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

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1. PART I: HISTORICAL PATTERNS IN AUSTRALIAN TAXATION TREATY PRACTICE

For most of the period since 1946 Australian taxation treaty policy has heavily emphasised source taxation. For much of that period there was tension in Australian policy between wanting to encourage investment in Australia through lowering of source country tax rates through treaties while at the same time wanting to get what was perceived to be Australia's fair share of tax from the exploitation of its natural resources. The latter consideration led Australia to argue for broad definitions of permanent establishment and for rates of withholding taxes which were high for a developed country and, after it joined the OECD, were unusual for an OECD country.

The draft Australian Taxation Treaty initially followed what the Australian Taxation Office has described as 'the colonial model'. Under this model 'industrial and commercial profits' were defined in terms which excluded items dealt with elsewhere in the treaty.¹ Until the second Australian treaty with Canada in 1980 no Australian treaty contained an 'other income' article. The thinking of the negotiators of these treaties was that full source country taxing rights were retained in relation to items not specifically dealt with in a treaty. Some of these treaties did not contain interest or royalty or capital gains articles. As will be seen later in this paper recent Australian court decisions have dealt with the issue of what taxing rights, if any, Australia had in treaties which contained neither a comprehensive capital gains article nor an other income article.

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¹ This terminology was used in Australian Taxation Office Rulings TR 2001/12 and TR 2001/13. The term had previously been used in J Newman, *United Kingdom Double Tax Treaties*, Butterworths, London, 1979 at 2. While the pattern of defining industrial and commercial profits in terms which excluded other items applied to United Kingdom treaties with Dominions such as Australia, Canada and New Zealand in this period it did not apply to the treaties with colonies (as distinct from Dominions) examined by Newman in 1979.

After Australia joined the OECD in 1971 Australia's draft treaty began to move closer to the OECD Model by using the term 'business profits' in an undefined sense and by including an income from alienation of property article. Nonetheless Australia's emphasis on source basis taxation remained. This can be seen in the Australia – Canada treaty of 1980 which was the first Australian treaty to fully sever structural ties with the colonial model by including an other income article. The other income article in that treaty, however, (and in most subsequent Australian treaties) differed from the OECD Model and was in a form similar to the other income article in the UN Model.²

Australia introduced a general capital gains tax (CGT) in 1985. Australia's taxation treaties up to and including the German Treaty of 1972 contained neither a capital gains article nor an 'other income' article. Between the German Treaty and the Austrian Treaty (negotiated before but entered into after the introduction of Australian CGT) Australian Treaties contained an 'alienation of property' article which differed significantly from the OECD Model capital gains article. A debate was to develop subsequently as to how, if at all, Australia's CGT jurisdictional claims were affected by Australia's pre CGT Treaties.

From the mid 1980s to the mid 1990s, under the Hawke and Keating governments in particular, Australia saw its economic fortunes as being increasingly linked to those of the rapidly expanding Asian economies. Exchange controls were lifted in this period, tariffs were progressively lowered and removed and the emphasis of economic policy shifted from protection of Australian industries to promoting offshore investment and exports. By the late 1990s and in the early 21st century Australian tax treaty policy began to respond to this shift and, from the 2001 Protocol to the Australia – United States Treaty, began to move to a more residence based tax treaty policy.

Australian tax treaty drafting in this period up to the mid to late 1990s was dominated by tax lawyers and tended to be more legalistic and technical than the drafting in the OECD Model. The Australian approach to tax treaty drafting in this period appears to have reflected and been a response to the technical and legalistic approach to statutory interpretation adopted by the Australian High Court in this period.³ As Australia became more involved in the OECD and as the Australian courts approach to statutory interpretation became more purposive and less literal so Australian draft tax treaties moved closer to the OECD model. Most recently this has been seen by Australia's abandonment of its long term opposition to the non discrimination article, in its lowering its rates of dividend and royalty withholding tax and in the capital gains article where Australian influence can be seen in the development of Article 13(4) of the OECD Model dealing with alienation of shares in land rich companies.

² Compare Article 21 of the Australia – Canada Double Taxation Treaty 1980 with OECD (1977) Article 21 and UN 1980 Article 21.

³ For a discussion of the legalism of the period in the context of tax judgments see Geoffrey Lehmann, 'The income tax judgments of Sir Garfield Barwick: a study in the failure of the new legalism.' (1983) 9 *Monash University Law Review* 115 to 156.

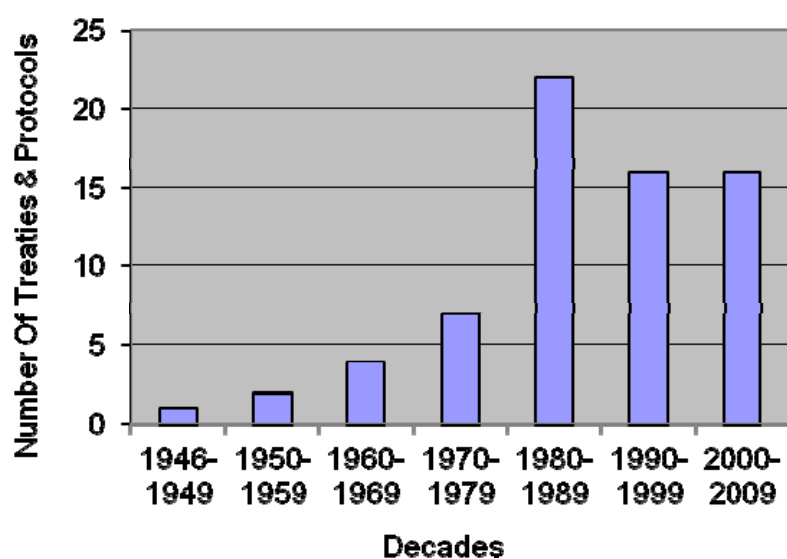
Chart 1: Australian treaties and protocols by decade

Chart 1 shows the number of Australian bi-lateral tax treaties and protocols signed in each decade since 1946.

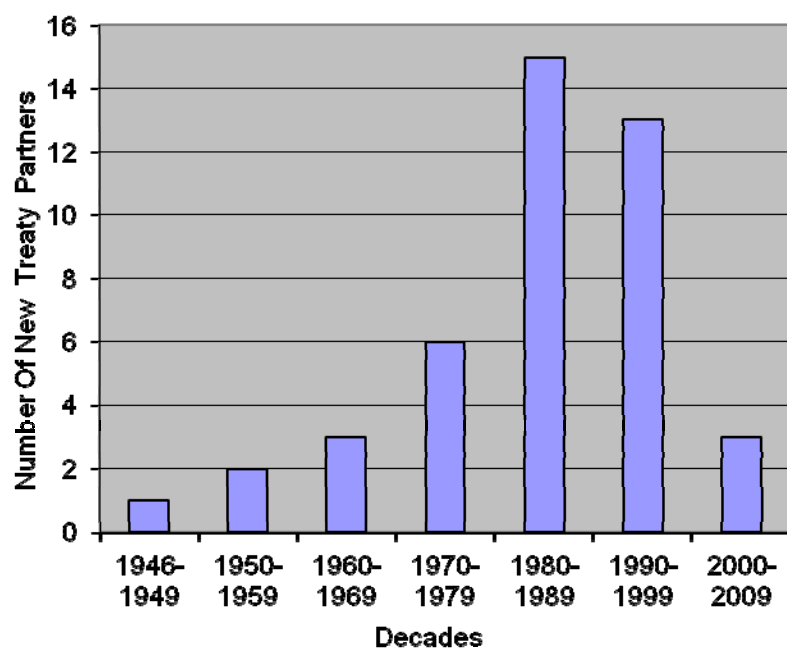
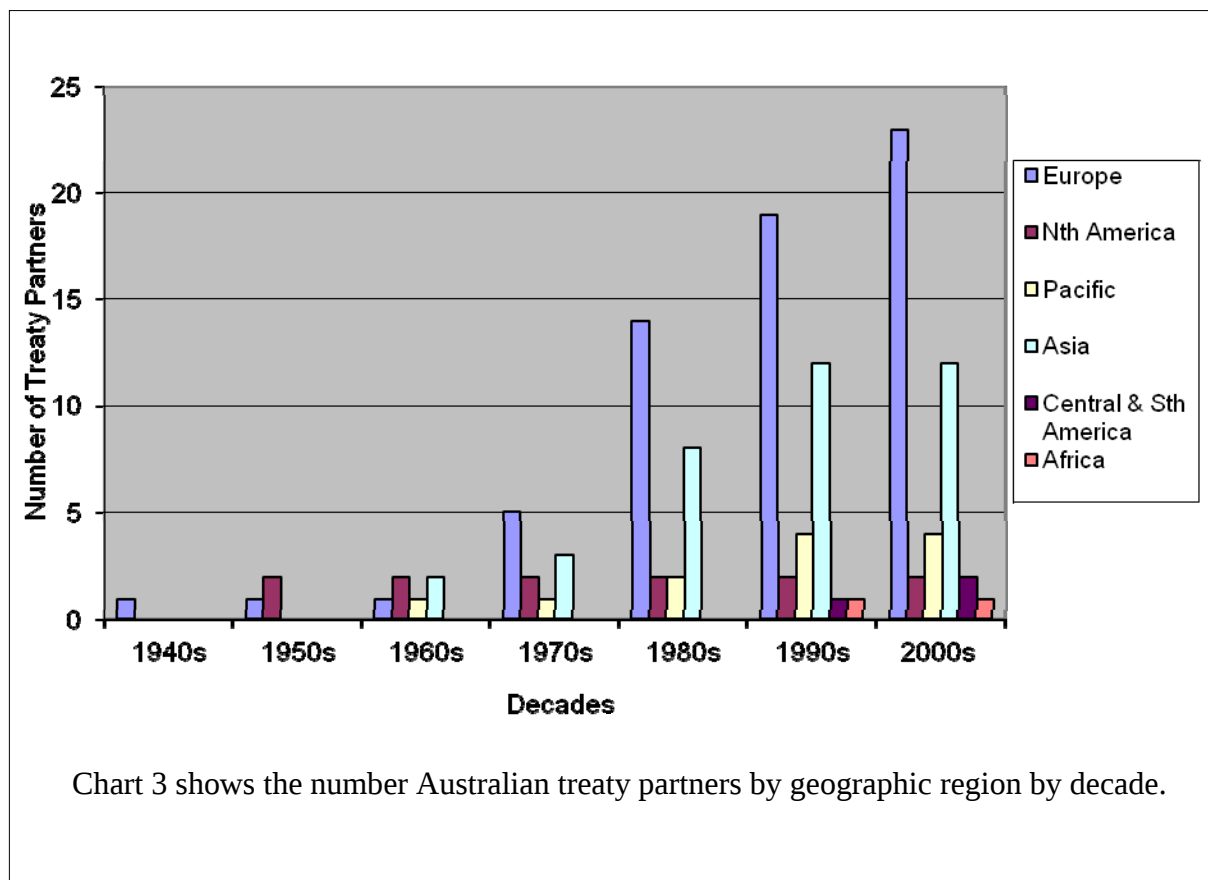
Chart 2: Australian new treaty partners by decade

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

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 features⁴ 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 evidence⁵ 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. In some instances it will be argued that, whatever the original justification for these distinctive features, the case for retaining them has weakened as the Australian economy has become more integrated into the World economy and the Asian region.

