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Two protocols amending double tax agreements with Canada and Malaysia

Background[1]

3.1 This chapter contains the results of the Committee's review of two proposed protocols that would amend:

- the *Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (the Convention); and
- the *Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income as amended by the First Protocol* (the Agreement).

3.2 Double tax agreements (DTAs) reduce or eliminate double taxation by limiting the taxing rights of signatories over various types of income. A typical limitation imposed by DTAs is that neither country will tax business profits derived from enterprises in the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment and income is attributable to that permanent establishment.

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1 Unless otherwise specified the material in this section was drawn from the National Interest Analyses (NIAs) for the *Protocol, done at Canberra on 23 January 2002, amending the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, done at Canberra on 21 May 1980* and the *Second Protocol and Exchange of Letters, done at Genting Highlands, Malaysia on 28 July 2002, amending the Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 20 August 1980, as amended by the First Protocol of 2 August 1999.*

3.3 Another important function of DTAs is the prevention of international fiscal evasion. DTAs address international fiscal evasion through profit shifting by providing an agreed basis for determining whether income returned or expenses claimed on related party dealings by members of a multinational group operating in both countries can be regarded as acceptable. Another means of preventing international fiscal evasion is by facilitating the exchange of information between the parties to the agreement.

3.4 Thus the general aim of DTAs is to promote closer economic cooperation through the elimination of overlapping taxing jurisdictions and to prevent international fiscal evasion. The specific aims of the proposed protocols amending the DTAs with Canada and Malaysia is to align these agreements with current Australian tax treaty policies and practice.

Proposed treaty actions

3.5 Both Protocols update tax treaty arrangements between Australia and the other party. Both DTAs extend the definition of royalties to include payments for reception or use of transmissions by satellites, cable, fibre optic or similar technology.

3.6 The terms of each of the Protocols will require the incorporation of their texts as schedules to the *International Tax Agreements Act 1953.*

3.7 On the most recent previous occasion that the Committee considered a DTA it recommended that:

> …the Australian Tax Office in consultation with the Australian Treasury and other interested parties, take immediate action to develop an effective methodology to quantify the economic benefits of double tax agreements [and that]
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> …the ATO report back to the Committee on the methodology developed before the Committee is required to recommend action on further double tax agreements.[2]

3.8 The Treasury provided greater detail of the specific issues and quantitative gains and losses that will accompany the amended DTAs with Canada and Malaysia through supplementary NIAs for each Protocol.

2 Recommendation 5 of *Report 46: Treaties Tabled on 12 March 2002*.

Protocol to DTA with Canada

3.9 The DTA between Australia and Canada entered into force on 29 April 1981. The proposed Protocol updates the terms of the Convention to bring them into line with current tax treaty policies and practices.

3.10 The Protocol will enhance the already substantial bilateral framework for trade and investment and is likely to reduce administration and compliance costs to businesses and individuals required to deal with the Australian Taxation Office (ATO) and the Canadian Customs and Revenue Agency (CCRA).

3.11 There are approximately 100 Australian companies active in the Canadian market with sizeable investments. Currently Canada is the 14th largest source of investment in Australia while Australia is the 11th largest investor in Canada. In terms of overall trade Canada is Australia's 17th largest trading partner with two-way trade reaching $A3.6 billion in the 2000-01 financial year.

3.12 The Protocol was signed on 23 January 2002. The Protocol shall have effect in Australia:

(i) in respect of withholding tax on income that is derived by a non-resident, in relation to income derived on or after 1 January in the calendar year next following that in which the Protocol enters into force; and

(ii) in respect of other Australian tax, in relation to income, profits or gains of any year of income beginning on or after 1 July in the calendar year next following that in which the Protocol enters into force.[3]

3.13 Taxation rates would undergo three changes if the Protocol enters into force:

- the adoption of a split rate of five percent for non-portfolio dividends and 15 percent for all other dividends;
- the reduction of the limitation on Canadian and Australian branch profits taxation for 25 percent (in Canada) to five percent; and
- the reduction of the limitation on interest withholding tax rates from 15 percent to ten percent.

