

eJournal of Tax Research

Volume 9, Number 3

December 2011

(Special Edition: Double Tax Agreements in the Asia Pacific)

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EDITORS' NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation.

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Editorial

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

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

From a completely different background, Australia's long and careful evolution of its DTA network emerges in the paper by Professor John Taylor. This stands in remarkable contrast to China and Russia. However, the paper suggests that Australia is not always so careful in its approach to establishing DTAs! The paper by Professor Vanderwolk on Hong Kong provides another completely different approach, with Hong Kong rapidly changing from a jurisdiction with no DTAs to one intent on a large number in a very short period of time. The final paper by Sharkey and Bain then considers what would happen if a DTA was negotiated between Australia and Hong Kong, considering both country's different priorities.

Together these papers make fascinating reading and demonstrate clearly that whilst the conclusion of DTAs is a growing trend worldwide, all countries come at the task with different priorities and approaches.

Finally, we would like to note that the genesis of this special edition of the journal was a conference jointly organised by Atax, UNSW and the Centre for Financial Regulation and Economic Development at the Chinese University of Hong Kong (CUHK). The conference was held on 13 December 2010 in Hong Kong and attracted a significant local audience. We would like to thank Jeff Vanderwolk at CUHK who jointly organised it with us, as well as the Faculty of Law at UNSW that provided some funding by providing us with a faculty grant.

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

Nolan Cormac Sharkey and Kathrin Bain (Editors)
School of Taxation and Business Law (Atax)
University of New South Wales

December 2011

Hong Kong's new tax treaty network

Jefferson Vanderwolk¹

1. INTRODUCTION

Before the late 1990s, Hong Kong had not entered into any comprehensive tax treaties (also known as double taxation agreements, or DTAs). Hong Kong is a party to numerous treaties in respect of the taxation of airline and shipping income,² but, until recently, broader tax treaties were not thought to be necessary, due to the limited and territorial nature of Hong Kong's tax system. Slightly more than ten years on, Hong Kong has entered into twenty-one comprehensive DTAs, most of which have been concluded in the past two years. This is a revolutionary change for a jurisdiction with a tax system so limited that the tax laws (other than treaties) contain, with very few exceptions (relating to special category taxpayers, including ship and aircraft owners and offshore funds), no provisions on the tax residence of either corporations or individuals, and no tax is imposed on foreign-sourced income or on investment income such as dividends, non-business interest, and capital gains.

What has caused the change, and what are its implications for Hong Kong taxation? Part 2 of this article will discuss the background. Part 3 will cover the recent creation of Hong Kong's treaty network and likely developments in this regard. Part 4 will discuss some of the Hong Kong tax issues that are arising, and other issues that may arise, as a result of the treaties.

2. BACKGROUND

The Hong Kong Inland Revenue Ordinance provides for tax to be charged on only three types of income: business profits, income from employment, and rental income from immovable property.³ Capital gains and other forms of investment income, such as dividends, are exempt from taxation. In addition, the Ordinance provides for a purely territorial tax system: only income arising in or derived from Hong Kong is chargeable to tax. The rates of tax are low. Corporate business profits are taxed at a 16.5 percent rate, and the top rate of tax on individuals is 15 percent.⁴

¹ Professor, Chinese University of Hong Kong.

² At the time of writing, Hong Kong had signed 37 double tax avoidance agreements regarding shipping or airline income, or both. The complete list of agreements is available at the website of the Hong Kong Inland Revenue Department, www.ird.gov.hk.

³ Laws of Hong Kong, Cap 112, ss 5, 8, and 14.

⁴ These are the rates in effect for the 2010-2011 year of assessment. No change in the rates has been proposed for future years.

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

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

For many years, most of the high-tax countries in the world (with the notable exception of the United States) tolerated their residents' use of companies formed in low-tax business and financial centres, even though domestic tax revenue was certainly being lost, or at least deferred, as a result. This complaisant attitude changed gradually. By 1990, nine high-tax countries had enacted controlled foreign company rules (the US first enacted such rules much earlier, in 1962).⁷ The Hong Kong government seemed to take no notice of these developments until the 1990s, when a Hong Kong-based lawyer began to call for the government to enter into tax treaties in order to strengthen Hong Kong's competitiveness as an international business and finance centre.⁸

As an example of the problems that could result from having no tax treaties, Marcovici cited the Italian government's inclusion of Hong Kong in a blacklist of tax havens. The blacklist was relevant to anti-avoidance rules denying tax deductions to Italian resident companies for expenses incurred in transactions with companies resident in listed tax havens.⁹ This would be sure to discourage Italian companies from doing business with Hong Kong companies. If Hong Kong had had a tax treaty with Italy that provided for reciprocal exchange of information, Hong Kong would not have been placed on the blacklist. Traditionalists scoffed at the idea of Hong Kong entering into tax treaties and agreeing to exchange information, but others could see the value of having treaties with trading partner countries.

⁵ See Departmental Interpretation and Practice Notes No. 10, available online at the Inland Revenue Department website, www.ird.gov.hk.

⁶ See Departmental Interpretation and Practice Notes No. 24 [21?], available online at the Inland Revenue Department website, www.ird.gov.hk.

⁷ By 1990, when the Australian rules took effect, controlled foreign company rules had been enacted by the US, the UK, Canada, France, Germany, Japan, and New Zealand.

⁸ Philip Marcovici, "Why Hong Kong Should Develop a Tax Treaty Network," *Tax Notes International*, January 1991, at p 95.

⁹ Ministerial Decree of 24th April 1992, and Art 110, para 10 of Presidential Decree No. 917.

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

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

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

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

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

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

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

¹⁰ Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Arts 5, 8, 18, 73, 106, and 108.

¹¹ Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation on Income, available at the website of the Hong Kong Inland Revenue Department, www.ird.gov.hk.

¹² See “Promoting Transparency and Exchange of Information for Tax Purposes: A Background Information Brief,” August 10, 2010, available online at www.oecd.org

¹³ *Ibid*

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

Soon after these events, the Hong Kong government introduced legislation in June 2009 empowering the Inland Revenue Department to obtain information, pursuant to a request under a DTA, in which it has no domestic tax interest.¹⁴ The legislation was enacted in January 2010, and secondary legislation was passed two months later.¹⁵ Immediately, the Hong Kong government began announcing the conclusion of new DTAs.

3. THE NEW TREATY NETWORK

During 2010 and the first quarter of 2011, Hong Kong concluded new DTAs with the following 16 countries:

- Indonesia
- Brunei
- the Czech Republic
- the Netherlands
- the United Kingdom
- Ireland
- Austria
- France
- Hungary
- Liechtenstein
- Japan
- Kuwait
- New Zealand
- Switzerland
- Spain
- Portugal

In addition, in 2010, Hong Kong concluded treaty protocols with Mainland China and Luxembourg, amending the exchange of information article so as to be consistent with that found in the 2004 OECD model treaty.

Hong Kong continues to work on expanding its treaty network. The HK government is conducting negotiations on new DTAs with:

- Italy
- Finland
- South Korea
- India
- Malaysia
- Malta

¹⁴ Inland Revenue (Amendment) Ordinance 2010, amending Cap 112, Laws of Hong Kong.

¹⁵ Inland Revenue (Disclosure of Information) Rules, Cap 112BI, Laws of Hong Kong.

- Mexico
- Pakistan
- Saudi Arabia
- United Arab Emirates

Table 1 below shows all of Hong Kong's existing DTAs, with the date the DTA was signed, the date it was ratified by the Hong Kong government, the date of its entry into force, and the first Hong Kong tax year of assessment for which the DTA is effective. Older versions of the treaties with Mainland China and Luxembourg are also shown.

Notable for their absence from the existing list of DTAs are several of Hong Kong's largest trading partners, including the United States, Canada, Australia, Germany, Singapore, and Taiwan. There are rumours, however, that some kind of double tax "arrangement" with Taiwan may be in the works.

Table 1: Hong Kong's existing DTAs

Country	Date Signed	Date of Order	Entry into Force	Effective Date
Austria	05.05.2010	28.09.2010	01.01.2011	Y/A 2012/2013
Belgium	10.12.2003	03.02.2004	07.10.2004	Y/A 2004/2005
Brunei	20.03.2010	22.06.2010	19.12.2010	Y/A 2011/2012
Czech Republic	06.06.2011			
France	21.10.2010			
Hungary	12.05.2010	28.09.2010	23.02.2011	Y/A 2012/2013
Indonesia	23.03.2010	22.06.2010		
Ireland	22.06.2010	28.09.2010	10.02.2011	Y/A 2012/2013
Japan	09.11.2010			
Kuwait	13.05.2010			
Liechtenstein	12.08.2010			
Luxembourg	11.11.2010			
Luxembourg	02.11.2007	22.01.2008	20.01.2009	Y/A 2008/2009
Mainland China	27.05.2010			
Mainland China	30.01.2008	15.04.2008	11.06.2008	11.06.2008
Mainland China	21.08.2006	17.10.2006	08.12.2006	Y/A 2007/2008
Mainland China	11.02.1998	24.02.1998	10.04.1998	Y/A 1998/1999
Netherlands	22.03.2010	22.06.2010		
New Zealand	01.12.2010			
Portugal	22.03.2011			
Spain	01.04.2011			
Switzerland	06.12.2010			
Thailand	07.09.2005	18.10.2005	07.12.2005	Y/A 2006/2007
Vietnam	16.12.2008	21.04.2009	12.08.2009	Y/A 2010/2011
United Kingdom	21.06.2010	28.09.2010	20.12.2010	Y/A 2011/2012

4. ISSUES ARISING UNDER THE DTAs

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

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

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

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

Exchange of information will undoubtedly give rise to issues in practice. Under the Inland Revenue (Disclosure of Information) Rules and the stated policy of the Inland Revenue Department in its Departmental Interpretation and Practice Notes No. 47, an information request from a treaty partner must contain certain particulars, in order to prevent so-called "fishing expeditions" by foreign governments. In addition, the person in Hong Kong who is the subject of a disclosure request must be notified and allowed to review the request and ask for amendments. If the Commissioner of Inland Revenue rejects requested amendments, the subject person can ask for review by the

¹⁶ See, eg, Hong Kong-Indonesia DTA, Article 27, available online at www.ird.gov.hk.

