotiations with Hong Kong. The analysis in Part 3 has also indicated areas where a DTA would have most impact. If treaty negotiations do commence, it is these areas that warrant the most discussion and negotiation.

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Some distinctive features of Australian tax treaty practice: An examination of their origins and interpretation

C. John Taylor*

1. PART I: HISTORICAL P

Chart 1: Australian treaties and protocols by decade

Chart 2: Australian new treaty partners by decade

Chart 2 shows the number of new Treaty partners with Australia by decade since 1946.

year

Chart 3: Australian treaty partners by region by decades

2. PART II: ORIGINS OF DISTINCTIVE FEATURES OF AUSTRALIAN TAXATION TREATIES

As will be discussed in more detail below, Australian taxation treaty practice still has many distinctive features which set it apart from the treaty practice of many OECD countries. Examination of Australian treaty practice between 1980 and the present shows the continuing influence of the Australian model that had developed by 1980. Despite changes in Australian treaty practice since 1980 several idiosyncratic features of the 1980 model persist in current Australian treaty practice. In several instances the archival evidence shows that these features persisted in the Australian model up to 1980 simply because they had always been there and that by 1980 the original reason for inserting these features had been forgotten.

Part II will examine the following features[4] of Australian treaty practice that either continue to be distinctive or have been distinctive and controversial until recently:

- the definition of permanent establishment;

[4] Emphasis has been placed on those distinctive features that have a more general application rather than on those that are only or primarily relevant to particular industries. Emphasis has also been placed on features where currently available archival evidence assists in understanding the origin of the distinctive feature.

- the savings clause in non arm’s-length situations;
- treaty articles giving income an Australian source that it would not have under domestic law;
- the other income article;
- not agreeing to and then modifying the non discrimination article;
- capital gains articles; and
- rates of withholding taxes on investment income.

In each case the historical background to these distinctive features will be discussed based on archival evidence[5] that has been available to the author. The argument of the paper is that these distinctive features continue to reflect their origins as part of Australia’s attempts to maximise source country taxation in the treaty context or to respond to Australian domestic law concerns. mon astin definition in the 1945 United States – United Kingdom Treaty.[7] The definition in the 1953 treaty had, however, in the words of the then Australian Commissioner of Taxation, been 'broadened in conformity with Australian aims.'[8] Clearly Australia's aims in this respect were to maximize source based taxation of the Australian branches of foreign enterprises.[9] In addition to indicia of a permanent establishment under the Australia – United Kingdom Double Taxation Treaty of 1946 the draft Australia – United States Treaty proposed that a permanent establishment should include a workshop, oilwell, office, an agency, a management and the use of substantial equipment or machinery. The most interesting inclusion was the specific reference to the use of substantial equipment. The same inclusion had been made in the 12th June 1950 Supplementary Convention to the 1942 United States – Canada Taxation Treaty[10] but had not been made in any other United States treaty up to 1952 and was not made in any other United States treaty for the rest of the 1950s. However, specific reference to 'substantial equipment' was included in several other Canadian treaties of

7th

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A ‘substantial equipment’ provision was also found in Australia’s 1957 Treaty with Canada and 1960 Treaty with New Zealand.

Australia tried unsuccessfully to have a substantial equipment provision included in its 1967 Treaty with the United Kingdom. The Australian Commissioner of Taxation, Sir Edward Cain in correspondence with Mr W B Johnson the Under Secretary of the United Kingdom Board of Inland Revenue prior to commencement of negotiations on the 1967 Australia – United Kingdom Treaty enclosed what was evidently the definition in the Australian model.[13] Johnson’s response was that while it was helpful to have Australia’s views he was not sure that the Australian draft (particularly paragraph (2)(ii) dealing with substantial equipment) was entirely satisfactory from the United Kingdom viewpoint. Johnson went on to say that he did not think that further discussion could be usefully carried on through correspondence but that it ought to be possible to reach a solution acceptable to both sides in the negotiations.[14]

During the negotiation of the 1967 Treaty in Canberra Australia raised the case of a United States company which had appointed a United Kingdom company as its sole distributor in Australia on a commission basis of its products. The United States company licensed the United Kingdom company to manufacture its products and use its trade marks, reimbursed the costs of manufacture and loaned all the machinery necessary to manufacture its products. The United States company was treated as having an Australian permanent establishment under the Australia – United States Treaty where permanent establishment was defined as including ‘the use for

Two other distinctive features of Australian treaty practice, mentioned in the then Assistant Treasurer's Media Release, originated with the Australia – United Kingdom treaty of 1967. These were including a building or construction, installation or assembly project within the set of examples of a permanent establishment where it existed for more than six months (in contrast to the twelve month requirement in the OECD Model) and deeming supervisory activities for more than six months in connection with a building site, or construction, installation or assembly project to be a permanent establishment.

The Australian Taxation Office Memorandum and a letter from the Acting Second Commissioner of Taxation to the Secretary of the Australian Treasury[22] commenting on the definition of permanent establishment in the United Kingdom draft of the 1967 Treaty noted that it differed in several respects from the Australian model.[23] Among these differences were that the definition did not regard as instances of a permanent establishment an installation project that lasted for more than twelve months nor supervisory activities on a building site or construction, installation or assembly project for more than twelve months. No previous Australian treaty had included installation projects or supervisory activities within the definition of permanent establishment. However, supervisory activities in relation to inter alia installation projects with a twelve month time limitation had been deemed to be a permanent establishment under Article II(1)(p)(iv)(aa) of the 1966 United Kingdom – New Zealand Treaty. The Australian Treasurer's submission to cabinet on the decision to commence negotiations for a new treaty with the United Kingdom in 1966 recommended pressing for a more comprehensive definition of permanent

operation of substantial equipment, in exploration for or exploitation of natural resources for period in aggregate of 90 days in any twelve month period] and Article 5(4)(c) operating substantial equipment for periods in aggregate exceeding 183 days in any twelve month period; Australia – Turkey Treaty, 2010 (not yet in force) Article 5 (3)(b) [operating substantial equipment for more than 6 months in any 12 month period].