2.1 Definition of permanent establishment

Australian tax treaty policy has always been and continues to be to seek a broad definition of permanent establishment. A former Australian Assistant Treasurer's view of the policy behind this approach to the definition of permanent establishment was as follows:

*'In order to preserve source country taxing rights over real property and natural resources, the definition of permanent establishment applies to a wider range of activities (including supervisory and consulting activities, natural resource activities, the operation of substantial equipment, and certain manufacturing and processing activities) and adopts shorter, specified time thresholds than the OECD Model. In addition, an anti-contract splitting clause is included to ensure that the specified time thresholds are not circumvented.'*⁶

2.1.1 Substantial Equipment Provisions

As noted in the former Assistant Treasurer's Media Release, substantial equipment provisions are one distinctive feature of the definition of permanent establishment in Australian treaties. These can be traced to the 1953 treaty between Australia and the United States. The definition of 'permanent establishment' in this treaty was substantially similar to the equivalent definition in the Australia – United Kingdom Treaty of 1946 which in turn had been based on but was narrower than the equivalent

⁵ The principal archives that have been consulted have been: the National Archives of Australia in Canberra; the United Kingdom National Archives, Public Record Office, at Kew; the archives of the Netherlands Foreign Ministry in The Hague; the Canadian Library and Archives in Ottawa; and the United States National Archives at College Park, Maryland.

⁶ The Hon Chris Bowen MP, Assistant Treasurer, Minister for Competition Policy and Consumer Affairs, Media Release 25/01/2008 No.004, 'Australia's Tax Treaty Negotiation Policy' 25th January 2008.

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 Treaty¹⁰ 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 the 1950s beginning with the 12th June 1950 Supplementary Convention to the 1942 United States – Canada Treaty.¹¹ Hence the question arises whether the broadening of the definition in this respect ‘in conformity with Australia’s aims’ was initiated by Australia or the United States. The terms of Canadian treaties in the 1950s suggest that including a substantial equipment provision became part of Canadian tax treaty policy in this period. Given that substantial equipment provisions do not appear in other United States treaties in the 1950s a reasonable conclusion is that Australia argued for the inclusion of a substantial equipment provision on the basis that the United States had agreed to such a provision in its Supplementary Convention with Canada in 1950.¹²

⁷ The definition of ‘permanent establishment’ in the 1946 Australia – United Kingdom Double Taxation Treaty was contained in Article II (1)(j) of the treaty. In the 1945 United States – United Kingdom Double Taxation Treaty the definition was contained in Article II(1)(l) of the treaty. There were minor differences in expression between the two definitions but the two definitions were substantially the same. The background to the 1946 Australia – United Kingdom Double Taxation Treaty is discussed in C John Taylor, ‘The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946’ [2009] *British Tax Review* 201 and C John Taylor, “ ‘ I suppose I must have more discussion on this dreary subject’: The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946’ in J Tiley (ed), *Studies in the History of Tax Law*, Volume 4, Hart Publishing, Oxford and Portland Oregon, 2010, at 213. The background to the 1945 United States – United Kingdom Double Taxation Treaty is discussed in John F Avery Jones, ‘The History of the United Kingdom’s First Comprehensive Double Taxation Agreement’ [2007] *British Tax Review* 211.

⁸ Memorandum from P S McGovern, Commissioner of Taxation, to The Commonwealth Treasurer (A W Fadden) 15th April 1952 at p2, paragraph 10. National Archives of Australia, Series Number A7073/21, Control Symbol J245/45/21 Pt3 ‘Double Taxation – USA – Australia 7/1/50 – 13/7/62 at p7 paragraph 46.

⁹ McGovern had noted, *supra* note 8 at p5 paragraph 29 that, in the negotiations, Australia had offered opposition to provisions which violated the prior right of the source country to tax and which could do little or nothing to encourage United States investment in Australia. McGovern also observed, *supra* note 8 at p7 paragraph 45, that it was in the interests of Australia to have the term ‘permanent establishment’ cover a wide variety of the means by which a resident of one country can conduct business operations in the other country.

¹⁰ See paragraph ‘o’ of Supplementary Convention 12th June 1950 to United States – Canada Taxation Convention of 1942

¹¹ Canada – South Africa Taxation Treaty, 1956, Article II(1)(j); Australia – Canada, 1957, Article II(1)(l); Belgium – Canada, 1958, Article II(1)(i)(bb); Finland – Canada, 1959, Article II(1)(j).

¹² To date the author has been unable to locate archival evidence, in either the National Archives of Australia in Canberra, the United States National Archives in College Park, Maryland, or in the

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 W H 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 installation of substantial equipment or machinery by, for, or under a contract with, an enterprise of one of the countries.' While the United Kingdom agreed that there was some justification for treating the company as having an Australian permanent establishment in the example given, the United Kingdom considered that the Australian formula was too wide as it might, for example, cover plant supplied under a hire purchase agreement or ordinary plant hire and hence might 'cut across' the royalty article.¹⁵ No further mention is made of this request in either the United Kingdom or Australian records of the negotiations nor in the subsequent correspondence. A substantial equipment provision was not included in the final version of the 1967 Australia – United Kingdom Treaty

Despite its non inclusion in the 1967 Australia – United Kingdom Treaty a substantial equipment provision was in the drafts which Australia sent to Japan in February 1968¹⁶ and to Singapore in August 1968¹⁷. The substantial equipment provision was

Canadian National Archives in Ottawa, indicating which country was the originator of the inclusion of a substantial equipment provision in the definition.

¹³ ET Cain, Commissioner of Taxation to WHB Johnson, Under Secretary, Board of Inland Revenue, Board Room, Inland Revenue, 13th December 1966. 'Revision of Double Taxation Agreement – Australia' United Kingdom National Archives, IR 40/16741 (hereafter '1967 UK – Australia, Treaty, Inland Revenue File')

¹⁴ WHB Johnson to ET Cain, 3rd February 1966, 1967 UK – Australia, Treaty, Inland Revenue File.

¹⁵ 'Notes of Meetings in Canberra, Third Day, Afternoon Session', 1967 UK – Australia, Treaty, Inland Revenue File.

¹⁶ The Australian draft is contained in the Australian Taxation Office file 'Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1. The substantial equipment provision is Article 3(4)(c). No substantial equipment provision was contained in the Japanese draft dated January 1968. The Japanese draft dated January 1968 is contained in 'Double Tax – Australia – Japan Tokyo Papers

not included in the final version of the 1969 Australia – Japan Treaty¹⁸. Although the Australian record of the negotiations does not mention the substantial equipment provision specifically it does record that Japan objected to the breadth of the definition of permanent establishment in the Australian draft. The Australian response to these objections was that, as the party that initiated the negotiations Japan could not expect more generous treatment than Australia had afforded to the United Kingdom as this would be embarrassing to the United Kingdom.¹⁹ This would appear to explain why the definition of permanent establishment in the Australia – Japan Treaty of 1969 is virtually identical to the equivalent definition in the Australia – United Kingdom Treaty of 1967. On the other hand, a substantial equipment provision was included without any apparent objection from Singapore²⁰, in the final version of the Australia – Singapore Treaty of 1969 and, with some variations in form, has often been found in Australian treaties ever since.²¹

and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1.

¹⁷ The draft, dated August 1968, is contained in the one of the Australian Taxation Office files relating to the negotiation, 'Double Tax Agreement Australia – Singapore' National Archives of Australia, Series A7073 (A7073/6) Control Symbol J245/69 Part 2. The substantial equipment provision is Article 3(4)(c).

¹⁸ Article 3(4) of the final draft treaty refers to supervisory activities but does not refer to substantial equipment. The final draft is contained in Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 2.

¹⁹ The Australian record of the negotiations is contained in Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1.

²⁰ The substantial equipment provision is not mentioned in either 'Singapore – Australia Double Taxation Negotiations – Outstanding Points' evidently compiled shortly after the conclusion of negotiations in Canberra in October 1968 nor in 'Memorandum' dated 3rd October 1968 signed by the leaders of the delegations E T Cain and S Thiruchelukum. Both documents are contained in, 'Double Tax Agreement Australia – Singapore' National Archives of Australia, Series A7073 (A7073/6) Control Symbol J245/69 Part 2.

²¹ The precise terms of the article referring to 'substantial equipment' vary and some extend the definition of permanent establishment further than others do. In some instances there is a general deeming, in others the deeming is only in the context of mining or exploration activities, in others there is no deeming but the use of substantial equipment is included in the list of examples of a permanent establishment. See: Australia – Singapore Treaty, 1969, Article 4(3)(b); Australia – Netherlands Treaty, 1976, Article 5(4)(b); Australia – France Treaty, 1976, Article 4(4)(b); Australia – Belgium Treaty, 1977, Article 5(4)(b); Australia – Philippines Treaty, 1980, Article 5(4); Australia – Switzerland Treaty, 1980, Article 5(4)(b); Australia – Canada Treaty, 1980, Article 5(4)(b); Australia – Malaysia Treaty, 1981, Article 5(4)(b); Australia – Sweden Treaty, 1981, Article 5(4)(b); Australia – United States Treaty, 1982, Article 5(4); Australia – Denmark Treaty, 1981, Article 5(4)(b); Australia – Ireland Treaty, 1983, Article 5(4)(b); Australia – Italy Treaty, 1983, Article 5(4)(b); Australia – Korea Treaty, 1983, Article 5(5)(b); Australia – Norway Treaty, 1983, Article 5(4)(b); Australia – Malta Treaty, 1984, Article 5(4)(b); Australia – Finland Treaty, 1985, Article 5(4)(b); Australia – Papua New Guinea Treaty, 1989, Article 5(4)(b); Australia – Thailand Treaty, 1989, Article 5(4); Australia – Sri Lanka Treaty, 1990, Article 5(4); Australia – Fiji Treaty, 1990, Article 5(4)(b); Australia – Hungary Treaty, 1991, Article 5(4)(b); Australia – Kiribati Treaty, 1991, Article 5(4)(c); Australia – India Treaty, 1991, Article 5(3)(a); Australia – Poland Treaty, 1991, Article 5(4)(b); Australia – Vietnam Treaty, 1992, Article 5(4)(b); Australia – Spain Treaty, 1992, Article 5(4)(b); Australia – Czech Republic, 1995, Article 5(4)(c) [heavy equipment]; Australia – Taipei Treaty, 1996, Article 5(4)(b); Australia – South Africa Treaty, 1999, Article 5(4)(c); Australia – Slovak Republic Treaty, 1999, Article 5(4)(b); Australia – Romania Treaty, 2000, Article 5(4)(b); Australia – Russian Federation Treaty, 2000, Article 5(4)(b) [heavy industrial equipment]; Australia – Mexico Treaty 2002, Article 4(a) [heavy equipment]; Australia – Chile Treaty, 2010 (not yet in force) Article 5(4)(b) [carrying on activities, including the

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 Treasury²² 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 existed for more than twelve months nor supervisory activities on a building site or a 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').

²³ The reference to these items appearing in the Australian model clearly suggests that Australia had developed a formal model treaty for use in negotiations by this stage. While the author as yet has not been able to locate a model Australian treaty dating from this period, it seems likely that it would have been developed in response to the several requests for a taxation treaty that Australia received from other countries between 1946 and 1966. Although Australia received requests from several European countries for a taxation treaty in this period it the only country with whom even preliminary steps toward negotiations commenced was Singapore. Singapore requested a treaty in 1963 the same year as the OECD draft model was released. It appears highly likely that the development of these features of the Australian model began at this time. The OECD draft model contained an article deeming a building site or construction or installation project to be a permanent establishment if it lasted for more than twelve months. The Australia – Singapore treaty of 1969 (the next taxation treaty entered into by Australia after the 1967 United Kingdom treaty) contained a similar provision within the 'includes' portion of the definition but with a more easily satisfied time requirement periods aggregating six months within any 12 month period. (Australia – Singapore treaty 1969 Article 4(2)(i). The Australia – Singapore treaty also contained a deeming provision in relation to supervisory activities for periods aggregating six months within any 12 month period.