¹⁷ See Su Lei, Wei Wenzhong, and Chen Guangping, "A Hong Kong Company Paid Tax on the Disposition of A Shares at the Amount of CNY379 Million," *China Taxation News*, June 30, 2010.

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

Another issue that has arisen as a result of Hong Kong's DTAs is whether arm's length transfer pricing is now required for Hong Kong tax purposes. Hong Kong has no arm's length pricing rule, per se. The Inland Revenue Ordinance contains an untested provision that imputes profits of a nonresident associate to a Hong Kong taxpayer if the business between them results in less profit for the Hong Kong taxpayer than might reasonably be expected.¹⁸ The Ordinance also includes a general anti-avoidance rule that applies when it would be concluded that a transaction was entered into for the sole or dominant purpose of obtaining a tax benefit.¹⁹ In addition, the courts have held that the deductibility of business expenses can be limited to a commercially reasonable amount in cases where the relevant transaction was between the taxpayer and a related person.²⁰

DTAs permit each party to impose arm's length pricing on transactions between associated enterprises resident in the two states. A correlative adjustment may be required by a DTA if a pricing adjustment has been made by the other treaty party. However, apart from that circumstance, there is nothing in Hong Kong's DTAs that requires Hong Kong to assess profits tax on the basis of arm's-length pricing. Nevertheless, in December 2009 the Inland Revenue Department asserted the right to use arm's length pricing for HK taxation generally, using Hong Kong's DTAs as one basis for its position.²¹ Hong Kong tax professionals are unsure what the state of the law is in this area.

5. CONCLUSION

In the space of just over one year, Hong Kong's tax treaty network expanded from five treaties to twenty-one treaties. The dramatic increase was motivated by fear of countermeasures by G-20 countries against uncooperative jurisdictions in the effective exchange of information, and by Hong Kong's desire to be part of the broader 'international tax community'. Hong Kong's new treaty partners include some major trading partner countries, such as Japan and the U.K., but do not include other major trading partner countries such as the United States and Australia. The treaties will give rise to new issues in Hong Kong taxation, including questions involving the application of anti-avoidance rules, the new regulations on exchange of information, and transfer pricing.

¹⁸ Inland Revenue Ordinance, s 20.

¹⁹ Inland Revenue Ordinance, s 61A. This provision was applied so as to require arm's-length pricing between affiliates in *Ngai Lik Electronics Company Limited v. Commissioner of Inland Revenue*, (FACV No.29 of 2008), Court of Final Appeal, 8 July 2009.

²⁰ See, eg. *So Kai Tong, Stanley v Commissioner of Inland Revenue* [2004] 2 HKLRD 416.

²¹ See Inland Revenue Department, Departmental Interpretation and Practice Notes No. 46, available online at www.ird.gov.hk.

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

Bin Yang¹ and Chun Ping Song²

1. INTRODUCTION

As of December 31, 2010, China has signed eighty-nine tax treaties with other countries and two tax arrangements with its own special administrative regions, Hong Kong and Macau. All these tax treaties and internal tax arrangements have come into effect. As the largest developing country with a huge net inflow of foreign investment, it seems quite reasonable for China to stick to the UN model, which gives more weight to the source principle than the OECD model does. However, China's current tax treaties exhibit an opposite pattern. Most of China's tax treaties, especially those with the OECD member states, are very close to the OECD model though somewhat diversified; while those with the developing countries are quite flexible.

This article studies the similarities and differences of OECD model, UN model and China's tax treaties with respect to rights to tax income and capital. By explaining the underlying rationales through comparison, the article sheds considerable light on the policies China may adopt when signing new tax treaties. Sections 2 to 5 deal with the rights to tax income from immovable property, business profits, investment income (including dividends, interests and royalties) and capital gains respectively. Section 6 then concludes the article. We expect China to adopt a more aggressive yet flexible policy in the future

2. RIGHT TO TAX INCOME FROM IMMOVABLE PROPERTY

Due to the fact that there is always a very close economic connection between the source of this income and the State of source, Article 6 of both the OECD model and the UN model prescribes that "Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State". This provision gives the State of source the exclusive right to tax, which applies to income from immovable property of an enterprise and income from immovable property serving for the

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performance of independent personal services. Income from immovable property which is attributable to a permanent establishment (PE for short hereinafter) shall be deemed as business profits, which are subject to different rules. The purpose of this provision is to ensure that the state of source has the right to tax any income from immovable property even if it is not attributable to a PE. The OECD model and The UN model have identical rules in this regard and China's treaties follow these rules without any reservation.

3. THE RESPECTIVE RIGHTS TO TAX BUSINESS PROFITS

3.1 The basic principles of allocating rights to tax business profits

The keys to deal with rights to tax business profits are the limitation levied by the state of source and the balance of fiscal interests of the state of source and the state of residence. Logically, three basic principles are to be followed in this respect: the PE principle for identifying the source of business profits, thus limiting the jurisdiction to tax of the state of source; the profits attribution principle and the independent enterprise principle for limiting the extent of right to tax of the state of source.

3.1.1 The PE principle

The OECD model and the UN model both state clearly that, "profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the PE may be taxed in that other State".³ This is the PE principle.

While the PE principle is a common recognition, the divergence lies in what constitutes a PE. The UN model, which attaches more importance to the capital importing countries (mostly developing countries), tries to enlarge the scope of a PE or uplift the restrictions on a PE compared to that of the OECD model. Assembly activities, duration of projects, furnishing of services, insurance business and agent sales are among the most controversial and negotiated subjects. The OECD model has generally more stringent rules for their recognition as a PE.

Although in general China would like to follow the UN model in that it's the largest developing country, it's actually quite flexible in this regard, either since it compromises with the other negotiating state, or since it carries on more activities through the potential PEs in the other negotiating state. For example, a duration of 6 months is required for a building site, a construction, assembly or installation project or supervisory activities in connection therewith to be recognised as a PE in the tax treaty with Nigeria; while a 9 month duration is required in the treaty with Qatar, which is different from that of both the OECD model and the UN model.

3.1.2 The profits attribution principle

As a natural extension of the PE principle, the state of source would tax the profits to the extent that they are attributable to a PE, profits that are not attributable to a PE shall be taxable only to the state of residence. But there are two different criteria on

³ Paragraph 1, Article 7 of both the OECD model (the version before 2010 unless otherwise indicated in context) and the UN model.

the attribution of profits to a PE. The OECD model adopts the economic connection principle in the attribution of profits. It stresses the economic connection of the business profits and the PE's activities, which follows that the state of source may only tax business profits arising from a PE's activities. In contrast, the UN model proposes a restricted force of attraction principle with stipulates that "the profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a PE situated therein".⁴ If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that PE; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE; or (c) other business activities carried on the same or similar activities of in that other State of the same or similar kind as those effected through that PE."⁵ The UN model illustrates that if a non-resident enterprise carries on the same or similar activities of its PE by circumventing it, the profits thus gained shall also be attributable to the PE and be subject to tax accordingly. "The same or similar activities of a PE under the same or similar conditions" is the restriction of the force of attraction principle. If, for example, the activities of the enterprise are different from those of the PE, the profits should not be attributable to the PE.

In practice, most international tax treaties adopt the economic connection principle for the convenience of tax administration and promotion of economic efficiency. Some tax treaties try to curb tax avoidance by introducing a force of attraction principle with stringent restrictions. As stipulated in the international tax treaty between Germany and the Philippines, if it can be proved that the enterprise is engaging in the same or similar activities as the PE solely for the purpose of avoiding taxes of the state of source, then all the profits arising directly from those activities shall be taxed by the state of source. There are similar provisions in the bilateral tax treaties between Germany and Indonesia, India, Pakistan, Turkey, Papua New Guinea and Mexico.⁶

3.1.3 The independent enterprise principle and the arm's length principle

The PE is not an independent legal entity. Its business activities as well as business profits are controlled by the enterprise. In order to implement the PE principle and source jurisdiction to tax, a PE should be viewed as if it were a separate tax entity. It is required that a PE calculates its profits independently, as if it were a separate and independent enterprise. This is the independent enterprise principle and there are similar rules in both models.⁷ It follows naturally that in a PE's dealings with the enterprise, other parts of the enterprise, associated enterprises etc., the arm's length principle should be used to determine a PE's profits which shall be taxed accordingly in the state of source.

China, as a non-member state of the OECD, clarifies expressly in the 2010 OECD model that while it fully understands and respects the separate and independent enterprise principle underlying the new version of article 7, due to its tax administration capacity it reserves the right to adopt the previous version of the article

⁴ The general force of attraction principle gives the state of source an unrestricted right to tax the source income, regardless of its economic connection with a PE.

⁵ Paragraph 1, Article 7 of the UN model.

⁶ Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (Kluwer Law International, 1997) 421-422.

⁷ Paragraph 2, Article 7 of both the UN model and the OECD model.

and, in some cases, to resort to simpler methods for calculating the profits attributable to a PE.

3.2 On the calculation of the business profits of a PE

3.2.1 The rules of deduction of expenses between a PE and the enterprise

The PE is different in legal status from a normal independent enterprise. Should deductions be allowed for expenses paid to the head office, such as royalties, commission for management and interest on loans? It's a key question for the effective implementation of the arm's length principle.

The UN model stipulates clearly under Article 7(3) "In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices".⁸

In 2010, the OECD model undertook a profound change in Article 7 by fully applying the arm's length principle in the determination of a PE's business profits. The new article 7 views a PE as a separate and independent enterprise. The attribution of profits to a PE will follow from the calculation of the profits (or losses) from all its activities, including dealings with other parts of the enterprise. The various dealings between a PE and its head office, such as franchising, patent leasing, providing services and loans, are recognised by the latest version, and the arm's length principle dictates whether or how much of the relevant expenses shall be deducted (or how incomes shall be calculated). The previous OECD model distinguishes itself from the UN model in that there are no restrictive clauses such as "no such deduction shall be allowed in respect of amounts, if any..." However, the OECD model does state similar but more specific views in its commentary.⁹

⁸ The corresponding provisions do not comprise formal provisions of the OECD model; rather they are to be found in its commentaries.