22 W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and accompanying memorandum, 16th November 1966 'Double Taxation : Re-negotiation of the Present Agreement between the United Kingdom and Australia", National Archives of Australia, Series Number A571 Control Symbol 66/3007 (hereafter '1967 UK – Australia Treaty, Australian Treasury file').22.36 -1.1467 TD .0002;5.5(a)7(e15 Tw [0036iffere)6.7(Archives TD .00c -1.1r T rRArchiv)

establishment which would include an agency, an oil well and an installation project existing for more than twelve months.[24]

The United Kingdom appears to have reasonably readily agreed to the Australian requests in relation to 'installations' and 'supervisory activities'. The United Kingdom 'Notes of Meetings' of the negotiations in Canberra relating to the 1967 Australian – United Kingdom Treaty record that on the third day the word 'installation' was added to sub-paragraph 2(g) to cover a person who contracts to manufacture, supply and install equipment.[25] It was also agreed on the third day that provision dealing with supervisory activities along the lines in the United Kingdom – New Zealand agreement would be added. It is clear from handwritten notes by an Australian Treasury official that these additions were requested by Australia.[26] The existence of a provision dealing with supervisory activities in the 1966 United Kingdom – New Zealand Treaty presumably made Australia's argument easier on this point.

Precisely how the minimum periods in these paragraphs came to be reduced to six months is not entirely clear. The United Kingdom Notes of Meetings record that on the fourth day, at Australia's request, the minimum period in sub-paragraph 2(g) was agreed to be reduced to six months.[27] The 1967 Treaty with the United Kingdom is the first instance in an Australian treaty with six months being the minimum required period for a building site, construction, installation or assembly project to be classified as a permanent establishment. The Australian Taxation Office Memorandum to the Secretary of the Australian Treasury had indicated that the Australian model of the time required a minimum period of twelve months before an installation project was regarded as a permanent establishment. Handwritten notes by an Australian Treasury official at the negotiations indicate that here Australia asked for the inclusion of a reference to an 'installation' project lasting twelve months and make no mention of a request to reduce the minimum period to six months.[28] When seen in the context of the Australian Taxation Office Memorandum, O'Reilly's (the Acting Second Commissioner of Taxation) letter and McMahon's cabinet submission the reduction in the minimum time to six months was clearly aimed at giving greater scope for source basis taxation of industrial or commercial profits.

From the 1967 Australia – United Kingdom Treaty onwards including 'installation projects'[29] comcabs4 Twntae in an AustraliiesTreasuryroject reduce the miimum uce thfoect wy onuce thng with supervisory actect w to six months.[30] All of these features were in the Australian drafts sent to Japan and Singapore in February and August of 1968 respectively. While there are exceptions,

[30] See Australia – Singapore Treaty, 1969, Article 4(2)(i) and Article 4(3)(a) [6 months within a 12 month minimum period]; Australia – Japan Treaty, 1969, Article 3(2)(h) and Article 3(4); Australia – Germany Treaty, 1972, Article 5(2)(h) and Protocol Article 1; Australia – Netherlands Treaty, 1976, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – France Treaty, 1977, Article 4(2)(h) and Article 4(4)(a) [12 months minimum on building sites, construction, installa

most notably the 1982 Australia – United States Treaty, the trend with a developed countries has been to not reduce the minimum time period below twelve months but to reduce it with less developed countries. Also, in some instances, with less developed countries the reference is to 'services, including consulting services' and not to 'supervisory activities', although, in some treaties with developing countries, separate articles refer to services and to supervisory activities.

2.2 Savings clause for domestic law in non arm's length situations

Every Australian Taxation Treaty has contained (either in the treaty itself or in a protocol to it) a savings clause for domestic law in relation to arm's length adjustments in the Business Profits Article and in the Associated Enterprises Article. A similar provision can be found in over 200 current taxation treaties worldwide and in the 2000 Malaysian Model Income Tax Agreement. The progenitor of the savings provisions in all subsequent Australian treaties was introduced in Australia's 1946 Treaty with the United Kingdom.

The background to the provision in the 1946 United Kingdom Treaty was that Australian Boards of Review had determined the profits of oil companies operating in Australia under the then Income Tax Assessment Act 1936 (Cth) s136.[31] Section 136 empowered the Commissioner of Taxation to determine the taxable income of a business carried on in Australia that was either: (a) controlled principally by non-residents; (b) carried on by a company in which the majority of shareholders were non-residents; or (c) carried on by a company which (directly or indirectly) held the majority of shares of a non-resident company. The Commissioner's powers could be exercised where it appeared to the Commissioner that the business either produced no taxable income or less taxable income than might otherwise be expected of a business of that nature. On appeal from a determination by the Commissioner, Australian Boards of Review had power to make assessments under s136.

including consulting services, for a period or periods aggregating 120 days in a 12 month period], Article 5(4)(a) [supervisory activities for more than 6 months]; Australia – South Africa Treaty 1999, Article 5(3) and Article 5(4)(a) [183 days in any 12 month period]; Australia – Slovak Republic Treaty 1999, Article 5(2)(h) [12 month minimum period for building site, construction, installation or assembly project], Article 5(2)(i) [services, including consulting services for a period or periods aggregating six months in a 12 month period], Article 5(4)(a) [supervisory activities for more than 12 months]; Australia – Argentina Treaty 1999, Article 5(2)(h) and Article 5(4)(a); Australia – Romania Treaty 2000, Article 5(2)(h) [9 month minimum on building site, construction, installation or assembly project], Article 5(4) [6 month minimum on supervisory activities]; Australia – Russian Federation Treaty 2000, Article 5(2)(h) [includes installation projects and supervisory activities but minimum period is 12 months]; Australia – Mexico Treaty 2003, Article 5(4) [installation projects and supervisory activities included n same paragraph]; Australia – Chile Treaty 2010 (not yet in force) Article 5(3) [building site, construction or installation project with six months minimum with an aggregation provision in Article 5(5) that takes into account activities by associated enterprises] and Article 5(4)(a) [no specific mention of supervisory activities but refers to services performed by one or more individuals for a period or period in aggregate of 183 days in a twelve month period. In calculating the minimum period the aggregation provision in Article 5(5) also applies]; and Australia – Turkey Treaty 2010 (not yet in force) Article 5(2)(g) [building site or construction or installation or assembly project with a six month minimum].