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 and supervisory activities in the definition of permanent establishment has been characteristic of Australian treaties and several subsequent Australian treaties have reduced the minimum time periods for various projects and supervisory activities

²⁴ William McMahon, ‘Confidential For Cabinet Committee On Taxation Policy, Submission 123 (McMahon, Submission 123) pages 23-24, paragraphs 46 to 47.

²⁵ Notes of Meetings, Third Day, 4th April 1967, Morning Session, p2, Inland Revenue file. Notes of discussions 13/3/67 – 14/4/67, Australian Treasury file, handwritten notes by an Australian Treasury official, 4th April 1967.

²⁶ Notes of Meetings, Third Day, 4th April 1967, Morning Session, p2, 1967 UK – Australia Treaty Inland Revenue file. Notes of discussions 13/3/67 – 14/4/67, 1967 UK – Australia Treaty Australian Treasury file, handwritten notes by an Australian Treasury official, 4th April 1967.

²⁷ Notes of Meetings, Fourth Day, 5th April 1967, Morning Session, p2, 1967 UK – Australia Treaty Inland Revenue file.

²⁸ Notes of discussions 13/3/67 – 14/4/67, 1967 UK – Australia Treaty Australian Treasury file, handwritten notes by an Australian Treasury official, 4th April 1967.

²⁹ ‘Installation projects’ lasting for more than twelve months have been included in the OECD Model definition of ‘permanent establishment’ since 1977 in Article 5(3).

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, installation or assembly projects but six months on supervisory activities]; Australia – Belgium Treaty 1977, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Philippines Treaty 1980, Article 5(2)(h) and Article 5(2)(k) [services including consultancy services in relation to any project or a connected project]; Australia – Switzerland Treaty 1980, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Canada Treaty 1980, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Malaysia Treaty 1981, Article 5(2)(h), Article 5(4)(a) [supervisory activities] and Article 5(4)(c) [services, including consulting services]; Australia – Sweden Treaty 1981, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Denmark Treaty 1981, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – United States Treaty 1982, Article 5(2)(h) [building site, construction, assembly or installation project for more than 9 months], Article 5(2)(i) [installation, drilling rig or ship for dredging or exploration of natural resources of sea bed and subsoil for 6 months in any 24 month period, Article 5(4)(c) [supervisory activities for 9 months in any 24 month period]; Australia – Ireland Treaty 1983, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Italy Treaty 1983, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Korea Treaty 1983, Article 5(3) and Article 5(5)(a); Australia – Norway Treaty 1983, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Malta Treaty 1984, Article 5(2)(h) and Article 5(4)(a) [183 days in any twelve month period]; Australia – Finland Treaty 1985, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Austria Treaty 1986, Article 5(2)(h) [includes installation project but no reference to supervisory activities and minimum period is twelve months]; Australia – China Treaty 1990, Article 5(3)(a), Article 5(3)(b) [services including consulting services where aggregate 6 months in any 12 month period], Article 5(3)(c) [structure, installation, drilling rig, ship or other equipment used in relation to exploration for or exploitation of natural resources if so used continuously or if those activities continue for more than three months]; Australia – Papua New Guinea Treaty 1989, Article 5(2)(h) and Article 5(4)(a) [90 day minimum period]; Australia – Thailand Treaty 1989, Article 5(2)(g) [where project or any two or more of them continue for more than 6 months], Article 5(i) [services, including consulting services, for a period or periods aggregating 183 days in a 12 month period]; Australia – Sri Lanka Treaty 1990, Article 5(3)(a) and Article 5(3)(b) [183 continuous days and services, including consulting services, rather than supervisory activities]; Australia – Fiji Treaty 1990, Article 5(2)(h) and Article 5(4)(a); Australia – Hungary Treaty, 1991, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Kiribati Treaty 1991, Article 5(2)(h) and Article 5(4)(a) [minimum period 90 days]; Australia – India Treaty 1991, Article 5(2)(k) and Article 5(3)(c) [services, including managerial services for a period or periods aggregating 90 days in a 12 month period or if both enterprises are within certain relationships described in the associated enterprises article]; Australia – Poland Treaty 1991, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Indonesia Treaty 1992, Article 5(2)(h) [installation, drilling rig or ship for the exploration or exploitation of natural resources in continuous use for more than 120 days], Article 5(2)(i) [building site or construction, installation or assembly project or supervisory activities which exist for more than 120 days], Article 5(2)(j) [furnishing of services, including consulting services, for a period or periods aggregating 120 days in a 12 month period]; Australia – Vietnam Treaty 1993, Article 5(2)(h) and Article 5(4)(a) [minimum period is 183 days]; Australia – Spain Treaty 1992, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Czech Republic Treaty 1995, Article 5(2)(h) and Article 5(4)(a) [includes installation project and supervisory activities but minimum period is twelve months]; Australia – Taipei Treaty 1996, Article 5(2)(h), Article 5(2)(i) [services,

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 in 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 Boards 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. Cables 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 by the arm's length provisions it would be equivalent to saying that those provisions could be ignored by the Commissioner. Indeed it might be taken as implying that Section 136 was not founded on the arm's length principle. We know that neither the Commissioner nor the Board of Review would ignore the principle in practice but the point is that they would be entitled to and might even be expected to and that is a position which we could not possibly accept. The agreement would be indefensibly one-sided if we were bound to observe the principle and you were not.'*³⁴

The power of the Australian Commissioner to make assessments under s136 was not at issue. Both sides agreed that this was possible and the United Kingdom view was that the onus would then be on the taxpayer to show that the assessment was not on an arm's length basis.³⁵

The Australian Commissioner (Patrick McGovern) preferred that the Treaty not include provisions dealing with ascertaining the quantum of taxable income of a taxpayer in either country at all but following advice from the Australian Solicitor General (Kenneth Bailey)³⁶ accepted that, because of Heads of Agreement between the Australian Prime Minister (J B Chifley) and the United Kingdom Chancellor of the Exchequer (Hugh Dalton) Article III(3) (and the equivalent provision in the associated enterprises article) would have to be included in the Treaty. Nonetheless McGovern requested that a savings clause aimed at protecting s136, in a form drafted by the Australian Solicitor General, be included in both articles.³⁷

The United Kingdom would not accept the Australian Solicitor General's draft of the saving provision in relation to s136.³⁸ The United Kingdom did not like the closing

³³ 'Drafting of the UK-Australia Agreement 1946. Cables of Draft of Agreement.' P McGovern to RJ Mair, 22nd May 1946 and 6th June 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

³⁴ UK National Archives IR 40/13740 R Willis to RJ Mair 20th June 1946, pp 197ff.

³⁵ UK National Archives IR 40/13740 R Willis to RJ Mair 20th June 1946, pp 197ff. Mair cabled Willis' letter to McGovern on the day of its receipt. Mair to McGovern, 20th June 1946, National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/19, 'Drafting of the United Kingdom – Australia agreement 1946. Cables of draft of agreement.' p67.

³⁶ The advice is quoted in full in 'Drafting of the UK-Australia Agreement 1946. Cables of Draft of Agreement.' P McGovern to RJ Mair, 14th July 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

³⁷ 'Drafting of the UK-Australia Agreement 1946. Cables of Draft of Agreement.' P McGovern to RJ Mair 14th July 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

³⁸ The Australian Solicitor General's draft savings clause included the following, 'that discretion shall be exercised or that estimate shall be made with the object that the amount so liable to tax shall be determined, as nearly as the information available to the taxing authority permits, in accordance with paragraph (3) of this Article, but the application of that law and liability of any taxpayer shall not

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 concerns in relation to s136 the United Kingdom suggested that the following be added to Article III(3):

*'If the information available to the Taxation Authority concerned is inadequate to determine the profits to be attributed to the permanent establishment nothing in this paragraph shall affect the application of the law of either territory in relation to the liability of the permanent establishment to pay tax on the amount determined by the exercise of a discretion or the making of an estimate by the Taxation authority of the territory provided that such discretion shall be exercised or such estimate shall be made so far as information available to the Taxation authority permits in accordance with principle stated in this paragraph.'*³⁹

Following advice from the Australian Crown Solicitor, the Australian Commissioner of Taxation agreed that this provision be added to Article III and to the associated enterprises article.⁴⁰

The inclusion of these provisions was perhaps understandable in 1946 given the terms of then ITAA1936 s136 under which the Commissioner was not required to apply arm's length principles in determining taxable income. The continued inclusion of similar provisions in Australian treaties and protocols following the repeal of the former s136 and the enactment of Australia's transfer pricing provisions (ITTA 1936 Part III Division 13) in 1982 is less understandable. ITAA 1936 ss136AD(1), (2) and (3) substitute arm's length consideration for actual consideration in cases where: (a) a taxpayer has supplied property under an international agreement and either the consideration is less than arm's length consideration (s136AD(1)) or there is no consideration (s136AD(2)); and (b) a taxpayer has acquired property under an international agreement and the consideration is more than arm's length consideration (s136AD(3)). Subsection 136AD(4) then states:

'For the purposes of this section, where, for any reason (including insufficiency of information available to the Commissioner), it is not possible or not practicable for the Commissioner to ascertain the arm's length consideration in respect of the supply or acquisition of property, the arm's length consideration in respect of the supply or acquisition shall be deemed to be such amount as the Commissioner determines.'

Presumably the savings provision in current Australian treaties is intended to protect the Commissioner's powers under s136AD(4). Whether such protection is necessary is questionable. Arguably, only in cases where a comparative uncontrolled transaction

otherwise be affected by that paragraph.' 'Drafting of the UK-Australia Agreement 1946. Cables of Draft of Agreement.' P McGovern to RJ Mair, 14th July 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

³⁹ Mair to McGovern, 25th July 1946, National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/19, 'Drafting of the United Kingdom – Australia agreement 1946. Cables of draft of agreement.'p115.

⁴⁰ 'Drafting of the UK-Australia Agreement 1946. Cables of Draft of Agreement.' P McGovern to RJ Mair, 27th July 1946. The Australian Crown Solicitor's opinion is quoted in RJ Mair to P McGovern, 25th July 1946. National Archives of Australia, Series No. A 7303/21 Control Symbol J 245/45/19.

is found can it be said that actual arm's length consideration has been ascertained. In many cases, as the OECD Transfer Pricing Guidelines recognise⁴¹, 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 OECD. This is particularly so where the Commissioner, in using powers under s136AD(4), has applied estimation methods approved by the OECD or least used an estimation method that was intended to find the price that would be used in the hypothetical circumstances contemplated in the articles.

My conclusion is that there is no need for a savings provision to protect the Commissioner's powers under s136AD(4) and that its use by Australia merely reflects the continuing influence of an early Australian treaty practice the original context of which has long been forgotten. The two most recent Australian treaties, with Chile and with Turkey (both signed in 2010 and both yet to come into force) suggest that the savings provision continues to form part of the Australian draft.

2.3 Tax treaty articles giving income an Australian source that it would not have under domestic law

Another unusual feature of Australian tax treaties is that, in some instances, they deem income to have an Australian source that it would not have under Australian domestic law. This practice originated with the 1967 Australia – United Kingdom Tax Treaty and has continued and, indeed been expanded in subsequent Australian tax treaties.