3 Department of Treasury, *Correspondence,* 10 September 2002, p.1.

3.14 The Convention revises the definition of 'substantial equipment' which is a criterion used to determine whether an establishment is permanent for taxation purposes. Substantial equipment is no longer confined by a 12 month time test or the application of natural resources. Equipment used in connection with a building site or construction, installation or assembly project is now explicitly excluded from being deemed a permanent establishment.

3.15 Income from real property is specified so as to include revenue from leases of land, exploration rights and the right to mine resources as well as the right to receive payments either as consideration for or in respect of the right to explore or exploit natural resources.

3.16 Profits arising from the sale of shares or other interests in land rich companies or other entities, whether the land is held directly or indirectly, also give rise to taxation in the country in which the real property is situated.

3.17 Monetary amounts under which employment in a country during a visit of less than 183 days were not taxed will be removed by the Protocol. The current levels of attracting exemption are $C3,000 and $A2,600.

3.18 The Protocol extends the definition of Australia to include the territory of Heard and MacDonald Islands.

Second Protocol to DTA with Malaysia

3.19 The DTA between Australia and Malaysia entered into force on 26 June 1981. The First Protocol to the agreement entered into force on 27 June 2000. [4]

3.20 The primary functions of the Second Protocol:

- extend tax sparing arrangements between Australia and Malaysia from 1 July 1992 to 30 June 2003; and
- exclude persons who benefit from the Labuan offshore business activity regime from receiving treaty benefits.

3.21 Tax sparing is an arrangement where tax foregone, for example in the form of tax holidays or tax reductions, by a foreign country on the income of an Australian resident is deemed to have been paid. Thus the tax foregone is credited as if it were actually paid.

4 For details of the Committee's consideration on the First Protocol of the DTA with Malaysia see *Report 25: Eight Treaties Tabled on 11 August 1999*, Ch.6.

3.22 The typical circumstance in which this arrangement operates is where a developing nation seeks to attract foreign investment through tax incentives. Without a tax sparing arrangement the incentive would be negated to the extent that Australia would collect the tax foregone by the source country.

3.23 In exchange for the Australian Government's agreement to extend tax sparing arrangements with Malaysia, the Labuan offshore business activity regime will be excluded from DTA benefits.[5] Labuan is an island off the coast of Malaysia that was given effective tax-free status by the Malaysian Government in 1990 to encourage investment. Because Labuan is still part of Malysia:

> companies based there still received advantages under the country's network of tax treaties with other nations, including Australia.[6]

3.24 There are 115 non-manufacturing Australian companies registered with AUSTRADE, Kuala Lumpur. In 2000 Australia was Malaysia's 12th largest trading partner while Malaysia was Australia's 10th largest trading partner overall and Australia's second largest trading partner in ASEAN after Singapore. In 1999-2000 Australian investment in Malaysia totalled $A389 million and in 2000 Malaysian investment in Australia totalled $A1,731 million.

3.25 The Second Protocol was signed on 28 July 2002. The Protocol shall have effect in Australia:

> in relation to income of any year of income beginning on or after 1 July in the calendar year next following that in which [it] enters into force.
>
> It will have effect in respect of Malaysian tax for any year of assessment beginning on or after 1 January in the calendar year next following the calendar year in which the second Protocol enters into force.[7]

3.26 Besides the extension of tax sparing arrangements and the exclusion from treaty benefits of Labuan tax beneficiaries the Second Protocol provides that, in the event that Malaysia introduces a dividend withholding tax, the rate would not exceed 15 percent.

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5 David Martine, *Transcript of Evidence*, 16 September 2002, p.24.