⁹ Commentaries on Paragraph 3, Article 7 of the OECD model.

3.2.2 The calculation of profits of mere purchase by a PE

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

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

3.2.3 Special methods for calculation of profits of a PE

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

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

3.3 The practices of China's treaties

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

¹⁰ Paragraph 5, Article 7 of the OECD model.

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

3.4 An exception to the PE principle-international transportation

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

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

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

¹¹ The treaty doesn't mention the exception of the banking or financial institutions with respect to interest.

¹² As above.

¹³ As above.

¹⁴ Jin Zhi Liu (translator), *Commentaries of UN model Tax Convention between Developed and Developing Countries* (China Financial & Economic Publishing House, 1996) 56.

Although most of China's treaties confer the right to tax to the state of residence, many other rules are also adopted. For example, the rights to tax in treaties between China and Qatar, Venezuela and Laos are conferred to the place of head office, whilst in treaties with Algeria, Morocco and Tunisia such rights are conferred to the place of effective management. The tax treaty between China and Indonesia is relatively special, which stipulates that "Profits from sources within a Contracting State derived by an enterprise of the other Contracting State from the operation of ships in international traffic may be taxed in the first-mentioned State, but the tax imposed shall be reduced by an amount equal to 50 per cent thereof".

4. RIGHTS TO TAX INVESTMENT INCOME

Two methods are used with respect to the taxation of investment income. The first one is to levy a withholding income in the state of source. The income is subject to a flat rate of income tax according to its total amount, with the beneficiary owner as the taxpayer and the payer as the withholding agent. Usually there will be due credits for these taxes so paid in the final settlements of the state of residence. This is the reason why it's called a "withholding tax". The second one is to levy an income tax with regard to business profits in the state of source. If the beneficial owner of the investment income, being a resident of a Contracting State, carries on business in the other Contracting State in which the investment income arises through a PE situated therein and the right or property in respect of which the royalties are paid is effectively connected with such PE, the investment income shall be treated as business profits and taxed accordingly. In order to avoid double taxation, first, it is necessary to fix the source of investment income. Moreover a set of rules for harmonisation need to be established to ensure that if contracting states have overlaps with respect to the source of such income, the investment income is allocated to only one source. Second, the respective rights to tax investment income may be given to the state of source or the state of residence.

4.1 The basic principles of allocating rights to tax investment income

Both the OECD model and the UN model have three special provisions respectively for dividends, interest and royalties. The UN model gives the rights to tax to both states – i.e. both the source jurisdiction as well as resident jurisdiction. No exception is made in respect to royalties. Granting rights to both states fully indicates the fact that income of franchising comes from the state of source, but the development of propriety rights such as patents and technical know-how results in large expenditures in the state of residence, making that state eligible to have a share of tax revenues. In contrast, an exclusive right to tax with regard to royalties is conferred to the state of residence in the OECD model, denying the source jurisdiction the right to tax. The income from franchising is recognised as coming from the state of residence where the beneficiary owner is a resident, since the propriety rights are usually developed in that state with a big investment over a long period while assuming big risks.

A reasonable and plausible solution here is to share the rights to tax: the state of source has the priority to tax royalties but at a low tax rate, while the state of residence may also gain some tax revenues. The priority to tax will encourage the state of source (developing countries in most cases) to introduce the advanced technologies and achievements, which also entitles them to have a macro regulation on its economic development and selective introduction of technologies. Moreover, the source jurisdiction can fight tax avoidance more effectively. However, as the country where

the beneficiary owner is a resident does account for the production of propriety rights, it too should also have due rights to tax because it provides public services and assumes risks for the development of these rights. China has been following the UN definition of royalty and insisting on granting the state of source the right to tax.

4.2. The respective rights to tax investment income

It follows to set a limitation on the source jurisdiction to tax investment income with respect to tax rates when the state of source and the state of residence both have rights to tax. Since the state of source has the natural privilege to tax in advance, the state of residence would have nothing to tax if the source jurisdiction taxes were not subject to a tax rate ceiling. It is customary that income is subjected to limited taxation in the state of source to make sure that the fiscal interests are balanced between the states.

The UN model and the OECD model diverges on the extent of the limitation. The OECD model deprives the state of source the right to tax royalties, while setting a strict limitation on the withholding tax rates. The OECD model stipulates that “the state of source must limit its tax to 5 per cent of the gross amount of the dividends, where the beneficial owner is a company that holds directly at least 25 per cent of the capital of the company paying the dividends, and to 15 per cent of their gross amount in other cases”.¹⁵ This article is definitely beneficial to the state of residence.

The UN model relaxes the limitation. It lowers the shareholding of the company paying the dividend to 10% for a tax preference. Moreover, no specific ceilings were set on the withholding tax rates with respect to investment income, which generally encourages the state of source to negotiate for higher tax revenues.

4.3. The practices of China's treaties

China insists on the source jurisdiction to tax investment income (including royalties), while accepting a reasonable limitation on the withholding tax rate. Apart from the fact that “interest arising in a Contracting State and paid to the Government of the other Contracting State, a local authority or the Central Bank thereof or any financial institution wholly owned by the Government of the other Contracting State, or paid on loans guaranteed or insured by the Government of a Contracting State, a local authority or the Central Bank thereof or any financial institution wholly owned by the Government of such Contracting State, shall be exempt from tax in the first mentioned State”, China certainly denies the state of residence the exclusive right to tax investment income.

The first two tax treaties of China were with Japan in 1983 and with United States in 1984. Since then, China has been active in entering tax treaties. With the exception of Chile, the other 32 OECD member states (including the former Czech Republic) have had tax treaties with China. Beginning in around 2000, China has been focusing on establishing tax treaties with developing countries: 35 of its last 39 agreements after 1996 were with developing countries. Table 1 presents an overview of China's tax treaties since 2000.

¹⁵ Paragraph 2, Article 10 of the OECD model.

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

Country	Date of Signature	Tax on Capital?	Withholding Taxes ¹			Taxation of Capital Gains ²	Tax Spar-ing?
			Dividends	Inter-est	Royal-ties		
Tajikistan	2008.08.27	YES	10%(5%,25%)	8%	8%	OECD	NO
Singapore	2007.07.11	NO	10%(5%,25%)	10% (7%)	10%	UN, 25%	YES
Algeria	2006.11.06	YES	10%(5%,25%)	7%	10%	OECD	NO
Hong Kong	2006.08.21	NO	10%(5%,25%)	7%	7%	UN, 25%	NO
Saudi Arabia	2006.01.23	YES	5%	10%	10%	UN, 25%	YES
Mexico	2005.09.12	NO	5%	10%	10%	UN, ?%	NO
Georgia	2005.06.22	YES	10%(5%,10%; 0, 50%)	10%	5%	OECD	NO
Barbados	2005.05.15	NO	5%	10%	10%	OECD	NO
Azerbaijan	2005.03.17	NO	10%	10%	10%	OECD	NO
Brunei	2004.09.21	NO	5%	10%	10%	OECD	YES
Albania ²	2004.09.13	YES	10%	10%	10%	OECD	NO
Macao	2003.12.27	NO	10%	10%	10%	UN, 25%	NO
Trinidad and Tobago	2003.09.18	NO	10%(5%,25%)	10%	10%	OECD	YES
Morocco	2002.08.27	NO	10%	10%	10%	OECD	YES
Sri Lanka	2003.08.11	NO	10%	10%	10%	UN, 25%	YES
Kirgiz	2002.06.24	NO	10%	10%	10%	UN, 25%	NO
Greece	2002.06.03	NO	10%(5%,25%)	10%	10%	OECD	NO
Bahrain	2002.05.16	NO	5%	5%	10%	UN, 25%	NO
Iran	2002.04.16	NO	10%	10%	10%	OECD	NO
Tunisia	2002.04.16	NO	8%	10%	10% (5%)	OECD	YES
Nigeria ³	2002.04.15	NO	7.50%	7.5%	7.5%	OECD	NO
Oman	2002.03.25	NO	5%	10%	10%	UN, 25%	YES
Indonesia	2001.11.07	NO	10%	10%	10%	OECD	NO
Kazakhstan	2001.09.12	NO	10%	10%	10%	OECD	NO
Venezuela	2001.04.17	YES	10%(5%,10%)	10%	10%	OECD	NO
Cuba	2001.04.13	NO	10%(5%,25%)	7.5%	5%	OECD	YES
Qatar	2001.04.02	NO	15%	10%	10%	UN, 25%	NO
Moldova	2000.06.07	NO	10%(5%,25%)	10%	10%	UN, 25%	NO

Source: State Administration of Taxation. Current as at 31 December 2010.

Table 1 Notes:

¹ There are a few specialties with respect to investment income of the relative articles of China's treaties. First, the dividends generally don't include the "jouissance" shares or "jouissance" rights, mining shares, founders' shares as expressed in the OECD model. Second, China has been following the UN definition of royalty and insists on the giving the state of source rights to tax.

² The treaty with Albania contains interest in a partnership or trust.

³ The tax treaty between China and Nigeria uses only the first three provisions of the article "capital gains" of the OECD model.

China adopts a country by country policy while negotiating the withholding tax rate of investment income of foreign residents. This is mainly determined by the fact that China holds quite different positions with different countries in international economic relations: while the developed countries (and the OECD member states in particular), are among the major investors of China, the developing countries are generally the host countries of China's investment. Regarding whether a tax preference is given to the dividend withholding tax rate based on level of ownership, China's tax treaties can be classified into two modes of six categories, discussed below.¹⁶ It's worth noting that the unified corporate income tax in 2008 dictates a 10% withholding tax rate and it shall prevail over any higher withholding tax rates, if any, in China's tax treaties.

4.3.1. A withholding tax preference for dividends of a high holding equity

The first category: a 5% withholding tax if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividend and 15% in all other cases, and a 10% withholding tax rate for both interest and royalties. For example, the treaties with South Korea, Armenia, Iceland, Lithuania, Latvia, Estonia are of this kind. There are also some minor exceptions as well. For example, the treaty with Austria gives only a 7% tax preference for a holding equity of at least 25%; the treaty with Canada requires only a 10% holding equity for a tax preference for dividends; the treaty with Luxemburg gives a 30% discount for the withholding tax of royalties.

The second category: a 5% withholding tax if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the company paying the dividend and 10% in all other cases, and separate withholding tax rates for interest and royalties. For example, the treaties with Trinidad, Tobago, Moldova and Greece prescribe a 10% withholding tax rate; the treaty with Tajikistan an 8% tax rate; the treaty with Cuba imposes a 7.5% tax rate for interest and 5% for royalties; and the treaty with Hong Kong imposes a 7% withholding tax rate. The treaty with Singapore stipulates a 7% withholding tax rate for interest paid to a bank or any other financial institutions and 10% withholding tax rate in all other cases.

4.3.2. No withholding tax preference for dividends of a high holding equity

The third category: a 10% withholding tax rate for all kinds of investment income. For example, the treaties with Japan, the Czech Republic, Slovakia, Cyprus, Hungary, India, Russia, Malta, Belarus, Vietnam, Turkey, Ukraine, Uzbekistan, Bangladesh,

¹⁶ A 10% withholding tax rate for all kinds of investment income was stipulated in the new Chinese Enterprise Income Tax Law since 2008. This rule shall prevail over any higher withholding tax rates, if any, in China's tax treaties.

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

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

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

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

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

5. THE RESPECTIVE RIGHTS TO TAX CAPITAL GAINS

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

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

effective management of the enterprise is situated¹⁷ or only in the Contracting State in which the enterprise is a resident. 4) Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.¹⁸

The differences lie in the taxation of income from alienation of shares or comparable interests. First, the UN model expands the right to tax of the state of source, in that it may tax gains from the alienation of interests in partnerships, trusts and estates which principally own immovable property situated therein. That is to say gains, in whatever form, from the immovable property situated in a Contracting State may be taxed in that State. Secondly, the UN model stipulates that gains from the alienation of shares, other than those shares of principally immovable property owning companies, representing a participation of ___ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.¹⁹ The OECD model does not distinguish those capital gains in its formal provisions; instead it claims that the contracting states are free to do so through bilateral negotiations.

China's treaties differentiate in this regard. Some treaties follow the UN model, which requires that "Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of 25% in a company which is a resident of a Contracting State may be taxed in that State". By way of example, this is the case in tax treaties with United States, Italy, Czech Republic, Sri Lanka, Oman, Moldova, Kyrgyzstan, Bahrain, Hong Kong, Macao. However, some treaties do not distinguish shares of capital not represented by immovable property, such as the tax treaties with Australia, Azerbaijan, Albania, Morocco, Indonesia, Kazakhstan, Kyrgyzstan, Iran, Japan, Yugoslavia, Netherlands, Tajikistan, Algeria, Georgia, Brunei, Trinidad and Tobago, Venezuela, Cuba, Barbados, and Tunisia. These treaties follow the OECD model.

In brief, two methods with respect to the taxation of capital gains are used in China's treaties (see Table 1). The first is to follow the standard of the OECD model, although sometimes with slight variations, which is denoted by OECD in the table; the second is to follow the standard of the UN model with a holding equity of at least 25%, denoted by UN, 25% in the table. There are also two special cases, the treaty with Mexico does not lay out the specific extent of participation in a company for the gains to be taxable in the state of source; and article 13 of the treaty with Nigeria only contains the first three paragraphs of that in OECD model. Although the two models both claim that "Gains from the alienation of any property other than that referred to in the model shall be taxable only in the Contracting State of which the alienator is a resident", China reserves the right for the state of source to tax in this regard.

¹⁷ Paragraphs 1, 2 and 3, Article 13 of the OECD model and the UN model.

¹⁸ The OECD model's rule of "deriving more than 50 per cent of their value directly or indirectly from immovable property" is the same as that of the UN model: the property of which consists principally of immovable property, as is described in its commentaries.

¹⁹ Paragraph 5, Article 13 of the UN model.

6. CONCLUSION

The dual fundamental purposes of the double taxation treaties are: eliminating international double taxation so as to guarantee that the income from international transactions shall be taxed only once; and reconciling contradictions of sovereign states so as to distribute income tax revenues of international economic activities properly. The prevailing view regarding tax treaties assume that they benefit every country involved. However, under the worldwide tax competition for highly mobilized capital, each country has been driven to take unilateral measures, such as tax credits and tax exemptions for foreign investments, which have eliminated international double taxation to a great extent. In this respect, the tax treaties serve less the economics goal of eliminating double taxation, but rather the function of redistributing tax revenues. Dagan even proved that tax treaties have much more cynical consequences, particularly redistributing tax revenues from the poorer countries to the richer signatory countries.²⁰ Empirical researches also reveal an insignificant effect of tax treaties on FDI growth.²¹

Tax treaties have many other benefits as well, such as coordinating tax terms between the contracting countries, improving tax administration, the introduction of tax sparing, recognition of the international community and ensuring greater certainty for taxpayers. These positive effects are of greater importance to developing countries than to developed countries, which partly explains why some countries enter into tax treaties even in the will experience a loss of tax revenue.

We expect China to adopt a more aggressive yet flexible policy in the future. The economic growth of China has dramatically reduced the benefits of tax treaties in two respects. First, the economic gains arising from tax treaties are trivial and still decreasing. Secondly, the mutual benefits of tax treaties are of decreasing importance to China for its ever frequent international communication. It is in this sense that the tax treaties have largely become an agreement of tax revenue distribution to China, and China is expected to be more aggressive yet flexible according to its positions in international economic activities.

²⁰ Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32 *New York University Journal of International Law and Policy* 939-996.

²¹ Ronald B. Davies, 'Tax Treaties, Renegotiations, and Foreign Direct Investment' (2003) 33 *Economic Analysis and Policy* 251-273.

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

Nolan Cormac Sharkey and Kathrin Bain¹

1. INTRODUCTION

With Hong Kong recently embarking on the rapid establishment of a significant double tax agreement (DTA) network, the possibility that it may conclude a DTA with Australia needs to be seriously considered by taxpayers, professionals and academics. Thus far it is notable that no announcement has been made about treaty negotiations, despite the fact that Hong Kong has concluded many DTAs with countries that are *prima-facie* similar to Australia in terms of taxation and economic development. Hong Kong and Australia have a very large business and social relationship and if it is suggested that DTAs are important to cross border trade, investment and employment, then a DTA should be considered between Australia and Hong Kong.

This article examines how a DTA would impact taxation in Australia and Hong Kong. In doing this it raises reasons why a DTA may bring significant benefits and it indicates where a DTA may not be thought to be desirable by either of the two jurisdictions. In balancing these findings against the background information on tax and DTA policy in both jurisdictions, as well as their economic relationship, it may be possible for commentators to speculate on why a DTA between Australia and Hong Kong may or may not come into existence.

The very significance of the relationship between the two jurisdictions means that a DTA will have a major impact in terms of both benefits and revenue losses. This significance may be why a DTA may not be thought to be desirable to Australia or Hong Kong when it is thought to be desirable between Hong Kong and other jurisdictions. In addition to this assistance with speculation on future developments, this article should make a major contribution to any contemplation that the Australian or Hong Kong authorities are having about the desirability of a DTA. It is also highly relevant in showing how a DTA would impact tax practice in both jurisdictions and will be invaluable if an announcement is made that treaty negotiations have commenced between Australia and Hong Kong. Finally, in its finding that much of the benefit that a DTA would bring to taxation in both jurisdictions is associated with the

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

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

2. BACKGROUND

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

2.1 Comparison of Australian and Hong Kong tax systems

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

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

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

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

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

⁴ Ayesha MacPherson and Garry Laird, *Hong Kong Taxation Law and Practice* (The Chinese University Press, 2010) 13. See *Inland Revenue Ordinance 1947* (HK) ss 5 (property tax), 8 (salaries tax), 14 (profits tax).

⁵ *Income Tax Assessment Act 1997* (Cth) Pts 3-1, 3-3. Australia's 'capital gains tax' (CGT) took effect from 20 September 1985. Rather than being a separate tax, a taxpayer's 'net capital gain' for the year is included in taxable income and taxed at normal income tax rates.

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

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

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

Australia's treatment of dividends is rather unique and worthy of discussion. Under the classical system of taxation, company profits are taxed at the company level. When the profits are distributed to shareholders in the form of dividends, the dividends are also taxed. This effectively results in economic double taxation – with the same amount of income being taxed twice, albeit in the hands of different taxpayers. In 1987, Australia introduced what is known as an imputation system¹³ in an attempt to eliminate the effect of double taxation. Under this system, tax paid by a company can be attributed ('imputed') to shareholders. When a company pays a dividend out of profits on which tax has already been paid, they can attach a 'franking credit' to the dividend (a dividend with a franking credit attached is a 'franked dividend'). The franking credit reflects the tax that has been paid by the company. If a dividend is paid from profits which have not been subject to tax at the company level (or the company decides not to attach franking credits to the dividend), it is known as an unfranked dividend. When a resident shareholder receives a franked dividend, they are required to include both the dividend received and the franking credit in assessable income. However, this franking credit then becomes a tax offset, which reduces the

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

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

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

⁹ *Inland Revenue Ordinance 1947* (HK) s 5, Sch 2.

¹⁰ *Inland Revenue Ordinance 1947* (HK) s 14. See also MacPherson and Laird, above n 4, 275-276.

¹¹ MacPherson and Laird, above n 4, 277.

¹² *Inland Revenue Ordinance 1947* (HK) s 26A.

¹³ *Income Tax Assessment Act 1997* (Cth) Pt 3-6.

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

When a dividend is paid to a non-resident, withholding tax would normally be imposed, at either the rate specified in the relevant DTA or 30 percent in the absence of a DTA.¹⁵ However, franked dividends are exempt from withholding tax under s 128B(3)(ga)¹⁶ (despite the fact that Australia may have taxing rights to the dividends under DTAs). Non-resident shareholders are not entitled to use franking credits to reduce their tax liability, but the franking credit essentially operates as the final tax on the dividend.

Withholding tax is also payable on interest and royalties payable to non-residents at the rate of 10 percent¹⁷ and 30 percent¹⁸ respectively, unless a DTA imposes a lower rate.

In light of these differences, it is not surprising that Australia has a higher proportion of tax revenue (compared to gross domestic product) than Hong Kong. In Australia, total tax revenue as a proportion of GDP was approximately 26 percent in the 2009-10 financial year.¹⁹ Although this is lower than the 2010 OECD average of 34 percent,²⁰ it is still significantly higher than Hong Kong, where in 2010 tax revenue as a proportion of GDP was only 13 percent.²¹

2.2 Australia's DTA network

2.2.1 History of Australia's DTAs

Australia is currently a party to 44 comprehensive DTAs (of which 26 are with OECD member countries) and an additional three that only relate to the taxation of individuals. Australia's DTAs are incorporated into domestic law through the *International Tax Agreements Act 1953* (Cth). With the exception of general anti-avoidance provisions, in the event of an inconsistency between a DTA and Australia's Income Tax Assessment Acts, the DTA will prevail.²²

Australia entered its first DTA with the UK in 1946 (coming into force in 1947). At the time the DTA was entered into, Australia was a self-governing Dominion of the British Commonwealth. The UK was the main source of foreign investment in Australia as well as Australia's main trading partner. Concern over the impact that double taxation would have on UK investment in Australia after World War II, as well

¹⁴ Excess franking credits for company shareholders are converted to carry forward tax losses: *Income Tax Assessment Act 1997* (Cth) s 36-55.

¹⁵ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(a).

¹⁶ *Income Tax Assessment Act 1936* (Cth).

¹⁷ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(b).

¹⁸ *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* (Cth) s 7(c).

¹⁹ Australian Bureau of Statistics, *Taxation Revenue as a Proportion of Gross Domestic Product (GDP)* (11 April 2011) Taxation Revenue Australia 2009-10

< <http://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5506.0Main%20Features52009-10?opendocument&tabname=Summary&prodno=5506.0&issue=2009-10&num=&view=>>.

²⁰ OECD, *Tax Revenues Stabilise in OECD Countries in 2010* (29 November 2011) OECD <http://www.oecd.org/document/18/0,3746,en_21571361_44315115_49102162_1_1_1_1,00.html>.

²¹ The Heritage Foundation, *2011 Index of Economic Freedom – Hong Kong* (2011) <<http://www.heritage.org/index/Country/HongKong>>.

²² *International Tax Agreements Act 1953* (Cth) s 4.

as the UK signing its first DTA with the United States (US) in 1945, led to a formal offer by the Secretary of State for the Dominions to each of the Dominions to enter into a DTA similar to that negotiated with the United States.²³ Taylor noted that “the negotiation of the treaty with Australia proved to be the most difficult of all the treaty negotiations that the United Kingdom had with the Dominions at this time”,²⁴ largely due to the differences between the Australian and UK tax systems. Post 1946, Australia’s DTA network was slow to develop. When Australia became a member of the OECD some 25 years later (in 1971), only an additional five DTAs had been entered into: the US (1953), Canada (1957), New Zealand (1960), Singapore (1969) and Japan (1969).

The US first offered to enter into a DTA with Australia in 1947, but Australian concerns over the potential loss of revenue, and a belief that benefits under the DTA would flow to the US Treasury rather than US investors, meant that a DTA was not signed until 1953. From Australia’s point of view, entry into the DTA was partly motivated by a desire to maintain good relations with the US following World War II, as well as the potential to obtain a loan from the US government.²⁵ As a result of the negotiation of the Australia-US DTA, enquiries were made by Canada as to whether Australia would enter into DTA negotiations. Although Australia was once again concerned with the potential loss of revenue, it was thought that a DTA would improve relations with Canada and help encourage Canadian investment. Additionally, political considerations were also in play, that is, there was concern how it would look politically if Australia refused to negotiate a treaty with Canada considering one had already been entered into with the US.²⁶

Australia’s close proximity to New Zealand has meant that the two countries have always had a strong economic and trade relationship. It may therefore be of surprise that a DTA was not concluded between the two countries until 1960. Although discussions regarding double taxation between the two countries began in 1947, a satisfactory agreement was unable to be concluded at that time due to differences in tax systems.²⁷

Prior to Australia entering the OECD in 1971, two further agreements were entered into with Singapore and Japan (both signed in 1969). Although at the time regarded as a ‘developing country’, Australia had had a strong connection with Singapore for many years. For example, the establishment of an Australian representative office in Singapore in 1941 represented one of Australia’s first foreign posts.²⁸ Australia’s DTA with Japan was signed approximately one month after the signing of the Australia-Singapore DTA, although negotiations had commenced with Japan prior to negotiations with Singapore. Japan represented an important country in terms of

²³ John Taylor, ‘The History of Double Tax Conventions – Australia’ (Paper presented at The History of Double Taxation Conventions Conference, Rust Austria, 3-5 July 2008) 3-4 <<http://www2.wu-wien.ac.at/taxlaw/events/Conferencepapers/Rust2008/NRRust2008AustraliaTaylor.pdf>>.

²⁴ Ibid 4.

²⁵ Ibid 10-11.

²⁶ Ibid 14.

²⁷ Ibid 16. See also New Zealand, *Report Of The Taxation Committee* (Wellington, 1951) 97.

²⁸ Gareth Evans, ‘Australia’s Relations with Singapore’ (Speech delivered at the Singapore Australian Business Council and Foreign Correspondents’ Club, Singapore, 27 October 1988). <http://www.gevans.org/speeches/old/1988/271288_fm_australias_singapore.pdf>

Australian trade, and there was concern that failure to sign a DTA would be viewed by Japan as a discriminatory action.²⁹

It is apparent that Australia joining the OECD in July 1971 had an effect on the countries with which Australia negotiated DTAs. In the fifteen years following Australia joining the OECD, 16 DTAs were entered into, 12 of which were with existing OECD members: Germany (1972), France (1976), Netherlands (1976), Belgium (1977), the Philippines (1979), Switzerland (1980), Denmark (1981), Sweden (1981), Italy (1982), Korea (1982), Malaysia (1980), Norway (1982), Ireland (1983), Malta (1984), Finland (1984) and Austria (1986).

In the latter half of the 1980s and the 1990s, Australia's focus shifted to signing DTAs with its Asia-Pacific neighbours. Between 1988 and 1996, 10 DTAs were signed with Asia-Pacific countries: China (1988), Papua New Guinea (1989), Sri Lanka (1989), Thailand (1989), Fiji (1990), India (1991), Kiribati (1991), Indonesia (1992), Vietnam (1992) and Taipei (1996). Also in the 1990s, Australia entered into DTAs with emerging economies in Eastern Europe: Hungary (1990), Poland (1991), Spain (1992), the Czech Republic (1995), Slovakia (1999), Romania (2000) and Russia (2000). It has been suggested by Taylor that it is likely that Australia had not entered into DTAs with these European countries earlier due to political and economic factors that existed whilst the countries were under a communist regime.³⁰ Political factors also influenced Australia's refusal to enter into DTA negotiations with South Africa while the apartheid policy existed,³¹ although an Australia-South Africa DTA was signed in 1999. In the same year, a DTA was also signed with Argentina.

From 2001 onwards, there has been little expansion of Australia's DTA network, with a focus instead of revising existing DTAs. Since 2001, only three new comprehensive DTAs have been entered into: Mexico (2002), Chile (2010) and Turkey (2010). Three additional DTAs that only relate to the taxation of individuals were also been signed during this period: the British Virgin Islands (2008), the Isle of Man (2008) and Jersey (2009).

Australia's early DTA history demonstrates that a number of factors are relevant when examining countries with which Australia should start DTA negotiations. One of the first factors to consider is the extent of double taxation that is occurring between the two countries, with a DTA unlikely to be considered important unless double taxation is occurring on a large scale. If the extent of double taxation is considered an impediment to cross-border relations, consideration needs to be given to how a DTA will help prevent this, and what will be the associated impact on taxation revenue. This will be the focus of Part 3 of this article. Outside the tax spectrum, political considerations also come into play.

2.2.2 Australia's DTA policy

There are a number of model DTAs in existence, with the two most well known being the OECD Model Tax Convention on Income and Capital (OECD Model) and the United Nations Model Double Tax Convention between Developed and Developing

²⁹ Taylor, above n 23, 32.

³⁰ Taylor, above n 23, 40.

³¹ Taylor, above n 23, 30.

Countries (UN Model). It is well accepted that the OECD Model, which grants greater taxing rights to the country of residence, is better suited for developed (capital exporting) countries.³² In response to this, the UN Model was developed as a more suitable model for developing (capital importing) countries – with a greater emphasis on source based taxation.

Australia generally follows the OECD Model with some modifications. This is not surprising considering that all but six of Australia's DTAs were entered into after Australia joined the OECD in 1971. Of those six DTAs that were entered into prior to 1971, all but one have been subsequently replaced by new DTAs. The original Singapore DTA is still in force, but it has been amended by protocol. Further, the majority of Australia's DTAs are with OECD members. However, it was noted in both the 1999 Review of Business Taxation³³ and the 2003 Review of International Taxation Arrangements that Australia's DTAs placed a greater emphasis on source based taxation than the OECD Model.³⁴ Examples of this include Australia's DTAs including a broad definition of permanent establishment (PE) and relatively high withholding tax rates.³⁵ In terms of royalties, the OECD Model does not grant any taxing rights to the country of source.³⁶ Australia has expressed a reservation to this article, and follows the UN Model³⁷ in the sense that in all Australian DTAs, the source country is given taxing rights over royalties (although limited to the amount specified in the treaty).

The Ralph Review highlighted the greater emphasis on source based taxation in Australia's DTAs was due to its traditional position as a net capital importer. In the early 1980s (when Australia's tax treaty network first started significantly expanding), Australian investment abroad was between 10 and 20 percent of the level of foreign investment in Australia.³⁸ However, in the 10 year period from 2001 to 2010, Australia's foreign investment abroad has consistently been approximately 60 percent of the amount of foreign investment in Australia.³⁹ The Review of International Taxation Arrangements expressed concerns that an emphasis on source taxation in DTAs would have a detrimental impact on Australian companies investing offshore.⁴⁰ In the more recent International Comparison of Australia's Taxes (released in 2006), it was stated that a key focus of Australia's international tax arrangements was to ensure that cross-border investment was encouraged.⁴¹

³² Bart Kusters, 'The United Nations Model Tax Convention and its Recent Developments' (2004) January/February *Asia-Pacific Tax Bulletin* 4, 4.

³³ Colloquially known as the Ralph Review or Ralph Report.

³⁴ Review of Business Taxation, *A Tax System Redesigned – More Certain, Equitable and Durable* (Commonwealth of Australia, Canberra, 1999) Recommendation 22.24.

³⁵ The Board of Taxation, *International Taxation – A Report to the Treasurer* (Commonwealth of Australia, Canberra, 2003) 89.

³⁶ OECD, *Model Tax Convention on Income and Capital*, Article 12.

³⁷ UN, *Model Double Tax Convention between Developed and Developing Countries*, Article 12.

³⁸ Review of Business Taxation, above n 34, Recommendation 22.24.

³⁹ Sourced from the Australian Bureau of Statistics, *International Investment Position, Australia: Supplementary Statistics, Calendar year 2009* (9 June 2011) Australian Bureau of Statistics <<http://abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5352.0Calendar%20year%202009?OpenDocument>>.

⁴⁰ The Board of Taxation, above n 35, 90.

⁴¹ Dick Warburton and Peter Hendy, *International Comparison of Australia's Taxes* (Commonwealth of Australia, Canberra, 2006) 302.

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

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

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

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

2.3 Hong Kong DTA network

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

Notwithstanding this, the Hong Kong Special Administrative Region Government (HKSARG) recognises that there are merits in concluding DTAs with our trading partners. A DTA provides certainty to investors on the taxing rights of the contracting parties; helps investors to better assess their potential tax liabilities on economic activities; and provides an added incentive for overseas companies to do business in Hong Kong, and likewise, for Hong Kong companies to do business overseas. Therefore, it has been the policy of the HKSARG to establish a DTA network that would minimise exposure of Hong Kong residents and residents of the DTA partner to double taxation. We have

⁴² The Board of Taxation, above n 35, 90.

⁴³ Chris Bowen (Assistant Treasurer and Minister for Competition Policy and Consumer Affairs), 'Australia's Tax Treaty Negotiation Policy' (Press Release, No. 004, 25 January 2008) <<http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/004.htm&pageID=003&min=ceb>>.

⁴⁴ The Board of Taxation, above n 35, 91.

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

Hong Kong entered into its first DTA with China in 1998.⁴⁶ Following this first treaty, Hong Kong's DTA network was very slow to develop. No further DTAs were signed until December 2003, when a DTA was signed with Belgium. From that point until 2009, only three new DTAs were signed: Thailand (2005), Luxembourg (2007) and Vietnam (2008).

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

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

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

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

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

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

⁴⁷ OECD, *Model Tax Convention on Income and Capital*, Article 26.

⁴⁸ John Tsang, 'Budget Speech by the Financial Secretary' (Speech delivered to the Legislative Council, Hong Kong, 25 February 2009) <<http://www.info.gov.hk/gia/general/200902/25/P200902250108.htm>>.

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

In regards to the amending legislation, the Commissioner of Inland Revenue, Chu Yam-Yuen, stated that "Hong Kong has entered a new phase in supporting the international effort to enhance tax transparency". The Commissioner further stated "Our target is to sign the new comprehensive agreement with all our trade partners. Our policy is not only to focus on exchange of information but we strive to negotiate the best deals for our taxpayers."⁵⁰

Since the legislation came into effect, Hong Kong's DTA network has expanded drastically. In 2010, DTAs were signed with 12 countries, all of which are now in force: Austria, Brunei, France, Hungary, Indonesia, Ireland, Japan, Kuwait, Liechtenstein, the Netherlands, New Zealand and the United Kingdom. A further five DTAs were signed in 2011, although as of December 2011 are not yet in force: Czech Republic, Malta, Portugal, Spain and Switzerland. In addition, Hong Kong is currently negotiating tax treaties with an additional 12 countries: Bangladesh, Canada, Finland, India, Italy, Jersey, Korea, Macao (Special Administrative Region), Malaysia, Mexico, Saudi Arabia, and the United Arab Emirates.

No negotiations are currently scheduled between Australia and Hong Kong. However, in a press release on 23 June 2011, the Hong Kong Government expressed interest in negotiating a DTA with Australia.⁵¹ As at December 2011, there has been no public response made by the Australian government.

From Hong Kong's perspective, the expanded DTA network is expected to increase their competitiveness against other Asian countries such as Singapore (which as of 1 December 2011, was a party to 68 in force comprehensive DTAs, with an additional 10 signed but not yet ratified).⁵² However, differences in tax regimes (such as difficulties in defining 'resident') would pose challenges. It will be demonstrated in Part 3 of this article that the impact of an Australia-Hong Kong DTA will be significantly different for both countries, due in large part to the differences in existing tax systems.

2.4 Australian-Hong Kong relationship

Australia's current DTA focus is on updating current DTAs with major trading partners before focusing on entering into DTAs with minor trading partners. Hong Kong has expressed a desire to enter into DTAs with all trading partners. Thus, before moving to the technical analysis in Part 3 which examines the impact that an Australia-Hong Kong DTA would have on each country's tax system (and associated

⁴⁹ *Inland Revenue Ordinance 1947* (HK) ss 51(4AA), 51B(1AA), 80(2D).

⁵⁰ Hong Kong Economic and Trade Office in Washington D.C., *Hong Kong Enters New Phase of Tax Policy* (April 2010) Hong Kong Circle: Hong Kong Economic and Trade Office in Washington D.C. Newsletter

<http://www.hketowashington.gov.hk/dc/circle/circle10/Mar-Apr_2010/Articles/article04.htm>.

⁵¹ Tsang, above n 2.

⁵² See Inland Revenue Authority of Singapore, *Tax Treaties* (15 December 2011) <<http://iras.gov.sg/irasHome/page.aspx?id=812>>.

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

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

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

Table 1: Hong Kong’s trade and investment with Australia⁵⁸

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

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

⁵⁴ Ibid.

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

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

⁵⁷ Ibid.

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

By way of comparison, it is noted that Hong Kong and New Zealand signed a tax treaty in December 2010, which entered into force in November 2011. On the one hand, the existence of a Hong Kong-New Zealand DTA may be considered irrelevant from Australia's point of view. On the other hand, the discussion of Australia's DTA history in Section 2.2.1 indicates that the DTA networks of close neighbouring countries may be considered relevant when deciding whether to enter into DTA negotiations. In this vein, Australia has consistently maintained a wider DTA network than New Zealand. Taking into account the Hong Kong-New Zealand DTA, New Zealand currently has 37 comprehensive tax treaties (compared to Australia's 44). In addition, of New Zealand's 37 treaties, all bar two are with countries that also have a DTA with Australia – the exceptions being DTAs with the United Arab Emirates (signed in 2003 and entered into force in 2004), and now Hong Kong.⁵⁹

When the Hong Kong-New Zealand came into force in November 2011, the New Zealand Minister of Revenue, Peter Dunne, stated: "It will further strengthen New Zealand's significant international cross-border trade and investment partnerships for the benefit of businesses, investors and taxpayers in both countries". It was also noted that New Zealand and Hong Kong have a significant trade and investment relationship, with Hong Kong being New Zealand's 12th largest export market and sixth largest source of foreign investment.⁶⁰

From Hong Kong's perspective, Australia is a more significant investment and trading partner than New Zealand. In terms of bilateral investment, by the end of 2009, New Zealand was the 28th largest source of foreign direct investment into Hong Kong (whereas Australia was the 16th largest source, as noted above). New Zealand was not a major destination of outward direct investment from Hong Kong.⁶¹ In terms of trade, a comparison of Hong Kong's trade with Australia and New Zealand for 2010 is detailed in Table 2 below.

Table 2: Hong Kong's Trade - Australia and New Zealand comparison⁶²

	AU (HK\$ million)	Size of market	NZ (HK\$ million)	Size of market
Domestic Exports	1,148	13 th largest	115	27 th largest
Re-exports	36,926	11 th largest	3,093	41 st largest
Total Exports	38,074		3,830	
Total Imports	16,064	21 st largest	3,574	26 th largest
Total Trade	54,138	17 th largest	6,527	40 th largest

⁵⁹ Inland Revenue New Zealand, *Tax Treaties* (December 2011) Inland Revenue New Zealand Policy Advice Division <<http://taxpolicy.ird.govt.nz/tax-treaties>>.

⁶⁰ Inland Revenue New Zealand, *NZ-Hong Kong DTA in Force* (10 November 2011) Inland Revenue New Zealand Policy Advice Division <<http://taxpolicy.ird.govt.nz/news/2011-11-10-nz-hong-kong-dta-force>>.

⁶¹ Hong Kong Regional Cooperation Division, Trade and Industry Department, *Hong Kong New Zealand Trade Relations* (March 2011) Hong Kong Economic and Trade Office Sydney <<http://www.hketosydney.gov.hk/hknztraderel.php>>.

⁶² Sourced from Hong Kong Regional Cooperation Division, Trade and Industry Department, above n 56 and n 61.

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

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

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

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

3.1 Residency

3.1.1 Residence of individuals

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

Australian taxation of Hong Kong people who came to Australia for relatively short periods of time. This is because Australia's multiple tests of residency for tax purposes and the way they have been administered are very wide and verge on the aggressive. For example, based on TR 98/17,⁶³ a person who spends very little time in Australia may be regarded as a resident for tax purposes if they are working in Australia. Given the very significant numbers of people from Hong Kong who come to Australia for a variety of work, study and leisure activities, this approach would certainly have been a concern in that they may have been drawn into Australia's worldwide tax jurisdiction upon becoming residents. For example, a Hong Kong professional with significant offshore wealth may have been deeply concerned that by taking a short term work position in Australia, they may have ended up with a large tax liability on their worldwide income. Also, the common law concepts used to determine tax residency in Australia are inherently flexible and can be difficult to anticipate with precision. This uncertainty itself would be a concern for such a visitor from Hong Kong.

A DTA would resolve this uncertainty by providing a tie-breaker test that would allocate most of these short term residents to Hong Kong (assuming they are Hong Kong residents generally). This is because when such a person is found to be an Australian resident and thereby a dual resident, the tie breaker would focus on their permanent home, centre of vital interests, habitual abode, and right of abode or nationality (in order) to determine which jurisdiction they would be allocated to for DTA purposes.⁶⁴ Given their established connections to Hong Kong, this would likely see them classified as residents of Hong Kong for DTA purposes and prevent Australia's taxation of their income that doesn't have the necessary connection to Australia.⁶⁵

The introduction of the temporary residence regime has reduced the impact a DTA would have in this area in that this regime generally ensures that a resident who is a temporary resident is not taxed on their foreign source income that is not part of their Australian employment income.⁶⁶ A temporary resident is generally tax resident who does not hold a permanent visa or citizenship and does not have an Australian spouse.⁶⁷ This ensures that many expatriate workers from Hong Kong would now not be taxed on their offshore income despite being tax residents of Australia. The DTA would still be of benefit to those who earn part of their employment income offshore in relation to their Australian employment, as temporary residents would still be taxed on such income. In contrast, under a DTA, such income would be excluded for Hong Kong residents as it is not derived from services rendered in Australia. This can be seen in the analysis in Section 3.2.1 on employment income below.

Finally, it should be noted that the uncertainty inherent in Australia's residency tests remains a major concern for many Hong Kong people despite the temporary residence regime. For these people, the certainty that a DTA would create and the reduction in Australian tax that a DTA would create (as outlined above) would be very beneficial.

⁶³ Australian Taxation Office *Taxation Ruling TR 98/17* 'Income tax: residency status of individuals entering Australia'.

⁶⁴ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(2). This treaty will be used as a general model for comments made in this analysis given its recent nature and inclusion of Hong Kong.

⁶⁵ The impact of Australian taxation on various categories of income is discussed below under the relevant headings.

⁶⁶ *Income Tax Assessment Act 1997* (Cth), s 768-910.

⁶⁷ *Income Tax Assessment Act 1997* (Cth), s 995-1.

The reason that Australia's residence rules are such a difficult area in relation to Hong Kong people is that the patterns of residence that Hong Kong people have in relation to Australia are complex and unanticipated by traditional concepts of residence. As noted above, many people from Hong Kong come and go from Australia regularly. In addition, many live their lives between the two jurisdictions with assets, work and family spread between the jurisdictions. An example of this is the well documented astronaut migration phenomenon⁶⁸ whereby one member of a couple works in Hong Kong most of the time but has a dependent spouse and children in Australia. Given the complex matrix of factors that can lead to residence of Australia, the residency status of such persons is inherently uncertain.⁶⁹ In addition many of them would have a permanent visa or would have a spouse with a permanent visa making temporary residence inapplicable to them. For this significant group of persons, a DTA would make a major improvement to their taxation status in Australia by providing certainty and also by reducing their tax liabilities.

A DTA would also have a major impact in relation to Australian people spending significant periods of time in Hong Kong. Under Australian law, an Australian is likely to remain domiciled in Australia and for this reason can only escape Australian tax residence if they can demonstrate that they have established a permanent home outside of Australia.⁷⁰ This is unlikely to be the case unless they have made a commitment to live in Hong Kong for a long period of time.⁷¹ Administratively this would usually require at least two years away from Australia and based in Hong Kong.⁷² Even if this period of time away is reached, Australian law may find that they remain a resident of Australia on a different basis such as regular return visits to Australia⁷³ and the existence of close family members in Australia.⁷⁴ For these reasons, the very significant group of expatriate Australians working in Hong Kong (as was demonstrated in Section 2.4) may have difficulty in escaping Australian tax residence. Again, even if they think they may have, they will not be able to be certain due to the uncertainty in the residence tests. Previously many workers may not have been concerned with this continued Australian tax residence due to the foreign service exemption that was available under s 23AG.⁷⁵ However, since this exemption was significantly restricted with effect from 1 July 2009,⁷⁶ this issue is likely to be of significant concern.

A DTA would make a major change to the taxation of these people. Hong Kong's DTAs to date are interesting in that they create a concept of residence of Hong Kong despite the fact that Hong Kong does not generally adopt residency as a concept relevant to its taxation laws. The tests that have been used for this purpose are familiar

⁶⁸ Yuying Tsong and Yuli Lui, 'Parachute Kids and Astronaut Families' in Nita Tewari and Alvin Alvarez (eds), *Asian American Psychology: Current Perspectives* (Psychology Press, 2008) 365-380.

⁶⁹ See for example: TR 98/17, above n 63, as well as cases cited below for an indication of the wide range of factors that may result in residence.

⁷⁰ *Income Tax Assessment Act 1936* (Cth), s 6(1) definition of 'resident'.

⁷¹ See for example: *FCT v Applegate* (1979) 9 ATR 899.

⁷² See for example: Australian Taxation Office, *Taxation Ruling IT 2650* 'Income tax: residency – permanent place of abode outside Australia'.

⁷³ See for example: *AAT Case 13,559* (1998) 41 ATR 1156.

⁷⁴ See for example: *Re Joachim and FCT* [2002] AATA 610; 50 ATR 1072.

⁷⁵ *Income Tax Assessment Act 1936* (Cth).

⁷⁶ The exemption now only applies to income earned as an aid or charitable worker or as a specified government employee (e.g. defence force personnel).

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

3.1.2 Corporate residence

As with individuals, the introduction of a Hong Kong DTA results in the introduction of a corporate residence concept for Hong Kong tax purposes that is not generally relevant to Hong Kong taxation but is essential for the operation of a DTA. To date, this test has been the common international standards of place of incorporation and/or management and control.⁷⁸ Thus, a company that is either incorporated in Hong Kong or is managed and controlled in Hong Kong will be a resident of Hong Kong for tax purposes. Australia adopts similar tests⁷⁹ and the key impact of a DTA in this area will therefore be its impact on dual resident companies. The tie-breaker that is likely to be adopted for dual residents is the OECD standard of place of effective management.⁸⁰

The major impact of a DTA between Hong Kong and Australia in this area will therefore be that certain companies that are currently regarded as tax residents of Australia will not be regarded as residents for DTA purposes with the consequent loss to Australia of significant taxing rights. This would primarily occur when a company incorporated in Australia has its management and control in Hong Kong by virtue of its directors being there. If such companies earned significant non-Australian source income, the DTA would prevent all Australian taxation of these amounts. A proportion of these companies may become controlled foreign companies (CFCs) for Australian tax purposes by virtue of the Australian control of their shares.⁸¹ This would allow Australia to retain some taxation rights through the CFC measures. However these are reduced from that which would be claimed from a resident.

For companies incorporated in Hong Kong, the DTA residence issues would have little impact. This is because Australia would only ever seek to tax them when they have at least their central management and control in Australia.⁸² If this is the case they will be likely to be allocated to Australia under the tie-breaker test as they would also be expected to have their place of effective management in Australia. There would therefore be little change to the Australian taxation of these companies.

Having discussed how a DTA would impact the residency status of Hong Kong and Australian individuals and companies, the analysis will now look at how different

⁷⁷ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(1)(a).

⁷⁸ *Ibid.*

⁷⁹ *Income Tax Assessment Act 1936* (Cth), s 6(1).

⁸⁰ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 4(3).

⁸¹ *Income Tax Assessment Act 1936* (Cth), Pt X.

⁸² The tests are more complex than this but will not be discussed here. See *Income Tax Assessment Act 1936* (Cth) s 6(1).

categories of income derived by such residents would be impacted by a DTA. The following will assume a clear residency status of taxpayers as either Hong Kong or Australian.

3.2 Active income

3.2.1 Employment income

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

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

In addition to providing certainty in relation to the source of employment income, a DTA will also impact Australian taxing rights in relation to work done in Australia by non-residents. It will do this by restricting Australia's taxing rights in relation to persons who do short term work in Australia. Under current Australian law, non-residents will be taxed on their Australian sourced employment income even if they worked in Australia for a very short time.⁸⁸ In contrast, it is a standard DTA feature that those who are in a foreign jurisdiction for less than half the income year are not taxed there.⁸⁹ This does not, however, apply to those that are employed by a resident of the foreign jurisdiction or in a PE in the foreign jurisdiction. Therefore, for persons working in Australia for shorter periods and employed offshore, a DTA will make a

⁸³ *Income Tax Assessment Act 1997* (Cth) s 6-5(3).

⁸⁴ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183.

⁸⁵ *FCT v French* (1957) 98 CLR 398.

⁸⁶ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(1).

⁸⁷ *FCT v Mitchum* (1965) 113 CLR 401.

⁸⁸ *Income Tax Assessment Act 1936* (Cth) s 6-5(3); *FCT v French* (1957) 98 CLR 398.

⁸⁹ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(2).

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

As with Australia, a DTA prima-facie makes little difference to the taxation of employment income by Hong Kong as Hong Kong generally only taxes employment income sourced in Hong Kong.⁹⁰ However, a more detailed analysis demonstrates that a DTA significantly alters the concepts that Hong Kong employs in taxing employment income. It is also noted that like Australia, Hong Kong's use of potentially uncertain common law principles in determining source will also be more certain under a DTA.

Hong Kong law has developed a concept of source that focuses on where the employment is located rather than where the work is performed. This location of employment is determined on the basis of factors including the location of the employment contract as well as the location of the employer and place of payment. These may all be in a different place to the place where the work is performed⁹¹ by an employee and would usually be outside Hong Kong when workers are sent to Hong Kong by foreign employers. In addition, Hong Kong's tax claim is statutorily altered by the exclusion of those whose employment is sourced in Hong Kong on these principles but who actually render all their services outside Hong Kong. Those without Hong Kong employment who render services in Hong Kong for more than 60 days in a year are added to the tax base by statute.⁹²

From the above, it can be seen that the basis for taxing employment income allowed under a DTA is quite different from that claimed by Hong Kong. With a DTA, Hong Kong would only be able to tax Australian residents if they actually rendered services in Hong Kong regardless of their having employment located or sourced in Hong Kong as determined on some other basis by Hong Kong law.⁹³ This is a significant reduction in Hong Kong's taxing jurisdiction and should have a notable impact on those with Hong Kong based employment, in particular those who work throughout the region. In addition, for those without Hong Kong based employment who spend between 60 and 180 days in Hong Kong, the DTA will prevent Hong Kong from its tax claim when services are rendered in Hong Kong for more than 60 days (assuming the person is not employed by a Hong Kong based person or PE).⁹⁴

The impact that this reduction in Hong Kong's tax base has on Australian residents that earn employment income with a connection to Hong Kong may in many cases be negligible, and simply amount to a transfer of tax from Hong Kong to Australia. This is a direct result of Australia's taxation of residents on their worldwide income. Without a DTA, Hong Kong's higher tax claim would be likely to be treated as a foreign income tax offset in Australia given Australia's higher income tax rates. This is particularly the case since the removal in 2009 of the general exemption for foreign service income under s 23AG. If s 23AG had been retained as it originally stood, the

⁹⁰ *Inland Revenue Ordinance 1947* (HK) s 8(1).

⁹¹ *CIR v Goepfert* (1989) 1 HKRC.

⁹² *Inland Revenue Ordinance 1947* (HK) s 8(1). An exemption for work of less than 60 days is given in s 8(1B).

⁹³ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(1).

⁹⁴ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 14(2).

signing of the DTA would have been a major benefit to many Australians working in Hong Kong for period of greater than 90 days and less than 180 days in particular, as the income would have been exempt in Australia and Hong Kong. Finally, it must be noted that despite the fact that Australia's prima-facie income tax rates are higher than Hong Kong's, they are not always higher in their final application to an amount of income. This is because Australia's income tax allows losses from investments and other categories of income to reduce the tax otherwise payable on employment income. This feature and the allowance for a full tax deduction for interest paid on investments means that the phenomenon of negative gearing may reduce the actual tax rates applied to many Australians wage income to the extent that it may be comparable to the tax they would pay in Hong Kong.

Thus it can be seen that in relation to the income earned by employees, a DTA between Australia and Hong Kong would make a significant impact on taxation outcomes for both the taxpayers themselves and the countries. In the case of both jurisdictions, a DTA would increase certainty in relation to taxing jurisdictions when compared to the vagaries of the common law determinations of source. This, it is submitted, would be a very positive outcome in relation to taxation in both jurisdictions. In addition, in relation to Australian tax, short term workers from Hong Kong will be significantly advantaged by a DTA that prevents Australia taxing persons that are in Australia for less than 180 days in the year. Hong Kong would be unlikely to increase its tax take to collect the Australian tax given up. Similarly, short term Australian workers in Hong Kong and those with Hong Kong located employment (but who don't work there most of the time) would be less likely to be taxed in Hong Kong. However, in many of these cases, the tax given up by Hong Kong may simply be collected by Australia. Thus, the net impact on Australian revenue would have to take into consideration both increases and decreases in different circumstances. Hong Kong however would see only a decrease in revenue from the DTA's treatment of employees.

Finally it should be noted that a DTA may provide tax relief to particular categories of persons deriving personal service income such as academics, officials and entertainers. There is a possibility that in some of these cases, this treatment may provide an additional constraint on the jurisdiction's taxing rights. These will not be further explored in this article.

3.2.3 Business profits

As noted in Section 2.4, Australia and Hong Kong have a substantial business relationship making the taxation of business profits of key interest. With business profits, as with employment income, a DTA between Australia and Hong Kong would bring the significant benefit of creating a higher degree of certainty in relation to taxing jurisdictions. Again, this is a direct result of both countries current reliance on uncertain common law concepts of source when taxing non-residents on their business profits. In addition, a DTA is also likely to constrain the taxing jurisdiction of both countries. This is not surprising in the case of Australia but perhaps less expected in the case of Hong Kong given its already narrow tax base.

In Australia, the income tax claim made on non-residents when there is no DTA is the same as in the case of employment income - they are taxed on their Australian sourced income. The concept of a PE has little relevance to the non-DTA tax claim that Australia makes in respect of business profits. The source of business profits is

determined in accordance with common law precedents and is, by its nature, something that evolves over time and can be difficult to determine with certainty given the array of possible business activities.⁹⁵ Thus, precedent indicates that the place of contracting may be important in trade while the place of manufacture may be highly significant in cases of manufacturing.⁹⁶ However, there is always the possibility that in a particular case, a particular factor may be held to be highly significant to the generation of a particular business profit and the location of this factor may be used as a major indicator of source. Precedent also indicates that the source of business profits may be apportioned between different territories where different factors are located in different territories.⁹⁷

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

The signing of a DTA between Hong Kong and Australia would alter Australia's tax claim to effectively only allow it to tax business profits that are attributable to a PE that a Hong Kong resident has in Australia.⁹⁹ This, it is submitted, is a significantly more certain concept than "sourced in Australia". Determinations of profit attributable to a PE, while far from trouble-free, are more certain as they rely upon a built up international body of knowledge on how they should be determined based on international tax and accounting practice and methods. In this respect, a DTA creates a more predictable business taxation environment in Australia.

In addition, there is no doubt that the allowed claim under a DTA is less than that allowed without a DTA. It is certainly possible to have business profits sourced in Australia without having a PE. This is indeed what tax planners often attempt to create when considering business profits earned in Australia. For example, it may be possible to sell products in Australia without establishing a PE. There would be a significant chance that selling in Australia would create an Australian sourced business profit but without a PE, Australia will be unable to tax such profits. In addition, even when a PE is established in Australia, the profits attributable to it may be less than what would be sourced in Australia under common law principles.¹⁰⁰ Thus, Hong Kong residents engaged in business in Australia would stand to significantly benefit from the conclusion of a DTA between the two jurisdictions. It is unlikely that Hong Kong would collect any tax that Australia did not collect as a result of the conclusion of a DTA.

⁹⁵ *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183.

⁹⁶ *D & W Murray Limited v Commissioner of Taxation* (WA) (1929) 42 CLR 332; *Commissioner of Taxation (NSW) v Kirk* [1900] AC 588.

⁹⁷ *Commissioner of Taxation (NSW) v Hillsdon Watts Ltd* [1937] HCA 13.

⁹⁸ *Income Tax Assessment Act 1936* (Cth), former ss 38 to 43.

⁹⁹ *Australia-Hong Kong Income and Capital Tax Treaty* (2010), Article 7.

¹⁰⁰ The converse is also possible and the deemed source rule, if applied, may actually increase the tax claim in certain instances.

Under its Profits Tax, Hong Kong will seek to tax a business profit when a trade, business or profession is carried on in Hong Kong and then to the extent that the profit arises in Hong Kong.¹⁰¹ The concept of a profit arising in Hong Kong is very similar to the concept of an Australian sourced business profit in Australia and courts in both jurisdictions have looked to similar precedents in deciding on these matters. Consideration of when a trade, business or profession is carried on in Hong Kong has focussed on whether a taxpayer has their central management and control in Hong Kong and the location of business assets and activities in Hong Kong.¹⁰² Simply having an office or soliciting orders in Hong Kong is not enough to meet the threshold. However, in *CIR v Bartica Investment Ltd*¹⁰³ the placing of bank deposits in Hong Kong, receiving interest in Hong Kong, keeping accounting and other records in Hong Kong, and having nominee directors meet in Hong Kong was enough to find the taxpayer was carrying on business in Hong Kong.

It can be seen that Hong Kong makes a narrower claim to the taxation of business profits than Australia in the sense that it not only requires the profit to arise in Hong Kong but also requires that the trade, business or profession is carried on in Hong Kong. The issue that then arises is whether a DTA would reduce Hong Kong's claim further. That is, does "profits attributable to a PE in Hong Kong" ever amount to less than "profits arising in Hong Kong from a trade, business or profession carried on in Hong Kong"? It is submitted that the answer to this will significantly depend on whether the factors that have been used in Hong Kong to determine that the trade, business or profession is carried on in Hong Kong will always amount to a PE in Hong Kong. The answer to this is no, as it is possible to conceptualise circumstances such as a variation on the *Bartica* scenario where a PE would not be found. Such situations would however be rare. The exclusions from the definition of PE in many DTAs would also increase these possibilities. Once a PE is found in HK, the second question that arises is whether the profits that would be attributable to it could be less than those that would arguably arise in Hong Kong from the trade, business or profession being carried on in Hong Kong. Again, this would seem to be a possibility that could arise in concept as long as the factor that links such business profit to Hong Kong is not part of the PE. Finally, it is noted that particular business profits are pushed out of the business profits article in DTAs and this may have the impact of reducing Hong Kong's tax base. For example, it may be argued that dealings in land are a business profit and the business profit may be linked to Hong Kong due to the flexible concept of source even if the land is outside of Hong Kong.¹⁰⁴ A DTA may push the land sale out of the business profits analysis and therefore prevent Hong Kong from taxing it.

It can therefore be seen that despite Hong Kong's narrow tax base, the signing of a DTA with Australia may still lead to a reduced tax claim in respect of business profits in Hong Kong. In the case of individual taxpayers, this reduction in Hong Kong tax is likely to be transferred to Australia through Australia's worldwide tax claim, its high tax rates and its use of foreign income tax offsets. In relation to companies however, Australia's granting of the s 23AH¹⁰⁵ foreign branch profits exemption will mean that the tax not collected by Hong Kong will be a genuine saving to taxpayers. Again, the

¹⁰¹ *Inland Revenue Ordinance 1947* (HK) s 14(1).

¹⁰² *Case A146* (1991) 1 HKRC.

¹⁰³ *CIR v Bartica Investment Ltd* (1996) 4 HKTC 129.

¹⁰⁴ *Kwong Mile Services Ltd v CIR* (2004) 7 HKCFAR 275.

¹⁰⁵ *Income Tax Assessment Act 1936* (Cth).

major benefit of the DTA is the predictability it creates in relation to tax claims over business profits in both jurisdictions. