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National Interest Analysis [2009] ATNIA 15

with attachment on consultation

Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, done at Paris on 26 June 2009

[2009] ATNIF 18

Regulation Impact Statement

NATIONAL INTEREST ANALYSIS: CATEGORY 2 TREATY

SUMMARY PAGE

Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, done at Paris on 26 June 2009, [2009] ATNIF 18

Nature and timing of proposed treaty action

1. The proposed treaty action is to bring the *Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* (the Treaty) into force. The Treaty will enter into force, pursuant to Article 30, on the date of the last note in an exchange of diplomatic notes between both countries confirming that their domestic requirements have been completed.

2. The provisions of the Treaty will take effect for Australia in five stages, namely:
   - in respect of withholding tax, on income derived on or after the first day of the second month following entry into force;
   - in respect of fringe benefits tax, on fringe benefits derived on or after 1 April in the year following entry into force;
   - in respect of other tax, on income derived in the year beginning 1 July following entry into force;
   - in respect of arbitration, on a date agreed in an exchange of diplomatic notes; and
   - in respect of administrative provisions, upon entry into force.

3. Article 30(3) provides that the Treaty will replace the existing *Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1997] ATS 23, as amended by the *Protocol amending the Agreement between the Government of Australia and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [2007] ATS 5.

Overview and national interest summary

4. The key objective of the Treaty is to promote closer economic cooperation between Australia and New Zealand by reducing barriers caused by the double taxation of residents of the two countries.

5. The Treaty also aims to improve certainty for Australian businesses looking to expand into New Zealand and for other Australian taxpayers by generally updating and modernising the tax arrangements between the two countries.

6. In this manner the treaty is expected to promote trade and investment between Australia and New Zealand and enhance the taxation arrangements for Australians engaged in trans-Tasman transactions, thereby improving the wellbeing of the Australian people.

Reasons for Australia to take the proposed treaty action

Reducing barriers to bilateral investment and trade

7. The Treaty is expected to reduce barriers to bilateral trade and investment, primarily by reducing withholding taxes on dividend, interest and royalty payments between the two countries. Rather than taking unilateral action to reduce withholding taxes under domestic law, Australia has adopted the approach of agreeing to any such reductions on a reciprocal bilateral basis. This approach 'locks-in' the withholding tax limits in both countries, ensuring a steady financial framework for business between the Treaty partner countries. See **Attachment B** for an overview of the operation of Australia's withholding tax rules.

8. In particular, the Treaty reduces the dividend withholding tax rate limit from 15 per cent to zero on cross-border intercorporate dividends on holdings of 80 per cent or more, subject to certain conditions, and to 5 per cent on intercorporate dividends on other holdings of at least 10 per cent (Article 10). This will promote direct investment and allow Australian companies to bring profits made by certain New Zealand subsidiaries back to Australia without facing any further tax. Reducing tax impediments to the repatriation of profits back to Australia will facilitate the most efficient allocation of funds within a group of related companies operating in both Australia and New Zealand.

9. The Treaty locks in a zero withholding rate on New Zealand sourced interest paid to unrelated Australian financial institutions where the two per cent New Zealand approved issuer levy has been paid (Article 11). The Treaty also contains a most favoured nation clause that obliges New Zealand to inform Australia if it provides more favourable treatment of interest derived by financial institutions in a subsequent treaty with another country, and to enter into negotiations with a view to providing Australia with the same treatment (Article 29(2)). This clause ensures the withholding rates applying to interest derived by Australian financial institutions will be at least equal to the most favourable New Zealand offers in its treaties. The Treaty also exempts interest paid to unrelated New Zealand financial institutions from withholding tax in Australia (Article 11).

10. The Treaty reduces royalty withholding tax from 10 to 5 per cent (Article 12). Reduced New Zealand withholding taxes on royalty payments are likely to encourage New Zealand businesses to source intellectual property from Australia. While the Australian company remains legally liable for tax on royalty income earned in New Zealand, contracts will often include provisions (known as 'gross up clauses') requiring the New Zealand company to absorb this tax. Consequently, lower withholding taxes on royalties are expected to reduce the costs for New Zealand businesses of accessing Australian intellectual property. Likewise the lower royalty withholding tax rate is expected to reduce the costs for Australian businesses of accessing New Zealand intellectual property.

Improved taxation arrangements for individuals

11. The Treaty allocates sole taxing rights over pensions and similar periodic remuneration to the recipient's country of residence (Article 18). However, Australians who receive a New Zealand pension will be exempt from Australian tax on that pension if it would have been exempt from New Zealand tax had it been received in New Zealand. New Zealanders who receive an Australian

pension will be entitled to a similar exemption from New Zealand tax. The Treaty also provides that a lump sum paid under a retirement benefit scheme, or in consequence of retirement, invalidity, disability or death, or by way of compensation for injuries, will be taxable solely in the country from which it is paid. These new rules will remove impediments to working and accumulating superannuation benefits in both countries.

12. The Treaty also ensures that an employee's remuneration during short term visits on secondment to one country is taxable only in the employee's country of residence (Article 14). These provisions will facilitate cross border secondments within an enterprise or company group and will simplify the taxation affairs of the receiving enterprise and the employee.

Increased certainty and reduced compliance costs for taxpayers

13. The Treaty (Article 14) allows for the taxation of the provision of services either: where an enterprise of one country performs services in the other country through an individual who is present in that other country for more than 183 days in aggregate in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities are derived from the provision of those services; or where one or more individuals perform services related to the same project, or connected projects, in the other country for more than 183 days in any twelve month period. In determining whether the time threshold has been met in the second instance, the Treaty allows the enterprise to disregard short periods of up to five days, unless those services are performed by that individual on a regular or frequent basis. This exception is expected to reduce compliance costs for Australian businesses whose employees perform services in New Zealand for short periods of time.

14. The Treaty ensures that no adjustments to the profits of an enterprise shall be made in transfer pricing cases (other than in those cases involving fraud, gross negligence or wilful default) after the expiration of a seven year period, unless an audit has already commenced (Articles 7 and 9). This limitation period removes the possibility of unlimited future profit adjustments of certain taxpayers, improving certainty for taxpayers over the tax treatment of their cross border transactions.

15. The Treaty provides increased certainty to taxpayers through a new arbitration procedure (Article 25). Arbitration improves certainty for taxpayers by providing them with an avenue for dispute resolution in cases where they are subject to ongoing disagreement between Australian and New Zealand tax authorities on matters of fact.

16. The Treaty protects taxpayers from one country from tax discrimination in the other country based on their nationality (Article 24). This would ensure that Australian nationals are not subject to more burdensome taxation than New Zealand nationals in the same situation, and vice versa. The prevention of tax discrimination provides certainty for Australian nationals that their tax treatment will be consistent with the tax treatment of New Zealand nationals when Australian nationals are taxed by New Zealand.

17. The Treaty extends treaty benefits to managed investment trusts (MIT) if they are listed on an Australian stock exchange, or if at least 80 per cent of the interests in the MIT are held by Australian residents (Article 4). By treating the MIT as an Australian resident for treaty purposes, the MIT is able to claim treaty benefits in respect of items of income flowing from New Zealand to

Australia. This will reduce complexity and compliance costs and improve certainty for investors in MITs.

Obligations

18. Articles 6 to 21 allocate taxing rights in respect of certain types of income and fringe benefits. The obligations contained in these Articles are of a kind already present within the existing Agreement, with the key differences being that Articles 7, 9 to 12, 14 and 18 implement the innovations discussed above in paragraphs 7 to 14.

19. Article 23 of the Treaty sets out a general obligation for both countries to relieve double taxation on cross-border income by permitting tax paid under the other country's laws and in accordance with the Treaty to be allowed as a credit against tax payable under their own laws. In contrast to the existing treaty, this Article extends this obligation to income derived by fiscally transparent entities.

20. Article 24 contains a general non-discrimination principle, requiring each country to treat nationals of the other country no less favourably than it treats its own nationals regarding taxation and any connected requirements.

21. Article 25 establishes procedures for dispute resolution, including a mechanism for taxpayers to present complaints to their country of residence where they consider that they have been taxed not in accordance with the Treaty. The country receiving a complaint which appears to be justified must endeavour to resolve it, either unilaterally or by mutual agreement with the other country. The Article strengthens existing dispute resolution procedures by requiring both countries to allow taxpayers to pursue arbitration where an issue of fact (or other issue agreed between the countries) remains unresolved after two years.