[31] For contemporary commentary on s136 and the resulting jurisprudence see JAL Gunn, OE Berger, JM Greenwood and RE O'Neill, Gunn's Commonwealth Income Tax Law And Practice, Butterworth & Co (Australia) Ltd, Sydney, 1948 at paras [1392] to [1397] and NE Challoner and CM Collins, Income Tax Law And Practice (Commonwealth), Law Book Company Sydney, 1953, at paras [895] to [906].

In the draft treaty prepared by the United Kingdom both the Industrial or Commercial Profits article (Article III) and the Associated Enterprises article (Article IV) contained provisions requiring that profits be determined using the arm's length principle. The relevant portion (paragraph 3) of the draft Industrial or Commercial Profits article stated:

> 'Where an enterprise of one of the territories is engaged in trade or business in the other territory through a permanent establishment situated therein, there shall be attributed to that permanent establishment the industrial or commercial profits which it might be expected to derive in the other territory if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.'

The draft Associated Enterprises article stated:

> 'Where:
>
> (a) an enterprise of one of the territories participates directly or indirectly in the management, control or capital of an enterprise of the other territory, or
>
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of one of the territories of an enterprise of the other territory, and
>
> (c) in either case conditions are made or imposed between the two enterprises in their commercial or financial relations, which differ from those which would be made between independent enterprises,
>
> then any profits which would but for those conditions have accrued to one of the enterprises but by reason of those conditions, have not so accrued may be included in the profits of that enterprise and taxed accordingly.'

The United Kingdom was concerned that s136 did not in terms require the use of arm's length principles in determining taxable income in these circumstances. Australia was concerned that the United Kingdom draft of the Treaty would require the Australian Commissioner to show that the relevant transaction was not for an arm's length price whereas the Australian appeal provisions required the taxpayer to show that the s136 assessment was excessive. Hence Australia wanted to 'arm's length' provisions in the draft treaty modified so as to leave the operation of s136 unaffected.[32]

Disagreement on this issue resulted in several discussions between officials of the two countries, numerous telegrams between the Australian delegation in London and the Australian Commissioner in Canberra and legal opinions by the Australian Crown Solicitor and the Australian Solicitor General. The Australian Commissioner was concerned that the formula that the Board of Review had applied was arbitrary and, although it represented an attempt to arrive at what would be an arm's length basis if

[32] 'Drafting of the UK-Australia Agreement 1946. Notes of Draft of Agreement.' R J Mair to P McGovern 9th May 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

sufficient information were available, it was not truly an arm's length basis.[33] The view of the United Kingdom Board of Inland Revenue was that United Kingdom enterprises were entitled to know that their profits would be determined on an arm's length basis and that preservation of s136 would produce uncertainty for them and would be inconsistent with the arm's length principle which was present in all United Kingdom taxation treaties of the time. In the words of the Secretary of the Board of Inland Revenue at the time:

'If ….the agreement were to provide that Section 136 should remain unaffected words of the draft saving provision as they might have prevented the taxpayer from exercising appeal rights to have profit determined in accordance with Article III. To meet Australia's con is found can it be said that actual arm's length consideration has been ascertained. In many cases, as the OECD Transfer Pricing Guidelines recognise[41] one or another method of estimation, some of which are far removed from the search for a comparative uncontrolled transaction, has to be used to determine an arm's length price for a transaction. Arguably in all cases where an estimation method is used it has not been possible or practicable to ascertain an actual arm's length price. Under the current terms of the Business Profits article and the Associated Enterprises article in the OECD Model the adjustment contemplated is to a hypothetical figure based on assumptions rather than to a figure corresponding to an amount charged in an actual situation.[42] Where one treaty partner uses one estimation method and the other treaty partner uses a different estimation method the taxpayer will often invoke the mutual agreement procedure or arbitration in an effort to remove the international economic double taxation that would otherwise result. The result of that lengthy process will often be a pragmatic compromise between the two tax administrations. If the saving provision were not there and the taxpayer were to challenge a transfer pricing adjustment made under s136AD(4) on the basis that it was inconsistent with Australia's treaty obligations under either the business profits or associated enterprises articles of the OECD Model it is likely, in the author's opinion, that the challenge would fail given the hypothetical nature of figure sought to be found under those articles and given the diversity and indirect nature of the methods accepted by the

commercial profits articles of the 1946 Australia – United Kingdom, the 1954 Australia – United States, the 1957 Australia – Canada and the 1960 Australia – New Zealand tax treaties, although it may have been deeming an Australian source for some items of income which would not otherwise exist, was arguably not extending Australia's taxing powers beyond those that existed, albeit on a different basis, under s136.

The industrial or commercial profits article in the 1966 United Kingdom draft tax treaty sent to Australia as part of the negotiations that led to the 1967 Australia – United Kingdom Tax Treaty did not contain a source rule. The definition of industrial or commercial profits did include income from the furnishing of services of employees or other personnel.[47] In commenting on the draft Australian tax officials recognised the inclusion was necessary to enable the country of source to tax profits of public entertainer companies but observed that a source rule along the lines of those in Australia's earlier tax treaties was necessary given that the ordinary source rules might mean that the income of the company arose outside Australia.[48]

The comment has to be seen in the context of the then recent High Court decision in *FCT v Mitchum* (1965) 113 CLR 401 under which it was uncertain when the income a company which provided the services of a public entertainer would have an Australian source. In *FCT v Mitchum* the actor, Robert Mitchum, who was not an Australian resident at any relevant time, entered into a contract in June 1959 with a Swiss company to be employed to provide consulting services (including performing) to the producer on behalf of the Swiss company in relation to two motion pictures and to be paid $50,000 for each motion picture for a period a 12 weeks with two weeks free. The Swiss company agreed to lend Mitchum's services to Warner Bros. Pictures Inc

(California) nor from Warners (London) for the services he performed. The Swiss company subsequently assigned its rights under the contract with Warners (California) to a Californian company DRM Productions Inc and Warners (California) then paid DRM Productions Inc the consideration it had agreed to pay the Swiss company in relation to Mitchum's services connected with The Sundowners. DRM Productions Inc then paid Mitchum in the United States $50,000 in discharge of the Swiss

> services of public entertainers or athletes such as are referred to in Article 15'.[51]

The United Kingdom objected that the Australian draft would deem there to be an Australian source and enable Australia to get tax in circumstances where this might not be possible under Australian domestic law. The United Kingdom view was that it was justifiable to ensure that a treaty did not open up avenues for avoidance but it was 'quite another matter' to use a treaty to make good gaps in domestic anti avoidance legislation.[52] It is possible that the United Kingdom reference to domestic anti avoidance legislation was to Income Tax Assessment Act 1936 s136 discussed above. In FCT v Mitchum (1965) 113 CLR 401 no attempt had been made under s136 to assess the Swiss company which loaned Mitchum's services to Warner Brothers for the filming of The Sundowners in Australia. This may have reflected doubts as to whether the Swiss company was carrying on business in Australia for the purposes of s136. The Australian alternative draft would have deemed the Swiss company to be carrying on business in Australia in these circumstances. This would have opened up the possibility of a s136 assessment and the deemed source rule in the industrial and commercial profits article. The United Kingdom, however, did not object to the presence of the deemed source rule in relation to profits determined under the arm's length principle in both the industrial or commercial profits article and the associated enterprises article and both of these articles in the final treaty contained the deemed source rule.

The solution to the public entertainers problem which was ultimately reached in the negotiations, at Australia's request,[53] was to exclude supplying the services of public entertainers from the definition of industrial or commercial profits.[54] Australia had previously indicated that it wanted Article 15 (dealing with Artistes and Athletes) strengthened to cover companies which supplied the services of entertainers.[55] During negotiations it was then agreed that, as it was conceivable that Australian courts might in some circumstances deem income from 'employment, etc.' exercised in Australia to have a non Australian source, a source rule was necessary in Articles 13, 14 and 15 (professional services, dependent personal services and entertainers respectively).[56] This is the first unambiguous example of a continuing Australian treaty practice of deeming there to be an Australian source where there might not be an Australian source outside the treaty.

Interestingly the United Kingdom does not appear to have objected to the existence of a deemed source rule in this context although, as noted above it objected to such an

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[51] 'Notes Of Meetings In Canberra', Third Day, 4th April 1967, Afternoon Session, p3, 1967 UK – Australia Treaty Inland Revenue file

[52] 'Notes Of Meetings In Canberra', Third Day, 4th April 1967, Afternoon Session, p3, 1967 UK – Australia Treaty Inland Revenue file

[53] Notes of discussions 13/3/67 – 14/4/67, 1967 UK- Australia Treaty Australian Treasury file, handwritten notes by an Australian Treasury official, 5th April 1967 'Article 4 (Cont)'. The handwritten notes record that this was at Australia's request and was based on the form of the Australia – New Zealand treaty which excluded such profits from the definition of industrial and commercial profits.

[54] Notes of Meetings, Third Day, 4th April 1967, Morning Session, p3, and Notes of Meetings, Fourth Day, 5th April 1967, Morning Session, p2, 167 UK – Australia Treaty Inland Revenue file.

[55] Notes of Meetings, First Day, 31st March 1967, Afternoon Session, p4, 1967 UK – Australia Treaty Inland Revenue file.

[56] Notes of Meetings, Fifth Day, 6th April 1967, Morning Session, p1, 1967 UK – Australia Treaty Inland Revenue file.

origins of the policy nor its apparent current rationale make it necessary to limit the operation of a treaty source rule by a domestic provision. The approach taken in the Australia – Germany Treaty of 1972 (of allowing Australia to deem, in its domestic law, income which it was entitled to tax under the treaty to have an Australian source) referred to above would, in the author's view, be far preferable to the current Australian approach.

2.4 The 'other income' article

Australian tax treaty practice varies from the OECD Model by partially reversing the effect of the 'other income' article. Under Article 21 of the OECD Model income not dealt with in preceding articles in the Model (other than income paid in respect of a right or property effectively connected with a permanent establishment through which a non resident carries on business in the source country) is to be taxed exclusively on a residence basis. Australian tax treaties, however, typically add an additional provision the effect of which is to give the source country the right to tax income from sources in that country not otherwise dealt with. This variation from the OECD Model dates from the 1980 Australia – Canada Treaty Article 21(2). In most cases the version of the 'other income' article in Australian tax treaties is either identical with or substantially similar to the equivalent article in the United Nations Double Taxation Convention of 1978 and the United Nations Double Taxation Convention of 1980.

As will be seen below, prior to the 1980 Australia – Canada Treaty, Australia had received requests to include an 'other income' article in its treaties but had refused to do so. It will be argued below that the failure to include an 'other income' article in Australian treaties prior to 1980 and the modification of the 'other income' article in Australian treaties after 1980 both reflect the longstanding Australian emphasis on source basis taxation. It will be further argued in this paper that the failure to include an 'other income' article in Australian treaties prior to 1980 was part of their distinctive structure and that this distinctive structure should be taken into account in interpreting particular articles in those treaties.