6 Allesandra Fabro, 'Loophole closed as Australia alters treaty with Malaysia', *Financial Review*, 19 September 2002.

7 Department of Treasury, *Correspondence*, 10 September 2002, p.2.

3.27 In addition, the Second Protocol provides that if Australia concludes an agreement with a third country granting more favourable treatment in relation to underlying tax on dividends and tax sparing concessions, the Governments of Australia and Malaysia will enter into negotiations with a view to providing similar treatment to Malaysia.

Provision of Regulation Impact Statement

3.28 The Committee inquired as to the reason that a Regulation Impact Statement (RIS) was not provided with the NIA for the Second Protocol amending the DTA with Malaysia and would accompany implementing legislation instead. Treasury informed the Committee that the Department of Foreign Affairs and Trade (DFAT) had advised it that the tabling of an RIS with the NIA was not necessary for this Agreement.

3.29 The Committee asked Treasury to provide information regarding the general procedures for determining when RISs were required to be tabled with treaty actions and why no RIS was required in the particular case of the Malaysian Protocol.

3.30 Treasury has assured the Committee that in the future RISs will be attached to relevant NIAs when they are tabled in order to avoid confusion.

Tax sparing arrangements

3.31 Concerns about the inability of the Government to quantify some amounts while apparently being more certain of others continued to occupy the attention of the Committee in relation to the estimated benefits and losses accompanying the extension of tax sparing arrangements with Malaysia.

3.32 Treasury outlined the difficulties that accompany the quantification of dynamic benefits associated with changes to taxation regimes:

> Using the Canadian protocol as an example, there is a reduction in dividend withholding taxes in Canada. In terms of the dynamic benefits, one would then need to start making assumptions about what the subsidiary of an Australian based multinational that is operating in Canada might do as a result of that … change. Will it retain those profits within Canada and seek to invest there or will it repatriate those profits back to Australia? If so, does it invest the profits here or distribute them to shareholders?[8]

8 David Martine, *Transcript of Evidence*, 16 September 2002, p.26.

Exchange of information

3.33 The Committee inquired as to the level of information exchanged between governments facilitated by international tax agreements such as those that Australia has with Malaysia and Canada. It was concerned about the balance between the right to privacy of tax paying individuals and entities and the need to prevent fiscal evasion.

3.34 Treasury advised that the Organisation for Economic Cooperation and Development has developed guidelines on how Exchange of Information (EOI) articles apply. EOI articles are important in ensuring that taxpayers pay the correct amounts of tax:

> … having the power to obtain information from overseas jurisdictions is seen as an important deterrent to fiscal evasion practices …[9]

3.35 The type of information that can be exchanged under EOI articles is limited in at least three ways. First, information obtained under an EOI article is limited to that which is relevant to taxes payable under the specific DTA in which the EOI article is included. Second, the information obtained under an EOI article is subject to all the secrecy requirements of the receiving tax administration. Third:

> A Contracting State is not required to do anything on request from another Contracting State that the requesting State would not be able to do under its own laws or administrative practices.[10]

Conclusion and recommendation

3.36 The Committee is cognisant of the fact that some of the information that it requires to fulfil its function of examining proposed treaty actions in terms of the impact upon the national interest may, if made public, compromise the very interest that the Committee has been established to protect. It notes and is satisfied with the efforts of Treasury to provide fuller and more specific details in relation to individual DTAs that come before it.

3.37 The Committee recognises that economics is far from being an exact science as it requires the making of assumptions about the conduct of individuals who have open to them a large number of possible actions. However, the Committee urges that Treasury continue in its efforts to provide as much information as possible about the assumptions on which

9 Department of Treasury, *Correspondence*, 30 September 2002, p.2.

10 Department of Treasury, *Correspondence*, 30 September 2002, p.3.

it makes its policy decisions and what it hopes to achieve from the actions it implements in DTAs.

Recommendation 2

The Committee supports the Protocol amending the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and recommends that binding treaty action be taken.

Recommendation 3

The Committee supports the Protocol and Exchange of Letters amending the Agreement between the Government of Australia and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income as amended by the First Protocol of 2 August 1999 and recommends that binding treaty action be taken.