22. Article 26 provides obligations for the exchange of information between both countries, including a specific obligation to gather and provide information upon request. Article 26(2) imposes a correlative obligation on the country receiving any such information to treat it as secret in the same manner as information obtained under its domestic laws. Article 26(3) allows either country to decline to provide requested information on limited grounds, including where to do so would be contrary to law or public policy. Article 2(2) requires each country to notify the other of any significant changes to laws relating to the taxes to which the Treaty applies.

23. Article 27 requires each country to assist the other in the collection of revenue claims upon request. Article 27(8) clarifies that there is no obligation on the assisting country to carry out measures at variance with its administrative practices, laws or public policy.

24. Article 29 obliges the two countries to consult each other on the operation and application of the Treaty within five years of entry into force of the Treaty and at intervals of no more than every five years.

25. Article 29(2) imposes a most favoured nation obligation on New Zealand, requiring New Zealand to inform Australia if it provides more favourable treatment of interest derived by financial institutions under any subsequent tax treaty with another country, with the view to renegotiating the Treaty to provide such rates to Australia.

Implementation

26. Amendments to the *International Tax Agreements Act 1953* will be made prior to the Treaty entering into force, to give the Treaty the force of law in Australia. No action is required by the States or Territories. There will be no change to the existing roles of the Commonwealth, or the States and Territories, in tax matters as a consequence of implementing the Treaty.

Costs

27. The reciprocal nature of tax treaties means that both countries can be reasonably expected to experience direct costs and benefits to their revenue bases, as a result of reductions in their withholding taxes and the flow on benefits to their own revenues arising from the reduction in the other country's taxes.

First round impact of the Treaty

28. Treasury has estimated the impact of the first round effects on forward estimates as unquantifiable. Identifiable costs to revenue associated with reductions in the rates of withholding tax and the change to taxing rights for pensions have been estimated as $142 million over the forward estimates. Estimating the revenue benefits to Australia flowing from reductions in New Zealand withholding taxes is problematic. Reductions in New Zealand withholding taxes can be expected to result in an increase in the amount of Australian tax revenue through reduced Foreign Income Tax Offsets and increases in Australian taxable income. Given the bilateral flows between Australia and New Zealand, the current features of the Australian and New Zealand tax systems, and the impact of the changes in the arrangements under the Convention, the revenue costs are likely to be broadly offset by revenue gains.

29. No other material costs have been identified as likely to arise from the implementation of the Treaty. Tax exemptions in respect of withholding taxes are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax. The closer alignment with more recent Australian and international treaty practice would generally be expected to reduce compliance costs.

30. There would be a small, unquantifiable cost in administering the changes made by the Treaty, including minor implementation costs to the Australian Taxation Office (ATO) in educating the taxpaying public and ATO staff concerning the new arrangements. There are also 'maintenance' costs to the ATO and the Department of the Treasury in terms of dealing with inquiries, rulings and other interpretative decisions and mutual agreement procedures (including advance pricing arrangements). However, these costs also apply to the existing Australia-New Zealand Agreement and will continue to be managed within existing agency resources.

Second round impact of the Treaty

31. The estimated revenue impact does not take account of additional revenues that may flow from the second round impacts generated by the Treaty. Second round impacts include revenue gains from changes in cross border investment levels, improved access to technology, reduced capital costs, economic growth and job creation. The revenue cost does not therefore take into account anticipated revenue benefits from expected increases in cross border trade and investment.

32. Treasury has not estimated the second round impact of the Treaty. This is because Treasury does not quantify the second round impact of new policy proposals as the benefits in any given year are likely to be small relative to the direct impacts and the timescale over which they accrue is extremely uncertain.

Regulation Impact Statement

33. A Regulation Impact Statement is attached.

Future treaty action

34. The Treaty does not provide for the negotiation of future legally binding instruments, although it does require both countries to periodically consult on the operation and application of the Treaty as discussed in paragraph 24.