2.3.1 1967 United Kingdom Treaty and Mitchum's Case

The industrial or commercial profits articles and the associated enterprises of Australia's tax treaties with the United Kingdom in 1946, with the United States in 1953, with Canada in 1957 and with New Zealand in 1960 had all contained a source rule which deemed profits calculated under those articles to be sourced in the country in which the permanent establishment was located (in the case of the industrial or

⁴¹ See in particular paragraph 1.12 of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

⁴² See, for example, paragraph 7 of the OECD Commentary on Article 9(2).

commercial profits article) or in the country in which the controlled enterprise (in the case of the associated enterprises article) was located.⁴³

The source rule had been included in the 1946 United Kingdom – Australia Tax Treaty at Australia’s request. The request for the inclusion of the source rule in the industrial or commercial profits article was made in the context of negotiations relating to the saving provision for *Income Tax Assessment Act 1936* (Cth) s136 discussed above. Where s136 applied the relevant taxpayer was ‘liable to pay income tax on a taxable income of such amount of the total receipts...of the business as the Commissioner determines’. Section 136 applied ‘notwithstanding any other provision of this Act’. The High Court had held, inter alia, in *The Texas Company (Australasia) Ltd v FCT* (1939) 63 CLR 382 that s28 could apply as long as part of the relevant business was carried on in Australia. In that case s28 applied to an Australian incorporated company, owned by a United States company, which carried on business in both Australia and New Zealand. The liability to pay tax on a taxable income determined under s136 was not in terms limited to payment of tax on such receipts of the business as had an Australian source although judicial dicta had indicated that a proper construction of s28 of the *Income Tax Assessment Act 1922* (the progenitor of s136) was that the reference to ‘the total receipts of the business’ should be confined to the total receipts ‘earned and derived in Australia’.⁴⁴ Nonetheless the courts had pointed out that the assessment s28 and under s136 was not based on the actual income of the business but on a notional income and identified planning based on inflated import prices in non arm’s length transactions as one form of planning that the section was aimed at combating.⁴⁵ In these circumstances the end effect of s136 deeming taxable income to be a percentage of the gross receipts of the Australian business was to reduce the deductions for the purchase price of imported items thus producing a quantitatively different amount of taxable income to that which would otherwise be deemed to have an Australian source under *Income Tax Assessment Act 1936* s38 to 42.⁴⁶ Hence it is possible that the source rule in the industrial or

⁴³ Australia – United Kingdom Treaty 1946, Article III(3); Australia – United States Treaty 1953, Article III(4) [deemed to be income of the permanent establishment but not explicitly deemed to have source in the country conducts trade or business]; Australia – Canada Treaty 1957, Article III(3); Australia – New Zealand Treaty 1960, Article III(3).

⁴⁴ See, for example, Starke J in *FCT v Munro: British Imperial Oil Co v FCT* (1926) 38 CLR 153 at 217.

⁴⁵ See *FCT v Munro: British Imperial Oil Co v FCT* (1926) 38 CLR 153 per Higgins J at 209 and per Starke J at 214 to 216. See also the subsequent comments of Williams J in *Lever Brothers Pty Ltd v FCT* (1948) 77 CLR 78 at 81.

⁴⁶ Section 136 was applied in these circumstances in a Board of Review Case, Reference Numbers 226-31/1944 discussed in NE Challoner and CM Collins, *Income Tax Law and Practice (Commonwealth)*, Law Book Company Sydney, 1953 at para [902]. Section 38 of the *Income Tax and Social Services Contribution Assessment Act 1936* dealt with importation and sale in Australia by a manufacturer of goods and read as follows:

‘Where goods manufactured out of Australia are imported into Australia and the goods are, either before or after importation, sold in Australia by the manufacturer of the goods, the profit deemed to be derived in Australia from the sale shall be ascertained by deducting from the sale price of the goods the amount for which, at the date the goods were shipped to Australia, goods of the same nature and quality could be purchased by a wholesale buyer in the country of manufacture, and the expenses incurred in transporting them to and selling them in Australia.’

Challoner and CM Collins, *supra* at [303], noted that s38 appeared to embody the principle laid down by the High Court in *FCT v W Angliss & Co Pty Ltd* (1931) 46 CLR 417. This view would see the principle of s38 as being concerned with how much of a profit from an international sale of goods transaction was sourced in particular jurisdictions. Challoner and Collins went on to comment at [303], ‘The effect of s38 is that overseas manufacturing profit, i.e., the difference between the overseas

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 of California (Warners California) to appear in and provide ancillary services in relation to the film *The Sundowners* to be produced partly in Australia and partly in England. It was agreed between the Swiss company and Warners California that Warner California would have the right to lend Mitchum's services to a United Kingdom company Warner Bros. Production Limited (Warners London) but stipulated that Mitchum should be deemed to be rendering services under the agreement between the Swiss company and Warners California to whom the Swiss company was to look for payment for the loan of Mitchum's services. Mitchum endorsed the contract and performed the services, including performing in Australia for eleven weeks in 1959. Mitchum was not entitled to any payment from Warners

manufactured cost and the wholesale purchase price is not derived from a source in Australia. Section 39 deemed the profit derived in Australia from an import sale of goods by person other than the manufacturer to be the sale price less the purchase price and expenses associated with transporting the goods to Australia. Section 40 provided that where profit could be ascertained under either s38 or s39 it was deemed to be such amount as the Commissioner determined. Section 41 deemed goods to be sold in Australia by a person where they were in Australia or were brought into Australia and were sold by means of anything done by the person or by the person's agent or representative. Section 42 provided that where, because of reasons circumstances specified in the section or for any other reason whatsoever, a question arose as to whether the whole or any part of a profit arose from Australian sources the question would be determined in accordance with the regulations or, if no regulation applied, would be determined by the Commissioner. No regulations under s42 were ever proclaimed.

⁴⁷ Article 6(6) of United Kingdom Draft, September 1966, 1967 UK – Australia Treaty Inland Revenue File.

⁴⁸ W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and accompanying memorandum, 16th November 1966, 1967 UK – Australia Treaty Australian Treasury File.

(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 company's obligations to him under the contract of June 1959. The Australian Commissioner of Taxation assessed Mitchum on a proportion of the \$50,000 on the basis that it was assessable under *Income Tax Assessment Act 1936* s25(1)(b) as gross income derived by Mitchum from sources in Australia that was not exempt income under s23r of that Act. On appeal to the Full High Court held that there was no rule of law that meant that the place of performance was the source of income from services but rather, consistent with prior Australian case law, the question of source of income was 'a practical, hard matter of fact'. In the words of Barwick CJ at 113 CLR 401 at 407:

'The conclusion as to the source of income for the purposes of the Act is a question of fact. There is no statutory definition of "source" to be applied, the matter being judged as one of practical reality. In each case, the relative weight to be given to the various factors which can be taken into consideration is to be determined by the tribunal entitled to draw the ultimate conclusion as to source. In my opinion there are no presumptions and no rules of law which require that that question be resolved in a particular sense.'

In correspondence with United Kingdom officials prior to the commencement of negotiations the Australian Commissioner of Taxation again raised problems associated with the taxation of public entertainer companies noting that the real profit might not be derived by the company which carried on the activity of providing the services of the entertainer. The Commissioner also indicated that Australia was interested in assigning territorial source to the profits of permanent establishments.⁴⁹ The United Kingdom reply was that, since publication of the draft OECD Model, it had not been United Kingdom practice to include a source rule, and while questioning whether a source rule was any longer necessary indicated that the United Kingdom would include a source rule if Australia thought it was necessary.⁵⁰

During the negotiation in Canberra of the 1967 Australia – United Kingdom Tax Treaty the Australian delegation explained its concern about Article 4(4) in the context of companies providing the services of public entertainers. The Australian fear was that Article 4(4) would not catch a company providing (possibly through an intermediary) the services of an entertainer under a slavery contract. Australia then submitted an alternative draft which read as follows:

'An enterprise of one of the territories shall be deemed to carry on business in the other territory though a permanent establishment situated therein in relation to income (other than dividends) which it derives from or in relation to contracts or obligations for the rendering within the other territory of the

⁴⁹ ET Cain, Commissioner of Taxation to WHB Johnson, Under Secretary, Board of Inland Revenue, 13th December 1966. 1967 UK – Australia Treaty Inland Revenue File.

⁵⁰ WHB Johnson to ET Cain, 3rd February 1966. 1967 UK – Australia Treaty Inland Revenue File.

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 request⁵³, 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

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.

extension in the context of industrial and commercial profits. In the former case the source rule (namely place of performance) was at least consistent with the permissive taxation by the place of performance in certain circumstances in the case of dependent services. In the latter case the effect of the Australian amendment rejected by the United Kingdom would have been to regard a non resident company deriving income outside Australia from a contract entered into by it outside Australia for the performance of services by its non-resident employee to be carrying on business in Australia and would have meant that the income would have been deemed to have an Australian source.

The deeming, in the 1967 Australia – United Kingdom Tax Treaty, of income to have an Australian source in circumstances where it would not under Australian domestic law was limited to professional and independent services, dependent services, entertainers and athletes. This pattern continued in the 1969 Australia – Singapore Tax Treaty and the 1969 Australia – Japan Tax Treaty.⁵⁷ A different, and some argue more sensible approach⁵⁸, was taken in Australia's 1972 Tax Treaty with Germany. There paragraph 3 of the Protocol to the Treaty allowed Australia, in its domestic law, to deem income which it was permitted to tax under Articles 6 to 8 and 10 to 16⁵⁹ of the Treaty to have an Australian source.

The Protocol to Australia's next tax treaty, its 1976 Tax Treaty with The Netherlands, reverted to deeming income to have an Australian source while extending the scope of the deeming to the same items of income that had been the subject of the Protocol to the 1972 Australia – Germany Tax Treaty. Subject to rare exceptions Australian tax treaties have continued to take a similar approach ever since. Australia's two most recent treaties, with Chile and Turkey in 2010, both contain the deemed source rule.⁶⁰ As Vann notes, in some instances the deemed source rule is 'turned off' in the *Income Tax International Agreements Act* 1953 where the deemed source rule would lead to more taxation than Australia wishes to achieve as a result of the treaty.⁶¹

Vann notes that the justification for the policy is apparently to prevent double exemption arising through gaps being created in the operation of treaties, disagrees with that policy and points out that it is clearly not sensible policy to place the source provision in a treaty and to then limit its operation by domestic law.⁶² Whatever the current justification for the policy, archival evidence from the negotiation of the 1967 Australia – United Kingdom Tax Treaty suggests that it originated in response to a specific problem raised by the High Court decision in *FCT v Mitchum*. Neither the

⁵⁷ Australia – Singapore Treaty 1969, (prior to amendments introduced by subsequent Protocols) Article 5(3) [business profits], Article 11(1) [personal, including professional, services], Article 11(2) [director's fees], Article 12(3) [public entertainers]; Australia – Japan Treaty, Article 4(2) [industrial or commercial profits], Article 10 [professional and independent services], Article 11(1) [dependent services], Article 11(4) [director's fees], Article 12(1) [public entertainers].

⁵⁸ R J Vann, 'Australian Branch Report, Tax Treaties and Tax Avoidance: Application Of Anti Avoidance Provisions' (2010) 95a *Cahiers de droit fiscal international*, pp79 -98 at pp92 – 93.

⁵⁹ These articles dealt with the following types of income: Article 6 – Real Property; Article 7 – Business Profits; Article 8 – Shipping and air transport; Article 10 – Dividends; Article 11 – Interest; Article 12 – Royalties; Article 13 – Independent personal services; Article 14 – Dependent personal services; Article 15 Director's fees; Article 16 Entertainers.

⁶⁰ Australia – Chile Treaty 2010 (not yet in force) Article 22; and Australia – Turkey Treaty 2010 (not yet in force) Article 22.

⁶¹ Vann, *supra* note 58 at p.93 and fn 78.

⁶² Vann, *supra* note 58 at p.93.

origins of the policy nor its apparent current rationale make it necessary to limit the operation of a treaty source rule by a domestic law 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.

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;⁶⁵ 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.