2.4.1 Initial rejection of 'other income' article in 1967 United Kingdom Treaty

The United Kingdom draft of September 1966 which was to form the basis for the negotiation of the 1967 Australia – United Kingdom Taxation Treaty contained an 'other income' article which gave the country of residence exclusive right to tax income not expressly mentioned in other articles.[63] During the negotiation of the Treaty in Canberra in March and April 1967 the Australian delegation clearly rejected the draft article. The United Kingdom notes of the negotiation record that the article 'contradicts the Australian's general philosophy concerning the taxation of income flowing abroad and they cannot accept it as it stands.' The notes record that the Australians were prepared to accept the results of the article as regards third country tax. It was observed that if the article were to be so restricted then there would be nothing in the Treaty dealing with alimony, but this was seen as being of comparatively minor importance. Australia at the time regarded alimony as exempt to the recipient and as non deductible to the payer. Restricting the article to third country tax was not seen to create problems in relation to trusts as both the United Kingdom

[63] Article 20 of United Kingdom Draft, September 1966, 1967 UK – Australia Treaty Inland Revenue File.

and Australia treated income flowing through a trust in which beneficiaries had an absolute interest as retaining its original identity. The notes comment that the absence of another income article would only be felt in the case of discretionary trusts which would be treated on an empirical basis. The notes then record that 'It was in consequence agreed that the Article should be amended to restrict its scope to third-country tax'.[64]

In the final version of the 1967 Australia – United Kingdom Taxation Treaty Article 18 dealt with the income of dual residents from third countries. The effect of the article was that, where the dual resident was treated as a resident of one only of the two treaty countries, the dual resident was exempt from tax in the other treaty country on income from a third country.[65] A corresponding provision was often inserted in subsequent Australian Tax Treaties prior to the Australia – Canada Treaty of 1980.[66] Provisions of this nature appear to have been unique to Australian treaties of the period.

It is reasonably clear from the notes that, by restricting the other income article to third-country taxes both parties considered that they would retain full taxing rights in relation to income not otherwise dealt with in the Treaty. This is particularly evident from the Australian comment that the original article, which gave exclusive taxing rights to the residence country, contradicted Australia's general philosophy concerning the taxation of income flowing abroad. The restriction of the other income article to third country taxes was thus both consistent with the 'colonial model' structure of earlier Australian treaties and was intended to maximise the scope for source country taxation. Maximising source country taxation was consistent with Australia's fiscal interests in relation to most of the countries (the United Kingdom 1946, the United States 1953, Canada 1957 and New Zealand 1960) with which it had concluded taxation treaties at up to 1967. In 1967 Australia was a net capital importer from all of these countries except New Zealand. At the conclusion of the negotiation of the 1967 Australia – United Kingdom Treaty Australia was to embark on negotiations with Japan in relation to whom it was also a net capital importer.

2.4.2 The inclusion of an 'other income' article in the 1980 Canada Tax Treaty

As discussed in Part I Australia became a member of the OECD in 1972 and as a consequence had entered into tax treaties with many of the then OECD member states.

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64 'Notes Of Meetings In Canberra; March – April 1967' 1967 UK – Australia Treaty Inland Revenue File. Fifth Day, 6th April 1967, Afternoon Session, p.2. The Australian delegation made similar points on the first day of negotiations. See Notes Of Meetings, First Day 31st March 1967, Afternoon Session, p.5.

65 Correspondence between officials indicates that restricting the exemption to dual residents was intended to circumvent planning by single residents involving diverting income to third countries to obtain the benefit of the exemption. See ET Cain to WHB Johnson, 16th June 1967, Inland Revenue file, Part II; FB Harrison to Chief Inspector (Mr Williams), Australian Agreement, 27th June 1967; FB Harrison, Comments on the amendments proposed in the attachments to Mr Cain's letter of 16th June 1967, Inland Revenue file, Part II; To: Mr Harrison, 3rd July 1967, 1967 UK – Australia Treaty Inland Revenue file, Part II; WHB Johnson to ET Cain, 4th September 1967, Inland Revenue file, Part II; ET Cain to The Commonwealth Treasurer (William McMahon) 8th September 1967, 1967 UK – Australia Treaty Australian Treasury file.

66 See, for example, Australia – Singapore Treaty 1969 (prior to amendments by subsequent Protocols) Article 16; Australia – Germany Treaty 1972, Article 20; Australia – Netherlands Treaty 1976, Article 22.

1978 and 1980 respectively. Archival sources relevant to the negotiation of the 1980 Australia – Canada Tax Treaty were not available to the author at the time of writing of this paper. Hence the author does not have documentary evidence of influence of the United Nations Draft Model on the other income article in the Australia – Canada Treaty of 1980 but given the similarities in effect and the relatively close proximity in time influence from the United Nations Draft Model seems at least possible.

The next Australian tax treaty to contain an other income article was the 1982 Australia – United States Treaty. There the 'other income' article exactly corresponded with the 1978 Draft UN Model and thus differed from both the OECD Model and the US Model.[70] Archival sources relevant to the negotiation of the 1982 Australia – United States Tax Treaty were not available to the author at the time of writing this paper. However, the following comment United States Congress Joint Committee on Taxation Explanation of the Treaty may indicate that the UN Model, or at least considerations relevant to the development of the UN Model, influenced several aspects of the Treaty:

> 'The proposed treaty resembles in a few respects a treaty between a developed country and a developing country. In these respects, it does not conform to the U.S. model treaty. It provides for relatively high rates of source country withholding taxes and it provides permanent establishment rules that permit taxation of enterprises in cases where the U.S. model treaty would not. In addition, its non discrimination provision does not apply to existing rules. Although Australia is not so industrialized as the United States, it is a developed country. Australia is, however, a capital importer. Also, on balance, it can be argued that the proposed treaty is the product of a hard bargaining over a period of 14 years and is better for U.S. interests than the existing treaty.'[71]

As noted in Part I from the 2001 Protocol to the Australia – United States Tax Treaty of 1982 Australian tax treaty policy shifted to a more residence based tax treaty policy. Under the Protocol Australia lowered its rate of withholding taxes on investment income and subsequently, in its 2003 Treaty with the United Kingdom agreed to a modified form of the non-discrimination article.[72] The change in policy reflected an awareness of the increased engagement of Australian business in offshore investment and the fact that Australia was a net capital exporter in many of its bi-lateral relationships. Despite these changes the 'other income' article in Australian tax treaties generally[73] still follow the model established in the 1980 Australia – Canada Treaty and in the 1982 Australia – United States Treaty, modified in more recent

[70] Compare Article 21 of the Australia – United States Double Taxation Treaty of 1982 with Article 21 of the 1977 OECD Model, Article 21 of the 1978 Draft United Nations Model, Article 21 of the 1980 United Nations Model and Article 21 of the 1996 United States Model.

[71] Tax Analysts, Worldwide Tax Treaties, United States, Australia, Joint Committee on Taxation Explanation (JCS-15-83, May 24, 1983)

[72] Australia – United Kingdom Double Taxation Treaty 2003, Article 25. Compare Article 24 OECD Model.

[73] One exception is the Australia – Sweden Treaty 1981. The Australia – Italy Treaty of 1983 contains the income of dual resident/third country tax article but not the standard Australian other income article of the period. Article 22 of the Australia – China Treaty of 1990 differs from the standard Australian 'other income' article but arguably produces a similar end result.

treaties to reflect changes in Australian taxation of capital gains as discussed below[74], irrespective of whether Australia is a net capital importer or a net capital exporter in the relationship with the treaty partner in question.[75] The persistence of this feature in Australian tax treaty practice reflects: (a) the continued influence at the level of detail of prior Australian tax treaty practice on both the Australian draft and on the expectations of Australian treaty partners; (b) the fact that in overall terms Australia is still a net capital importer and that moving to a more residence based tax treaty practice in this and other respects would have a revenue cost to Australia.

2.5 Not agreeing to and then modifying the non discrimination article

Between its 1967 and 2003 Tax Treaties with the United Kingdom a distinctive feature of Australian tax treaty practice was to refuse to agree to the non discrimination article. As will be seen below, with one exception, throughout this period Australia managed to persuade its treaty partners to omit the non discrimination article in their treaties with Australia.

2.5.1 The 1967 United Kingdom Treaty

The United Kingdom draft of September 1966 contained a non discrimination article. None of Australia's previous Double Taxation Treaties had contained a non discrimination article and, moreover, a non discrimination article had not been requested by Australia's treaty partner in any of those earlier treaties. A Japanese draft sent to Australia in 1964 during preliminary negotiations had included a non discrimination article which the Australian negotiators rejected. Australia did not conclude a taxation treaty with Japan until 1969.[76]

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[74] See, for example, Australia – United Kingdom Treaty 2003, Article 20(3) and Australia – Japan Treaty 2008 , Article 21(2).

[75] See Australia – United Kingdom Treaty 2003, Article 20(3); Australia – United States Treaty 1982, Article 21(3); Australia – Canada Treaty 1980, Article 21(2); Australia – New Zealand Treaty 1995, Article 22(1); Australia – Japan Treaty 2008, Article 21(2); Australia – France Treaty 2006, Article 20(3); Australia – Malaysia Treaty 1981, Article 21(3); Australia – Denmark Treaty 1981, Article 21(2); Australia – Ireland Treaty 1983, Article 23(2); Australia – Korea Treaty 1983, Article 22(2); Australia – Norway Treaty 2006, Article 21(3); Australia – Malta Treaty 1984, Article 21(2); Australia-Finland Treaty 2006, Article 20(3); Australia – Austria Treaty 1986, Article 21(2); Australia – Papua New Guinea Treaty 1989, Article 21(2); Australia – Thai Treaty 1989, Article 22(2); Australia – Sri Lanka Treaty 1990, Article 21(2); Australia – Fiji Treaty 1990, Article 23(2); Australia – Hungary Treaty 1991, Article 22(3); Australia – Kiribati Treaty 1991, Article 21(2); Australia – India Treaty 1991, Article 22(2); Australia – Poland Treaty 1991, Article 22(1); Australia – Indonesia Treaty 1992, Article 22(2); Australia – Vietnam Treaty 1993, Article 21(2); Australia – Spain Treaty 1992, Article 21(2); Australia – Czech Republic Treaty 1995, Article 21(2); Australia – Taipei Treaty 1996, Article 21(2); Australia – South Africa Treaty 1999, Article 21(3); Australia – Slovak Republic Treaty 1999, Article 21(2); Australia – Argentina Treaty 1999, Article 22(2): Australia – Romania Treaty 2000, Article 21(2); Australia – Russia Treaty 2000, Article 21(3); Australia – Mexico Treaty 2002, Article 21(3); Australia – Chile Treaty 2010 (not yet in force), Article 21(3); Australia – Turkey Treaty 2010 (not yet in force), Article 21(3).

[76] The Japanese draft of 1964 is contained in Australian Taxation Office file 'Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series

Australian tax officials reviewing the 1966 United Kingdom draft pointed out respects in which Australian domestic tax law currently discriminated between residents and non residents and respects in which the article would limit Australia's future freedom of action. The Acting Second Commissioner of Taxation commented in a letter to the Secretary of the Treasury, 'Even if it were drafted to permit us to continue all our present "discriminations" it would still be clearly restrictive on future policy'.[77]

A similar attitude was evident at the ministerial level. The Treasurer's submission to cabinet on the September 1966 United Kingdom draft noted that the proposed article would conflict with certain provisions of Australian law such as the restriction of the inter-corporate rebate to resident companies. The Treasurer commented that, 'While it might be possible to negotiate provisions with sufficient qualification to make them compatible with our law, I think it would be best to avoid any provisions on "non-discrimination".'[78]

During the afternoon session of the first day of negotiations on the 1967 Australia – United Kingdom Treaty in Canberra the Australian delegation indicated that the article was not acceptable to Australian ministers.

> negotiable: in fact, for Australia the inclusion or exclusion of the clause could not be weighed in the overall balance of concession and counterconcession.'[87]

Cain's comment is consistent with the more general point he made in the negotiations, that, as Japan had initiated the negotiations it could not expect greater concessions than those that Australia had given to the United Kingdom in the 1967 Australia – United Kingdom Treaty.[88] The final version of the 1969 Australia – Japan Treaty did not contain a non discrimination article.

The absence of a non discrimination article from the Australian draft sent to Singapore in August 1968 does not appear to have been raised in the negotiation of the treaty and the final version of the treaty did not contain a non discrimination article.[89]

Australia maintained its opposition to the non discrimination article throughout the 1970s, 1980s and 1990s. The basis of Australia's objection to the non discrimination article in the early 1970s was set out in de

Subsequent Australian treaties contain similar carve outs, with varying degrees of precision[95], from the Non Discrimination article. Australia's 2006 treaty with France does not contain a non discrimination article. It is understood that France would not agree to the carve outs from the non discrimination article that Australia was seeking.

2.6 Capital gains articles

Australia's first taxation treaty, with the United Kingdom in 1946, unlike the 1945 United Kingdom – United States Treaty, did not contain a capital gains article. Nor did either party to the negotiations ever propose that the Australia – United Kingdom Treaty of 1946 contain a capital gains article. This was understandable as neither Australia nor the United Kingdom at the time taxed capital gains as a general rule. Under the 'colonial model'[96] structure of the 1946 treaty the intention was clearly that domestic rules were to operate in relation to items not specifically dealt with in the treaty. This can be seen from the correspondence at the time[97] and the treatment ultimately given to interest and mineral royalties in the Treaty and from the definition of industrial and commercial profits. The Treaty defined 'industrial and commercial profits' in terms which excluded items that were either dealt with under the distributive articles of the treaty or in relation to which the source country was intended to retain full taxing rights. Hence income in the form of dividends, interest, rents, royalties, management charges, or remuneration for personal services was excluded from the definition. The treaty contained distributive rules for dividends, some royalties (but significantly neither mineral royalties nor film royalties) and personal services but not for the other items excluded from the definition of industrial and commercial profits. Defining 'industrial and commercial profits' in this way and not dealing with items where the source country was intended to retain full taxing rights were to become structural features of the treaties that Australia entered into until

article would thus seem natural to United Kingdom tax officials as it would mirror the structure of United Kingdom domestic law taxing capital gains.

During the afternoon of the first day of negotiations in Canberra on the 1967 United Kingdom – Australia Treaty the Australians pointed out that, although Australia had no capital gains tax at present, the existence of the article would 'tie their hands' in relation to the United Kingdom if they ever introduced one in the future. The United Kingdom pointed out that the draft article was reciprocal but that an article based on the OECD Model was an alternative if Australia did not like the draft article. The Australians questioned the need for the article and indicated that they would prefer that the article be dropped altogether something which the United Kingdom delegation indicated they would consider.[101] Handwritten notes by an Australian Treasury official observe that the political climate, in the Senate for example, was against CGT and that the inclusion of the article might prevent passage of the Treaty through the Senate.[102] The article is not mentioned again in either official record of the discussions until the fifth day where both official records confirm that the article was to be omitted.[103] It is clear from the notes of the meeting that the Australian delegation considered that by not including a capital gains tax article in the treaty Australia would retain full rights to levy capital gains tax on United Kingdom residents if it subsequently introduced a capital gains tax.

Australia's 1969 Treaty with Japan[104] and its 1969 Treaty with Singapore[105] did not contain a capital gains article and retained the 'colonial model' structure. The 1972 Australia – Germany Treaty did not contain capital gains or an alienation of property article.

The 1976 Australia - Netherlands Treaty was the first Australian treaty to contain an alienation of property article. The article gave the source country the right to tax income from the alienation of real property, rights to exploit or explore for natural resources, and shares in companies the assets of which consisted wholly or principally of real property or rights to exploit natural resources situated in the source country. The article, however, differed from the OECD Model in several respects. First, its title was 'Alienation of Property' not 'Capital Gains'. Secondly, it referred to 'income from the alienation of property'. Thirdly, it referred only to the limited range of possible forms of income from the alienation of property referred to above. Fourthly, it did not contain a catch all provision equivalent to Article 13(3) of the 1963 Draft

[101] Notes Of Meetings, First Day, 31st March 1967, Morning Session, p4, 1967 UK – Australia Treaty Inland Revenue file. See also Notes of discussions 13/3/67 – 14/4/6, 1967 UK – Australia Treaty Australian Treasury file, handwritten notes by an Australian Treasury official, 31st March 1967.

[102] See also Notes of discussions 13/3/67 – 14/4/67, 1967 UK – Australia Treaty Australian Treasury file, handwritten notes by an Australian Treasury official, 31st March 1967..

[103] Notes Of Meetings, Fifth Day, 6th April 1967, Morning Session, p1, 1967 UK – Australia Treaty Inland Revenue file. Report of discussions on 6th April 1967, Australian Treasury file. The Australian record makes it clear that the article was omitted at Australia's request.

[104] Neither the February 1964 Draft nor the January 1968 capital gains o 'Alienation 3(preas)]T4-20.43 0 TDrt.9(y)-6.5t

> '6. Gains of a capital nature from the alienation of property, other than that referred to in the preceding paragraphs shall be taxable only in the Contracting State of which the alienator is a resident.'

2.7 Rates of withholding taxes on investment income

Consistent with the Australian policy of maximizing source basis taxation, Australian rates of tax on investment income beginning with its 1946 Treaty with the United Kingdom have always been high by OECD standards. Between the 1967 Australia – United Kingdom Treaty and the 2002 Protocol to the Australia – United States Treaty Australian tax rates in treaties on investment income were remarkably consistent. From the 2002 Protocol to the Australia – United States Treaty of 1982 Australia has lowered its treaty rates of withholding tax on some dividends and royalties but its treaty rates, particularly on interest, remain high by OECD standards.

Prior to the 1946 Australia – United Kingdom Treaty, Australia taxed all Australian sourced income derived by non residents on assessment basis at relevant marginal

(2) Australian source dividends paid by

States delegation to agree to a uniform 15% rate on all dividends,[117] apparently arguing that this would mean that the total level of Australian tax on dividends flowing to the United States would approximate the tax previously payable on such dividends prior to recent Australian tax increases and noting that there had still been substantial United States investment in Australia when taxes had been at the previous levels.[118] Australia also appears to have argued that a uniform rate would encourage the joint supply of capital to Australian companies by Australian and United States investors without United States investors suffering taxation disadvantages.[119] The Australian Commissioner of Taxation advised the Treasurer that a lesser reduction in Australian tax on dividends would not encourage United States investment in Australia, that a uniform rate would encourage Australian – United States joint contributions to capital, and that any greater reduction in Australian tax on dividends would benefit the United royalties.[126] Article XII permitted Australian residents deriving mineral royalties from the United States to continue to be taxed on a 30% gross withholding tax basis or to lodge a return claiming expenses and to have tax imposed at a rate appropriate to the net income.[127]

As was the case with the 1946 Australia

United Kingdom Treaty, Australia would gain revenue in the 100% subsidiary situation but would lose revenue in the 25% subsidiary situation. They pointed out that that, because of the availability of a United Kingdom credit for underlying tax for United Kingdom companies having at least 10% of the voting power in the paying company, the United Kingdom revenue would generally not benefit in these cases from any reduction in the Australian tax on dividends below 15%. They noted, however, that the United Kingdom's 1966 Treaty with New Zealand had applied a 15% source country rate to all dividends. By this stage Australia imposed withholding tax on dividends at the rate of 30% but still taxed interest and royalties paid to non residents on an assessment basis although during the course of negotiations Australia advised the United Kingdom of its intention to introduce a withholding tax on interest and to alter its taxation of royalties paid to non-residents. On interest they pointed out that neither the 1946 Australia – United Kingdom Treaty nor the 1966 New Zealand – United Kingdom Treaty contained an interest article and advised that this meant that full source country taxing rights were retained in relation to interest. On royalties they contrasted the draft article with the equivalent provision in the United Kingdom – New Zealand treaty. That treaty imposed an upper tax rate of 10% on the source taxation of royalties except in the case of royalties effectively connected with a permanent establishment. The officials commented that under the United Kingdom – New Zealand treaty motion picture royalties were excluded with the effect that they remained taxable under the provisions of the law of each country. The officials noted that New Zealand currently levied taxes equivalent to 11% of the gross rentals of British films.[130]

The Australian Treasurer recognised that any new treaty with the United Kingdom would stand as 'something of a precedent'. The Treasurer's submission to cabinet question was reserved for further discussion later.[133] The United Kingdom raised the issue of rates again on the morning session of the second day suggesting that the OECD rates of 15% for portfolio dividends and 5% for non portfolio dividends apply. The United Kingdom also suggested that the OECD definition of the type of company qualifying for the lower rate be adopted but did not consider this test sacrosanct.[134]

subsidiaries.[137] During the negotiations and in subsequent correspondence rates of source country tax on investment income we but (except in the case of back to back loans) no source country tax was payable on interest derived by financial institutions dealing independently with the payer. Where interest was effectively connected with a permanent establishment or fixed base of the lender in the source country then the interest was taxable under the business profits article or independent personal services article.[142] The rate on royalties was reduced to 5% but, as had been the case under the original treaty, royalties were taxable under the business profits or independent personal services article where the royalty was effectively connected with a permanent establishment or fixed base in the source country of the person beneficially entitled to the royalties.[143]

By the late 1990s investment flows in and out of Australia were changing. While Australia remained a net capital importer there had been a significant increase in both non portfolio and portfolio outbound investment by Australians.[144] This led the Australian Board of Taxation in 2003 to recommend that, in future, Australia should move towards a more residence based treaty policy. The Board of Taxation also recommended that the key country treaties be reviewed and kept up to date in line with the recommendation of moving towards a more residence based treaty policy. Furthermore the Board of Taxation recommended that in future Australia should enter into treaty negotiations with other countries in the order of the most important investment partners with Australia.[145] The Government accepted these recommendations and they generally have been reflected in Australia's subsequent treaty practice.

3. PART III: CONCLUSION

Although Australian tax treaty policy and practice since 2001 has moved closer to OECD norms (particularly in the rates of withholding tax imposed and in agreeing to the non discrimination article) this paper has sought to demonstrate that Australian tax treaty policy and practice still has many distinctive features. In virtually every case there is evidence that these distinctive features were a product of Australia's emphasis on source basis taxation and in many instances were responses to Australian domestic law concerns. Even in two areas in which Australian practice has clearly moved closer to OECD norms, withholding tax rates and the non discrimination article Australian policy and practice still differs from the OECD Model. Current Australian treaty withholding tax rates are at the outer limits of the OECD Model (and exceed it in the case of royalties) and, as has been seen above, the Australian non discrimination article has savings clauses in relation to several Australian domestic law provisions and is not acceptable to some Australian treaty partners such as France. Even in the case of capital gains, where the modern Australian article closely aligns with the OECD Model, many extant Australian tax treaties contain a capital gains article in similar form to the article in the 1988 Australia – China Treaty which gives the source country the right to tax capital gains not otherwise mentioned in the article.

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[142] United States – Australia Protocol 2001, Article 7 of the Protocol amending Article 11 of the Treaty.
[143] United States – Australia Protocol 2001, Article 8 of the Protocol amending Article 12 of the Treaty.
[144] The Review of Business Taxation in 1999 noted that whereas in the first half of the 1980s Australian outbound investment represented only 20% of inbound investment by the late 1990s it represented 60%. Australia, Review of Business Taxation, A Tax System Redesigned, Canberra, 1999, at p679.
[145] Australia, Board of Taxation, International Taxation: A Report To The Treasurer: Volume 1 – The Board's Recommendations, Canberra, 2003, pp 89 to 97, Recommendations 3.5, 3.7 and 3.8.

Hence, the pervasive influence of the emphasis on source basis taxation in Australian tax treaty practice and policy up to 2001 remains evident in many of the detailed provisions in Australian tax treaties. If Australia is to move to a more residence based treaty practice then significant rethinking needs to take place in relation to the articles discussed in this paper and in other distinctive articles that are products of Australia's earlier emphasis on source basis taxation.

1. INTRODUCTION

2. DOUBLE TAX AGREEMENTS

2.1 Residency

3.1 Russia-Cyprus DTA

3.1.1 Amendments to the Russia – Cyprus DTA

4.0 CONCLUSION