35. The Treaty does not contain specific amendment procedures, meaning that it may be amended from time to time by mutual consent of both countries. Article 29(2) obliges New Zealand to enter into negotiations with Australia if New Zealand has provided more favourable treatment of interest derived by financial institutions in a tax treaty with any other country, with a view to providing at least the same treatment to Australia. Any such amendments would be subject to Australia's domestic treaty process, including tabling and consideration by the Joint Standing Committee on Treaties.

Withdrawal or denunciation

36. Either country can terminate the Treaty after a period of five years from the date of its entry into force, provided written notice of termination is given at least six months prior to the end of a calendar year (Article 31). Termination by Australia would be subject to Australia's domestic treaty process. The Treaty would then cease to be effective, in the case of Australia, from either the first day of the second month after the termination notice is given (in respect of withholding tax on income derived by a non-resident), or 1 April or 1 July next following the date on which the notice of termination is given (in respect of fringe benefits tax or other Australian tax respectively).

CONTACT DETAILS

Tax Treaties Unit
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ATTACHMENT ON CONSULTATION

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37. The then Assistant Treasurer's Press Release No. 4 of 25 January 2008 invited submissions from stakeholders and the wider community in relation to issues that might be raised during negotiations. Treasury also sought comments from the business community through the Tax Treaties Advisory Panel, members of which include:

- Australian Bankers' Association
- Australian Chamber of Commerce and Industry
- Australian Financial Markets Association.
- Business Council of Australia
- CPA Australia
- Corporate Tax Association
- Institute of Chartered Accountants in Australia
- International Fiscal Association
- Investment and Financial Services Association
- Law Council of Australia
- Minerals Council of Australia
- Taxation Institute of Australia
- Property Council of Australia

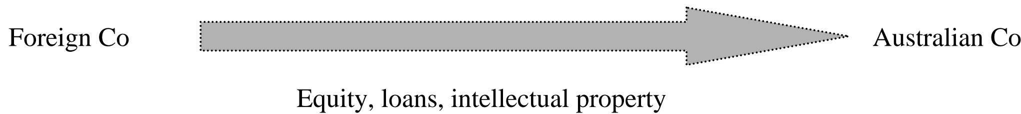
38. In general, business and industry groups recognised the significant commercial relationship between Australia and New Zealand and welcomed the renegotiation of the existing Australia-New Zealand Agreement. Business and industry groups strongly supported reductions in withholding taxes on dividends, interest and royalties. In particular, business and industry groups supported the dividend withholding tax reductions and exemptions for related companies, as well as interest withholding tax exemptions for financial institutions. There was also broad support for the reduction in royalty withholding taxes to five per cent. Business and industry groups also supported the time limits for transfer pricing adjustments, the inclusion of arbitration provisions and the extension of treaty benefits to fiscally transparent entities, in particular Australian managed investment trusts. The new Treaty broadly reflects these preferred outcomes.

39. The State and Territory Governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information on the negotiation of this Treaty was included in the schedules of treaties to State and Territory representatives from August 2007.

ATTACHMENT B

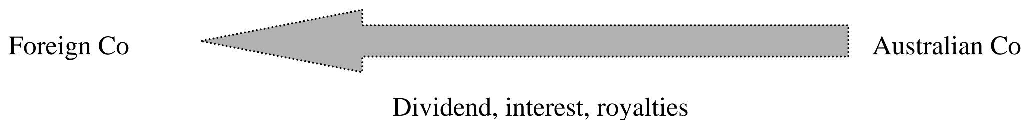
How do withholding taxes work?

Step 1



An Australian company (Australian Co) obtains equity, loans, and intellectual property from a Foreign company (Foreign Co).

Step 2



In return for equity, loans, and intellectual property, Australian Co pays dividends (for equity), interest (for loans), and royalties (for intellectual property) to Foreign Co.

Step 3

Foreign Co earned dividend, interest, and royalties from Australia, so it is liable to pay Australian tax on that amount.

However, it is difficult for the Australian Taxation Office to collect tax from Foreign Co, since it is located outside Australia. Rather than requiring Foreign Co to lodge an Australian tax return, Australian Co is instead required to collect tax, by "withholding" an amount from its payment of

dividend, interest, and royalties to Foreign Co. This amount of tax is referred to as a “withholding tax”.