The trading and investment relationships that Australia had with these states were not as significant as those that it had with its earlier treaty partners – the United Kingdom, the United States, Canada, New Zealand and Japan. Thus, with the exception of the treaty with New Zealand, the tax treaties that Australia had with its then most significant trading and investment partners were all with countries in relation to which it was a net capital importer. At the time of negotiation of the 1967 Australia – United Kingdom Tax Treaty and at the time of negotiation of the 1969 Australia – Japan Tax Treaty and the 1969 Australia – Singapore Treaty the Australian draft did not include an ‘other income’ article and did not include the ‘third country tax’ article that had been included in the 1967 Australia – United Kingdom Treaty.⁶⁷ The Australia–Singapore Treaty of 1969 did, however, include a third country tax article modelled on Article 18 of the Australia – United Kingdom Treaty of 1967.⁶⁸ Presumably the inclusion of the third country tax article was either the result of an examination by Singapore of Australia’s previous treaty practice or the product of an Australian response to a request by Singapore for an ‘other income’ article. Given that Australian Tax Treaties between 1967 and 1980 included a third country tax article modelled on Article 18 of the 1967 Australia – United Kingdom Tax Treaty but did not include an ‘other income’ article it is likely that at some point this reflected the Australian draft in this period. However, this has not been able to be confirmed from archival evidence examined to date. The draft had developed in the context of negotiating with countries in relation to which Australia was a net capital importer. Characteristics of the draft that were perceived to be particularly relevant to protecting Australia’s emphasis on source based taxation, such as the third country tax article and the absence of an ‘other income’ article, appear to have been retained in the draft notwithstanding that between 1969 and 1980 many of Australia’s tax treaties were either with countries with which Australia did not have particularly significant trade or investment links or were with countries in relation to which Australia was a net capital exporter. In latter case precedents from prior Australian tax treaty practice might have made it more difficult for Australia to argue for more residence based tax treaties. A cabinet submission by the then Australian Treasurer shortly before commencement of negotiations leading to the 1969 Australia – Singapore Treaty recommends that a policy decision be made that in effect meant that the policy of emphasising source basis taxation continue notwithstanding that Australia at the time was a net capital exporter to Singapore.⁶⁹

As mentioned above, the ‘other income’ article in the 1980 Australia – Canada tax Treaty differed from the 1977 OECD Model in that it preserved the source country’s right to tax income not otherwise expressly where that income was sourced in that country. The form of the article is similar to but does not exactly correspond with the draft Article 21 of the United Nations Double Taxation Convention and the subsequent Article 21 of the United Nations Double Taxation Convention published in

⁶⁷ The Australian draft exchanged with Japan dated February 1968 is contained in Double Tax – Australia – Japan – Tokyo Papers And Agreement Negotiation Records, National Archives of Australia, Series Number A7073/6 Control Symbol J245/65/1 Part 1. The Australian draft exchanged with Singapore dated August 1969 is contained in Double Taxation Agreement – Australia – Singapore, National Archives of Australia, Series Number A7303/6 Control Symbol J245/69 Part 2.

⁶⁸ Australia– Singapore Treaty 1969 (prior to amendments by subsequent Protocols) Article 16.

⁶⁹ William McMahon, Confidential, Cabinet Committee On Taxation Only, Double Taxation – Singapore, Submission 116 (McMahon, Submission 116) p.2. Double Taxation Agreement – Australia – Singapore, National Archives of Australia, Series Number A7303/6 Control Symbol J245/69 Part 2

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 generally⁷³ 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 of 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 below⁷⁴, 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

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 – Thailand 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 Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1. In the record of the 1964 negotiations the Australian delegation made it clear that a non discrimination article was not acceptable to Australia. In addition in his letter to the Secretary of the Treasury dated 16th November 1966 W J O'Reilly the then Acting Second Commissioner of Taxation referred to a memorandum, dealing with non discrimination, sent to the Treasurer, dated 7th July 1964, as part of the Japanese negotiations. To date the author has not been able to locate a copy of the memorandum referred to in O'Reilly's letter.

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 re-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. Although Australia did not discriminate on the basis of nationality the delegation gave several examples of ways in which Australia did discriminate against non residents. The discriminatory treatments listed were: (a) the inter-corporate dividend rebate; (b) the exemption for profits for uranium mining; (c) the tax reliefs to residents who subscribe capital for mineral exploration. The United Kingdom notes of the negotiations record that, while Australia at the time did not levy a branch profits tax and while the then government was not contemplating levying such a tax, there had been a good deal of political controversy on the subject. Including a non discrimination article in the treaty was seen as likely to be highly embarrassing by adding fresh fuel to arguments over branch profits tax.⁷⁹

The United Kingdom responded to the Australian arguments on the non discrimination article on the first day by saying that one of functions of a double taxation agreement was to do away with discrimination against non-residents and that a non discrimination article was therefore 'a natural constituent of an agreement' and pointed to similar articles in their agreements with the United States, Canada and New Zealand. The United Kingdom argued that there was nothing in the draft article that would prevent Australia from 'refusing the dividend rebate' and that it could be amended so as to enable the exemption for uranium mining to be continued in its present form. The United Kingdom delegation pointed out that the absence of a non discrimination article would mean that Australian insurance companies would not be able to get full relief for their management expenses.⁸⁰ On the argument that the

⁷⁷ W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and accompanying memorandum, 16th November 1966, 1967 UK – Australia Treaty Australian Treasury file.

⁷⁸ McMahon, Submission 123, page 20 paragraph 38.

⁷⁹ 'Notes Of Meetings, First Day, 31st March 1967, Afternoon Session, p5, 1967 UK – Australia Treaty Inland Revenue file.

⁸⁰ In *Ostime v Australian Mutual Provident Society* [1960] AC 459 a majority of the House of Lords held that an Australian insurance company's taxable surpluses were 'industrial and commercial profits' and hence were only taxable under Article III(2) of the 1946 United Kingdom – Australia Treaty and not on a proportion of its world wide income attributable to the United Kingdom under United Kingdom domestic law. As a consequence the United Kingdom amended its domestic law so as to continue to apply a global apportionment approach to determining the income of a life assurance company that was

inclusion of the article would restrict Australia's freedom in the future the United Kingdom delegation responded that this was true of any article in the agreement.⁸¹

The non discrimination article continued to be discussed throughout the negotiations and the presence or absence of the article became a bargaining point in negotiations on other more economically significant features of the treaty, namely the treatment of United Kingdom resident companies with predominantly Australian source income and Australian shareholders (the New Broken Hill situation), shipping and air transport profits, rates of source country tax on non portfolio dividends and restricting the availability of underlying foreign tax credits.⁸² The eventual trade off was that Australia agreed to residence basis taxation of shipping and air transport and to restrictions on underlying foreign tax credits in exchange for relief (exempting Australian residents from United Kingdom withholding tax on dividends predominantly sourced in Australian profits) in the New Broken Hill situation, a uniform rate of source country tax of 15% on all dividends and omission of the non discrimination article. Correspondence between United Kingdom Inland Revenue officials at the time reveals that they regarded the non discrimination article as being 'of little practical significance' in the overall context of the treaty.⁸³

Neither the Australian draft sent to Japan in February 1968⁸⁴ nor the Australian draft sent to Singapore in August 1968⁸⁵ contained a non discrimination article. The Japanese draft sent to Australia in 1968 did contain a non discrimination article.⁸⁶ In negotiating the 1969 Australia – Japan Treaty the delegations referred to both the Australian and Japanese drafts simultaneously. In the course of negotiations Japan requested that a non discrimination article be included in the final treaty. The official Australian record of the negotiations notes the following Australian response to this request:

'Mr O'Reilly explained why Australia did not wish such a clause and explained the internal inconsistencies of the clause as drafted. Mr Cain referred to the failure of the United Kingdom to have a non-discrimination provision written into its new agreement with Australia. Summing up Mr O'Reilly said that his instructions on the point were strong to the point of the clause's not being

subject to United Kingdom tax. The draft treaty contained savings clause in relation to these provisions in United Kingdom domestic law. Johnson had commented in his letter to Cain of 3rd February 1967 that in the absence of the savings clause Australian life companies could only claim management expenses except that under the non discrimination article relief could be allowed against the part of the dividends attributable to the United Kingdom branch.

⁸¹ Notes Of Meetings, First Day, 31st March 1967, Afternoon Session, p6, 1967 UK – Australia Treaty Inland Revenue file.

⁸² See, Notes Of Meetings, Fourth Day, 5th April 1967, Morning Session, p1, 1967 UK – Australia Treaty Inland Revenue file; Notes Of Meetings, Sixth Day, 7th April 1967, Morning Session, p1, 1967 UK – Australia Treaty Inland Revenue file.

⁸³ See Telegram, from Canberra To Commonwealth Office, Following For Brookes From Johnson, 12th April 1967, 1967 UK – Australia Treaty Inland Revenue file, Part II.

⁸⁴ The Australian draft of February 1968 is contained in 'Double Tax – Australia – Japan, Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073/6 Control Symbol J245/65/1 Part 1.

⁸⁵ The Australian draft of August 1968 is contained in 'Double Tax Agreement Australia – Singapore' National Archives Of Australia, Series A7073 (A7073/6) Control Symbol J245/69 Part 2.

⁸⁶ The Japanese draft of January 1968 is contained in 'Double Tax – Australia – Japan, Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073/6 Control Symbol J245/65/1 Part 1.

*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 detail in Australian observations to the OECD Working Group No 4 on Non Discrimination dated 21st December 1971.⁹⁰ The thrust of that submission was succinctly summarised by the Australian Treasurer in a submission to cabinet in 1976 as:

'The objective behind proposals for non-discrimination articles is to ensure that foreign-owned companies cannot be made to bear a heavier tax burden than locally-owned companies. However, the articles proposed have been off-target and technically unsatisfactory because they could not provide that security, yet a number of tax measures which could be necessary to ensure equal treatment of nationals and non-nationals could be formally in conflict with the articles as drafted. No way of drafting an article which would be sufficiently close to the target seems possible. Furthermore, there are other objections having nothing to do with tax burdens as such: while we do not follow a policy of discrimination against foreign nationals or residents, or companies owned by them, we have not wished to tie our hands in this respect since it is possible, especially with the growing significance of multi-national corporations, that the

⁸⁷ 'Japanese Double Taxation Negotiations, 14 February 1968' p.2 in 'Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1

⁸⁸ 'Japanese Double Taxation Negotiations, 14 February 1968' p.4 and Cain's comments recorded in 'Japanese Double Taxation Negotiations, 9 February 1968' p.5 in 'Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1.

⁸⁹ The absence of a non discrimination article is not mentioned in either 'Singapore – Australia Double Taxation Negotiations – Outstanding Points' evidently compiled shortly after the conclusion of negotiations in Canberra in October 1968 nor in 'Memorandum' dated 3rd October 1968 signed by the leaders of the delegations E T Cain and S Thirucheluyum. Both documents are contained in, 'Double Tax Agreement Australia – Singapore' National Archives Of Australia, Series A7073 (A7073/6) Control Symbol J245/69 Part 2.

⁹⁰ OECD Working Party No 1 On Double Taxation Of The Committee On Fiscal Affairs; Working Party No4 On Non-Discrimination; Observations from the Australian Delegation, 21st December 1971. A copy of these observations is contained in National Archives of Australia, Series A12909, Control Symbol 782, Barcode 7426926.

*activities of foreign-owned businesses may create economic and other problems which can only be regulated by appropriate tax measures.*⁹¹

In 1982 Australia agreed to include a non discrimination article in its treaty with the United States. It is understood that including a non discrimination article in the Treaty was regarded as a non negotiable requirement by the United States. The article, however, varied from the OECD and US Models by including the following provisions:

23(2) Nothing in this Article relates to any provision of the taxation laws of a Contracting State:

- (a) in force on the date of signature of this Convention;*
- (b) adopted after the date of signature of this Convention but which is substantially similar in general purpose or intent to a provision covered by sub-paragraph (a); or*
- (c) reasonably designed to prevent the avoidance or evasion of taxes;*

provided that, with respect to the provisions covered by sub-paragraph (b) or (c), such provisions (other than provisions in international agreements) do not discriminate between citizens or residents of the other Contracting State and those of any third State.

23(3) Without limiting by implication the interpretation of this Article, it is hereby declared that, except to the extent expressly so provided, nothing in this Article prevents a Contracting State from distinguishing in its taxation laws between residents and non-residents solely on the basis of their residence.

23(4) Where one of the Contracting States considers that the taxation measures of the other Contracting State infringe the principles set forth in this Article the Contracting States shall consult together in an endeavour to resolve the matter.

In addition this article was never given the force of law in Australia and, from the Australian perspective merely had the status of an agreement between governments⁹². Many other countries attempted to persuade Australia to agree to the inclusion of a non discrimination article in this period but none succeeded. Protocols to several of Australia's taxation treaties in this period, however, contained a most favoured nation provision in the event of Australia entering into a subsequent taxation treaty containing a non discrimination article.⁹³

In some respects the policy of not agreeing to the non discrimination article reflected Australia's emphasis on source basis taxation. It also, as was apparent from its

⁹¹ P Lynch (Treasurer) Submission No 782 – Double Taxation Agreements – Non –Discrimination and Tax on Parent/Subsidiary Dividends, 22nd October 1976. National Archives Of Australia, Series A12909, Control Symbol 782, Barcode 7426926.

⁹² *Income Tax (International Agreements) Act 1953* s6(1) gives the force of law to Articles 1 to 22 (inclusive) and Articles 24 to 29 (inclusive) of the 1980 Treaty with the United States. The effect is that Article 23 (the non discrimination article) was not given the force of law in Australia.

⁹³ Most favoured nation provisions in relation to non discrimination were contained in Protocols to Australia's Treaties with France, The Republic of Korea, Finland, Spain, South Africa, Romania, and Mexico, the Netherlands, Switzerland, Italy, Norway, Finland and Austria.

observations to OECD Working Group No.4 in 1971, reflected the technical and legalistic approach to statutory interpretation in Australia in the 1960s and 1970s. By the 1990s, as the expansion of Australian business offshore increased, and as Australian courts moved to a more purposive approach to statutory interpretation, the relevance of both of these considerations diminished.

In 1999 the Howard Government commissioned Review of Business Taxation noted that Australia was the only OECD country which did not include a non discrimination article in its taxation treaties. The Review further noted that a recent study had found that Australia's tax rules constituted one of the least discriminatory regimes applying to non-residents. In addition the Review noted that the inclusion of a non discrimination article would protect Australian businesses as they invested overseas and would facilitate the renegotiation of Australia's existing Treaties some of which had not been renegotiated for twenty years. Hence the Review recommended: 'That Australia agree to a non-discrimination article (NDA) in future Treaties in accordance with international norms.'⁹⁴

Subsequently Australia's 2003 treaty with the United Kingdom included a non discrimination article. The article, however, varies from the OECD Model in several respects. The non discrimination article in the 2003 Australia – United Kingdom treaty contains the following provisions which do not appear in the OECD Model:

5. *Nothing contained in this Article shall be construed as obliging a Contracting State to grant to individuals who are residents of the other Contracting State any of the personal allowances, reliefs and reductions for tax purposes which are granted to individuals so resident.*
6. *This Article shall not apply to any provisions of the laws of a Contracting State which:*
 - (a) *is designed to prevent the avoidance or evasion of taxes;*
 - (b) *does not permit the deferral of tax arising on a transfer of an asset where the subsequent transfer of the asset by the transferee would be beyond the taxing jurisdiction of the Contracting State under its laws;*
 - (c) *provides for consolidation of group entities for treatment as a single entity for tax purposes provided that Australian resident companies that are owned directly or indirectly by residents of the United Kingdom can access such consolidation treatment on the same terms and conditions as Australian resident companies;*
 - (d) *provides deductions to eligible taxpayers for expenditure on research and development; or*
 - (e) *is otherwise agreed to be unaffected by this Article in an Exchange of Notes between the Government of Australia and the Government of the United Kingdom.*

⁹⁴ Australia, *Review Of Business Taxation: A Tax System Redesigned, Report, July 1999*, AGPS, Canberra, 1999, at pp 678 and Recommendation 22.22 at p678.

Subsequent Australian treaties contain similar carve outs, with varying degrees of precision⁹⁵, 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 time⁹⁷ 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 the end of the 1960s.

Australia's next three treaties with the United States in 1953, Canada in 1957 and New Zealand in 1960 did not contain a capital gains article. It appears that the drafts that formed the basis for these treaties did not contain capital gains articles. Significantly the United States Senate Foreign Relations Committee Report on the 1953 Australia – United States Treaty noted that it did not contain any provisions restricting the United States ability to tax capital gains.⁹⁸ The observations of the Senate Committee give

⁹⁵ For a more specific, itemised, approach see Article 26 of the Australia – Japan Treaty 2008 and paragraphs 20 and 21 of the Protocol to that treaty.

⁹⁶ This structure was described by Newman as the 'colonial model' in J Newman, *United Kingdom Double Tax Treaties*, Butterworths, London, 1979 p 2., The usage was subsequently adopted by the Australian Taxation Office, see ATO Ruling TR 2001/12 and ATC Ruling TR 2001/13.

⁹⁷ See Mair to McGovern, 20th May 1946, National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/19, 'Drafting of the United Kingdom – Australia agreement 1946. Cables of draft of agreement.'p32. See also 'Items Not Specifically Covered' in National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/21, Drafting of United Kingdom – Australia agreement 1946 – Matters additional to those in agreement. See also, McGovern to Mair, 7th June 1946, National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/19, 'Drafting of the United Kingdom – Australia agreement 1946. Cables of draft of agreement.'p48 at p50. See also, Mair to McGovern, 27th June 1946, National Archives of Australia, Series No A 7303/21, Control Symbol J245/45/19, 'Drafting of the United Kingdom – Australia agreement 1946. Cables of draft of agreement.'p74 at p76.

⁹⁸ Tax Analysts, *Worldwide Tax Treaties*, United States, Australia, Belgium, Senate Foreign Relations Committee Report, (S. Exec. Rpt. No.2, 83-1, July 2, 1953.

support to the view that Australian treaties adopting the colonial model were not intended to limit the taxing rights of the treaty partners in relation to categories of income that were not either expressly dealt with by the distributive articles nor within the definition of industrial and commercial profits in the treaty.

The September 1966 draft sent to Australia by the United Kingdom as part of the negotiation of the 1967 United Kingdom – Australia treaty did contain a capital gains article. Australian Taxation Office officials commenting on the United Kingdom draft noted that the capital gains article had no real relevance while Australia did not have a capital gains tax and observed that the article added little, if anything, to existing United Kingdom law.⁹⁹ The draft article differed from the 1963 Draft OECD Model in that Article 13(1) of the OECD Model gave the state of situs the right to tax gains from the alienation of immovable property. Under the 1966 United Kingdom draft source taxation of capital gains, except in the case of gains from the alienation of ships and aircraft, was confined to situations where the gain was from the alienation of property forming part of a permanent establishment in the source state or pertaining to a fixed base available in the source state for the purpose of performing professional personal services. Source taxation on this basis was also permitted under the OECD Model. Both the draft and the OECD Model also permitted source taxation of gains from the alienation of the permanent establishment itself or of the fixed base. Australian officials commented that the effect of the article would be to impose similar limitations on Australian source taxation of capital gains if Australia ever introduced a capital gains tax. One advantage of the article was seen as being that it would limit United Kingdom taxation of capital gains on Australian property to, effectively, what was within present United Kingdom law.¹⁰⁰

The fact that source taxation under the capital gains article in the draft was confined to situations where the property alienated formed part of the property of a permanent establishment or pertained to a fixed base, together with the fact that capital gains (unlike dividends, interest and royalties) were not explicitly excluded from the operation of the industrial and commercial profits article raises questions about the scope of the industrial and commercial profits article. As the draft contemplated that capital gains on property forming part of the property of a permanent establishment were to be taxed under the capital gains article it is clear that the draft did not intend for such capital gains to also be the subject of source taxation of a permanent establishment under the industrial and commercial profits article. In other words the draft did not consider that capital gains were within industrial and commercial profits as defined even though (unlike dividends, interest and royalties) they were not expressly excluded from the definition. The explanation for this may be that under United Kingdom and Australian law capital gains had not been included in the ordinary concept of an income as a business gain and in the United Kingdom had only been taxed through the introduction of statutory provisions that explicitly taxed capital gains. An interpretation of treaties which saw industrial and commercial profits as not including capital gains and which saw capital gains as being taxed under a separate

⁹⁹ W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and accompanying memorandum, 16th November 1966, 1967 UK – Australia Treaty Australian Treasury file.

¹⁰⁰ W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and accompanying memorandum, 16th November 1966, 1967 UK – Australia Treaty Australian Treasury file.

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 Japan¹⁰⁴ and its 1969 Treaty with Singapore¹⁰⁵ did not contain a capital gains article and retained the ‘colonial model’ structure. The 1972 Australia – Germany Treaty did not contain a 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 – 14/4/6, 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 draft provided to Australia by Japan contained a capital gains or alienation of property article. The February 1968 draft provided by Australia to Japan did not contain a capital gains or an alienation of property article. These drafts are contained in ‘Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records’ National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1.

¹⁰⁵ The Australian draft provided to Singapore in August 1968 did not contain a capital gains or an alienation of property article. The draft is contained in ‘Double Tax Agreement Australia – Singapore’ National Archives Of Australia, Series A7073 (A7073/6) Control Symbol J245/69 Part 2.

OECD Model. It is notable that, evidencing the lingering influence of the colonial model, the Treaty did not contain an OECD style ‘other income’ article but did contain a dual resident third country tax article modelled on the equivalent article in the 1967 Australia – United Kingdom Treaty.

Australia’s treaties entered into after joining the OECD but prior to the introduction of capital gains tax (from the 1976 Netherlands Treaty to the 1986 Austrian Treaty) all contain an ‘alienation of property’ article but in some of these (such as the Netherlands and Belgium Treaties) only refer to ‘income from the alienation of property’ while others (such as the 1976 French Treaty, the 1980 Canadian Treaty and the 1982 United States Treaty) refer to ‘income, profit or gains’. None of these Treaties contain a provision equivalent to Article 13(4) of the 1977 OECD Model. In *FCT v Lamesa Holdings BV* (1997) 36 ATR 589 the alienation of property article in the 1976 Australia – Netherlands Treaty was held by the Full Federal Court not to give Australia the right to tax an indirect interest in an Australian land rich company. Following this decision, in a clear but rare Australian example of treaty override, Australia amended the *International Tax Agreements Act 1953* (Cth) by adding s3A which included the following provisions:

‘3A(1) This section applies if:

- (a) an agreement makes provision in relation to income, profits or gains from the alienation or disposition of shares or comparable interests in companies, or of interests in other entities, whose assets consist wholly or principally of real property (within the meaning of the agreement) or other interests in relation to land; and*
- (b) this Act gave that provision the force of law before 27 April 1998.*

3A(2) For the purposes of this Act, that provision is taken to extend to the alienation or disposition of shares or any other interests in companies, and in any other entities, the value of whose assets is wholly or principally attributable, whether directly or indirectly through one or more interposed companies or other entities, to such real property or interests.

3A(3) However, subsection (2) applies only if the real property or land concerned is situated in Australia (within the meaning of the relevant agreement).’

Australia introduced a general capital gains tax effective from midnight on 19th September 1985. The jurisdictional scope of Australian capital gains tax at the time of its introduction extended to taxing capital gains of non residents on shares in Australian resident private (generally unlisted companies other than subsidiaries of listed companies), and non portfolio (greater than 10%) shareholdings in Australian resident public companies (generally listed companies). Commencing with the Australia – China Treaty of 1988 the alienation of property article in Australia’s Treaties started to contain a clause preserving Australia’s taxing rights in relation to matters not dealt with in the previous clauses in the alienation of property article.

A debate developed as to how Australia’s CGT jurisdictional claims in its domestic law were affected by Australia’s Treaties entered into prior to the introduction of a general capital gains tax in Australia. The view expressed in ATO Rulings was that the Treaties prior to the introduction of capital gains tax in Australia left Australia

with full taxing rights in relation to capital gains. This was either because capital gains tax was not a tax covered by these treaties (this view required a static rather than ambulatory approach to interpretation of Article 2(4)) or if capital gains tax was a covered tax then it was not dealt with under the distributive rules.¹⁰⁶ The private practitioner view was that Australia was unable to tax the capital gains of residents of countries where these Treaties applied.¹⁰⁷ The question of whether Australia's pre capital gains tax treaties provided protection from Australian taxation of capital gains made by enterprises that did not have a permanent establishment was answered in the affirmative in *Virgin Holdings SA v Commissioner of Taxation* [2008] FCA 1503 and in *Undershaft v Commissioner of Taxation* [2009] FCA 41. By contrast, the analysis above of the negotiation of the 1967 Australia – United Kingdom Treaty and of the structure of Australia's pre CGT treaties suggests that the intention of the negotiators at the time these treaties were entered into was that full source country taxing rights would be retained in relation to capital gains.¹⁰⁸

Australia changed its jurisdictional rules in relation to capital gains by legislation introduced in 2006. In broad terms Australia's CGT rules¹⁰⁹ in relation to non residents are now restricted to taxing capital gains on: (i) Australian real property and mining, quarrying and prospecting rights where the minerals, petroleum and quarry materials are situated in Australia; (ii) direct and indirect non portfolio interests in Australian land rich companies; (iii) a CGT asset, not otherwise covered by (i) or (ii), that has been used in carrying on a business through a permanent establishment in Australia; (iv) options or rights to acquire a CGT asset covered by (i), (ii) or (iii); and (v) an asset in relation to which a taxpayer chose¹¹⁰, when ceasing to be an Australian resident, for it to continue to be a taxable Australian asset. From 2005 onwards the capital gains article in Australia's treaties is consistent with the jurisdictional scope of its domestic law and no longer contain a provision preserving Australia's taxing rights in relation to capital gains other than those dealt with under the alienation of property article. Rather Australia's recent treaties broadly reflect the OECD position of taxing residual capital gains only in the country of residence.

Australia's new policy is reflected in Article 13(6) of the 2010 Australia – Chile Treaty (which is not yet in force):

¹⁰⁶ ATO Ruling TR 2001/12.

¹⁰⁷ See for example, *Ian V Gzell QC*, 'Treaty Protection from Capital Gains Tax' (2000) 29 *Australian Tax Review* 25.

¹⁰⁸ See also the discussion of these cases in R J Vann, 'Comment on *Virgin Holdings SA v Commissioner of Taxation* [2008] FCA 1503 and *Undershaft v Commissioner of Taxation* [2009] FCA 41' (2009) 11 *International Tax Law Reports* 653-672.

¹⁰⁹ The rules are set out in *Income Tax Assessment Act 1997* s855-15.

¹¹⁰ Under *Income Tax Assessment Act 1997* s104-160(1) CGT event I1 takes place when an individual or company stops being an Australian resident. A capital gain or loss can be triggered by CGT event I1 depending on the market value of those of the taxpayer's assets which are not taxable Australian property. Instead of triggering an immediate capital gain or loss an individual can elect to disregard the capital gain or loss. Under s104-165(3) if the individual so elects then all of the individual's assets will be regarded as taxable Australian property until the individual either disposes of them or becomes an Australian resident again. The effect of the election is that, although a capital gain or loss will not arise when the individual ceases to be an Australian resident, a capital gain or loss may arise where a CGT event takes place in relation to any CGT asset owned by the individual during the time that the individual is not an Australian resident.

‘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 an assessment basis at relevant marginal rates. In the case of dividends where the paying company was a non resident and the recipient shareholder did not have property in Australia the Australian Taxation Office refrained from assessing the dividend. Companies paying interest to non residents were taxed at the rate of 30% on the interest paid but were entitled to deduct the tax from the interest paid unless they could establish that the creditor could enforce payment of the interest without the deduction of tax at source. Australian tax legislation in 1946 also included provisions requiring residents who had the receipt, control or disposal of a non-resident’s money to retain funds from those monies to pay tax assessed on the non-resident when they were notified of the assessment. Similar provisions also applied to royalties paid by residents to non-residents.¹¹¹

The initial United Kingdom proposal to Australia when offering to enter into a taxation treaty in 1945 was that under the treaty:

- (1) *Australia would not tax dividends paid to United Kingdom residents and that the United Kingdom would not apply surtax to dividends paid by United Kingdom companies to Australian residents; and*
- (2) *Interest and royalties would be taxed on a residence basis except in the case of payments between a parent and subsidiary.*¹¹²

Australia rejected all of these proposals as being inconsistent with the longstanding Australian emphasis on source basis taxation, negotiations between officials proceeded and then broke down but an in principle agreement was finally reached at a meeting between Australian and United Kingdom politicians and officials on 3rd May 1946. The agreement included the following points:

- (1) *Australia was not to tax dividends paid by a 100% subsidiary of a United Kingdom company;*

¹¹¹ See the discussion in JAL Gunn et al, *supra* note 31 at paras 1363-1371, 1849 and 1850.

¹¹² Notes by R Willis of a meeting on 29 May 1945 between Sir Cornelius Gregg (Chairman of the United Kingdom Board of Inland Revenue, Robert Willis (Secretary of the Board of Inland Revenue) and S G McFarlane (Secretary of the Australian Treasury) and Gregg to McFarlane 1 June 1945 and ‘Outline of United Kingdom proposals for a double taxation agreement with Australia’, United Kingdom National Archives IR 40/13740

- (2) *Australian source dividends paid by United Kingdom companies would be exempt from Australian tax but United Kingdom companies trading in Australia would be subject to undistributed profits tax;*
- (3) *Australia was to reduce its tax on other dividends paid by Australian companies to United Kingdom residents by one half;*
- (4) *Literary and industrial royalties were to be taxed on a residence basis;*
- (5) *Australia was to retain full source country taxing rights in relation to films;*
- (6) *Full source country taxing rights were to be retained in relation to rents and mineral royalties; and*
- (7) *Full source country taxing rights were to be retained in relation to interest (other than interest on government securities which both countries exempted in their domestic legislation).¹¹³*

The implementation of these points in the final treaty meant that Australia exempted dividends paid by 100% subsidiaries to United Kingdom parents and dividends paid by United Kingdom companies to non residents from Australian tax but reduced Australian tax on other dividends by one half. In practice, this meant that the Australian rate of tax on dividends (other than those paid by a 100% subsidiary to its United Kingdom parent) was 15% being half of the then Australian corporate rate of 30%. Interest and the royalties on which Australia was to retain full source country taxing rights were specifically excluded from the definition of 'industrial or commercial profits'. No article in the final treaty expressly dealt with interest or these royalties the intention of the negotiators being that full source country taxing rights were to be retained in relation to items excluded from the industrial or commercial profits article but not otherwise mentioned.

Initially in the negotiation of Australia's next taxation treaty with the United States in 1952 the United States negotiators argued that the 1946 Australia – United Kingdom Treaty set the pattern for Australia's treaties with countries from whom non portfolio investment might be expected to be encouraged.¹¹⁴ On the basis of previous United States treaty practice the Australian negotiators formed the view that the United States would accept a reduction in source country tax to 5% in the 95% subsidiary situation. The Australian view was also that Australian taxes approximating United States taxes would not deter United States investors and that any reductions below United States levels would, because of the United States foreign tax credit system, benefit the United States Treasury and not United States investors.¹¹⁵

Australia in 1952 still did not have any withholding taxes and by this stage; in practice the rate of Australian tax on dividends paid to non residents was 35% and in the case of dividends paid to a United Kingdom resident (other than a parent of a 100% subsidiary) the rate was 17.5%.¹¹⁶ In negotiations the United States representatives indicated that they sought a 5% rate of source tax on dividends paid by a 95% subsidiary to its United States parent but would be satisfied with a 15% rate on all other dividends. The Australian representatives appear to have persuaded the United

¹¹³ 'Double Taxation – Australia: Conference at 11 Downing Street, on May 3, 1946; Heads Of Agreement' dated 4th May 1946. United Kingdom National Archives IR 40/13740

¹¹⁴ McGovern, *supra* note 8 at p4 paragraph 22.

¹¹⁵ McGovern, *supra* note 8 at p5 paragraphs 27 and 28.

¹¹⁶ McGovern, *supra* note 8 at p10 paragraph 76.

States delegation to agree to a uniform 15% rate on all dividends¹¹⁷ 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 States Treasury and not United States investors.¹²⁰

Consistent with the precedent set in the 1946 Australia – United Kingdom Treaty, the United States had argued that both literary and industrial royalties should be taxed exclusively on a residence basis.¹²¹ Australia replied that it was a more common practice for United States companies, in contrast to United Kingdom companies, to exploit their intellectual property by granting licences to Australian residents. The relatively small loss of Australian revenue involved in agreeing to a residence basis taxation of industrial royalties in context of the 1946 Australia – United Kingdom Treaty explained why Australia had agreed to the exemption.¹²² When pressed the United States representatives withdrew their view that industrial royalties should be taxed exclusively on a residence basis. The end result was that the final treaty contained an article giving exclusive taxing rights on cultural royalties to the residence country but did not contain any articles on other royalties.¹²³

Article XII taxed royalties for minerals and other natural resources on a source basis. The main function of Article XII was to ensure that the country of source only levied tax on a net basis on mineral royalties.¹²⁴ At the time Australia taxed royalties on a net basis¹²⁵ but the United States imposed a 30% gross basis withholding tax on rents and

¹¹⁷ McGovern, *supra* note 8 at pp10 to 12 and particularly paragraphs 77 and 90.

¹¹⁸ McGovern, *supra* note 8 at p11 paragraph 82.

¹¹⁹ McGovern, *supra* note 8 at p11 paragraph 85.

¹²⁰ McGovern, *supra* note 8 at p12 paragraphs 90 to 92.

¹²¹ McGovern, *supra* note 8 at p15 paragraph 124.

¹²² McGovern, *supra* note 8 at p16 paragraph 125.

¹²³ McGovern, *supra* note 8 at p16 paragraphs 126 and 127.

¹²⁴ McGovern, *supra* note 8, at p16 paragraph 135.

¹²⁵ McGovern, *supra* note 8, at p17 paragraph 136. In 1952 s26(f) of the *Income Tax And Social Services Contribution Assessment Act 1936* included ‘any amount received as or by way of royalty’ in a taxpayer’s assessable income. Jurisdictional limits were not expressly stated in s26(f). One analysis of the *Income Tax And Social Services Contribution Assessment Act 1936* known as the ‘central provision analysis’ was that all amounts deemed to be assessable income via specific statutory provisions such as s26(f) nonetheless were included in assessable income, in the sense of being an amount against which expenses were deducted to arrive at taxable income on which tax was levied, must have been included via *Income Tax Assessment Act 1936* s25(1) which included ‘gross income’ in a taxpayer’s assessable income and contained jurisdictional rules. The broad effect of s25(1) was that, subject to such items of income as were expressly deemed to be exempt income by s23, the worldwide gross income of residents was included in assessable income while only the gross income from Australian sources was included in the assessable income of non residents. Under the alternative analysis of the *Income Tax And Social Services Contribution Assessment Act 1936* items deemed to be assessable income in s26 and elsewhere were thereby included in assessable income for the purposes of deducting expenses against them in

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 the 1953 Australia – United States Treaty did not contain any specific article dealing with interest. Clearly the assumption of the negotiators was that this meant that full source country taxing rights were retained in relation to interest.¹²⁸ Interest and royalties were excluded from the definition of ‘industrial or commercial profits’ and the 1953 Australia – United States Treaty did not contain an ‘other income’ article.

Australia’s next treaties with Canada in 1957 and with New Zealand in 1960 followed the pattern set in the 1953 Australia – United States Treaty on rates of source country tax on investment income.

Rates of tax on investment income became an issue in the negotiation of the 1967 Australia – United Kingdom Treaty. The United Kingdom draft sent to Australian in September 1966 had not specified rates of source country tax on investment income but had clearly contemplated a lower rate of tax on non-portfolio dividends and, consistent with general United Kingdom policy had proposed taxation of interest and royalties (other than mineral royalties) on a residence basis.¹²⁹

Australian Taxation officials assumed that the United Kingdom was seeking a 5% rate on non-portfolio dividends where there was a 25% or more shareholding and a 15% rate on other dividends and pointed out that, as compared with the 1946 Australian –

determining taxable income. In theory under this analysis there were no jurisdictional limits on items included in assessable income under s26 but in practice the Commissioner only taxed non residents on Australian source income. The central and parallel provision analyses are discussed in R W Parsons, *Income Taxation In Australia*, Law Book Company Ltd., Sydney, 1985 at [1.8] and at [1.30] to [1.4]. Expenses relevant to the derivation of royalty income were allowable as deductions under s51(1) of the *Income Tax And Social Services Contribution Assessment Act 1936*. Although no withholding tax applied to payments of royalties to non residents under *Income Tax Assessment And Social Services Contribution Act 1936* s256(1) the Commissioner could require the payor to retain an amount from the royalty in respect of tax due or which might become due by the non-resident. Section 256(1) as it applied in 1952 is discussed in NE Challoner and CM Collins, *Income Tax: Law And Practice (Commonwealth)* Law Book Co of Australasia Pty Ltd, Sydney, 1953 at [1365].

¹²⁶ McGovern, *supra* note 8 at p17 paragraph 137.

¹²⁷ McGovern, *supra* note 8 at p17 paragraph 138.

¹²⁸ See the discussion of the negotiations relevant to this point in relation to the 1946 Australia – United Kingdom Double Taxation Treaty in C John Taylor, ‘The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946’ [2009] *British Tax Review* 201 at 237 to 238 and in C John Taylor, “ ‘I suppose I must have more discussion on this dreary subject’: The Negotiation and Drafting of the UK-Australia Double Taxation Treaty of 1946” in J Tiley (ed) *Studies in the History of Tax Law*, Volume 4, Hart Publishing, Oxford and Portland Oregon, 2010, 213 at 265.

¹²⁹ The draft dated September 1966 is contained in ‘Revision of Double Taxation Agreement – Australia’ United Kingdom National Archives, IR 40/16741. Article 9, the dividend article, did not specify rates of source country tax on dividends but contemplated that source country tax be levied on a gross basis and that different rates apply for 25% or more shareholders and other shareholders. Article 10, the interest article, provided that (except in the case of interest attributable to a permanent establishment, interest deemed to be a distribution under certain domestic law provisions, domestic law bond washing provisions, and in the case of non arm’s length transactions) interest would be exclusively taxed on a residence basis. Equivalent provisions (excluding the anti bond washing exception) applied in the case of royalties under Article 11 of the draft. The definition of ‘royalties’ in Article 11(5) of the draft excluded mineral royalties.

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 argued for a uniform 15% rate on dividends, noting that this was consistent with the rates agreed to by the United Kingdom in its recent treaties with Canada and New Zealand. Eliminating the exemption for dividends paid by 100% subsidiaries to their United Kingdom parent would increase the overall tax burden on these dividends but would put them in the same position as United Kingdom companies with a 10% or more shareholding in an Australian company who would obtain a United Kingdom foreign tax credit for the underlying Australian corporate tax. This was seen as removing the strong incentive that the exemption provided for United Kingdom companies to acquire and retain 100% ownership of Australian companies. Using the same logic Australia did not favour the United Kingdom proposal for a further reduction in withholding tax for dividends paid to United Kingdom companies with 25% or more ownership.¹³¹ On interest and royalties the Treasurer's submission argued for the retention of full source country taxing rights and proposed the introduction of a withholding tax system for both interest and royalties.¹³²

During negotiations in Canberra in March and April 1966 the Australian delegation proposed a rate of 15% for both portfolio and non portfolio dividends but that the

¹³⁰ Comments on the United Kingdom draft are contained in W J O'Reilly (Acting Second Commissioner of Taxation) to The Secretary to the Treasury (Sir Richard Randall) and an accompanying memorandum both dated 18th November 1966. 1967 UK – Australia Treaty Australian Treasury File.

¹³¹ McMahon, Submission 123, at pp16-17, paragraphs 27 to 29.

¹³² McMahon, *supra* note 131.

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 The Notes of Meetings then set out in some detail the arguments that the United Kingdom advanced in favour of its proposal. The provisions in the 1946 Agreement, which exempted dividends paid to a 100% United Kingdom parent, were characterised as being inconsistent with modern conditions and with Australia's policy of encouraging local participation. It was admitted that the United Kingdom had agreed to a uniform 15% rate on dividends in several of its recent agreements but the United Kingdom delegation regarded the situation with Australia as distinguishable as, given that the complete exemption for wholly owned subsidiaries had been running for a long time, a large number of companies would be affected by any change and a 15% withholding tax would only add to their tax burden. The United Kingdom balance of payments would suffer both from the reduction in the rate on outbound portfolio dividends and from an increase in Australian tax on inbound dividends from 100% subsidiaries. Previously existing programmes were already restricting the increase in United Kingdom investment in Australia but a 15% withholding tax on dividends paid to direct investors would be a positive discouragement of it.¹³⁵ The United Kingdom also argued that there should be broad equality of treatment between a branch and a subsidiary. For this reason Australian tax on subsidiary dividends should be kept to a minimum as a high rate would encourage United Kingdom businesses to convert their subsidiaries to branches.¹³⁶

The Australian delegation's response to these arguments was that Australia had long been unhappy with the exemption for dividends paid by 100% subsidiaries. All of Australia's other agreements had a uniform 15% rate on dividends and to concede a lower rate on dividends paid to United Kingdom parents would cause Australia difficulties in negotiations with other countries and political opinion in Australia was strongly against it. Given the imbalance of income flows between the two countries a low rate of tax on subsidiaries' dividends would cause a substantial loss to the Australian revenue. By contrast a 15% rate would not cause a loss to the United Kingdom revenue as the extra tax would be borne by the companies concerned (presumably because of limitations on the United Kingdom's foreign tax credit although this is not stated in the Notes of Meetings). A 15% rate on dividends taken with the Australian rate of corporate tax would produce a total rate of around 51% on non portfolio dividends which Australia did not regard as exorbitant. Australia was not concerned about possible avoidance (by implication through the conversion of subsidiaries to branches) as Australia would not be any worse off than it was now given that it was not collecting any tax on dividends paid by wholly owned

¹³³ 'Revision of Double Taxation Agreement – Australia' United Kingdom National Archives, IR 40/16741s Of Meetings, First Day, 31st March 1967, Morning Session, p3. 1967 UK – Australia Treaty Inland Revenue File.

¹³⁴ Notes Of Meetings, Second Day, 3rd April 1967, Morning Session, p1. 1967 UK – Australia Treaty Inland Revenue File.

¹³⁵ Notes Of Meetings, Second Day, 3rd April 1967, Morning Session, p1. 1967 UK – Australia Treaty Inland Revenue File.

¹³⁶ Notes Of Meetings, Second Day, 3rd April 1967, Morning Session, p1. 1967 UK – Australia Treaty Inland Revenue File.

subsidiaries.¹³⁷ During the negotiations and in subsequent correspondence rates of source country tax on investment income were also intertwined with negotiations on the United Kingdom's desire to restrict the availability of its underlying foreign tax credit (a consequence of its shift to a classical system of corporate – shareholder taxation in 1965) on the non discrimination article and on a residence basis for shipping and air transport. The final treaty provided for a uniform rate of 15% on dividends and a rate of 10% on interest and royalties.

In its next treaty negotiations with Japan Australia used the 1967 United Kingdom Treaty as a precedent arguing that it would be embarrassing to the United Kingdom for Australia to grant any more concessions to Japan than it had granted to the United Kingdom.¹³⁸ The argument was successful in the context of rates of tax on investment income in the 1969 Australia – Japan Treaty mirrored those in the 1967 Australia – United Kingdom Treaty. Indeed until the 2002 Protocol to the 1982 Australia – United States Treaty Australia was remarkable successful in maintaining its rates of source country tax on investment income.

The beginnings of a shift in policy can be seen in Australia's 1995 Treaty with New Zealand under which withholding tax on non portfolio dividends was reduced to 5%. It is possible that the shift in the Australian view resulted from the fact that since the reintroduction of a dividend imputation system in 1987 Australia had not levied dividend withholding tax on the franked portion of dividends paid to non residents.¹³⁹

The 2001 Protocol to the Australia – United States Treaty represented a still more significant change in policy. Among the significant amendments introduced by the Protocol were changes in the withholding tax rates. The previous 15% withholding tax rate on all dividends under the 1982 Treaty meant that extremely high effective marginal tax rates applied where Australian companies derived United States source income and then redistributed it to Australian shareholders as a dividend. The Protocol reduced the withholding tax rate on non portfolio dividends to 5% and to zero in the case of 80% shareholdings (subject to certain qualifications).¹⁴⁰ In part the change in policy might be explained by further features of Australian corporate – shareholder taxation. At the time non portfolio dividends funded from United States active business income were exempt from Australian corporate tax, and payments of foreign tax were not creditable for Australian dividend imputation purposes; hence these reductions in withholding tax directly benefited either the Australian company or its Australian resident shareholders.¹⁴¹ Withholding tax on interest remained at 10%

¹³⁷ Notes Of Meeting, Second Day, 3rd April 1967, Morning Session, p1. 1967 UK – Australia Treaty Inland Revenue File.

¹³⁸ See the Australian record of the negotiations in 'Double Tax – Australia – Japan Tokyo Papers and Agreement Negotiation Records' National Archives of Australia, Series Number A7073 (A7073/6) Control Symbol J245/65/1 Part 1.

¹³⁹ The franked portion of a dividend paid to a non resident is exempt from withholding tax under *Income Tax Assessment Act 1936* s128B(3)(ga) and is not subject to tax on an assessment basis because of *Income Tax Assessment Act 1936* s128D.

¹⁴⁰ *Protocol Amending the Convention between the Government of Australia and the Government of the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income of 6 August 1982*, Canberra 27 September 2001 (entry into force 12 May 2003) [hereafter 'United States – Australia Protocol 2001'] Article 6 of the Protocol amending Article 10 of the Treaty.

¹⁴¹ See the discussion of this issue in P Norman, 'Australia's Recent Tax Treaties And Protocols' (2003) 57 *Bulletin For International Fiscal Documentation* 397 at 398 to 401.

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.

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.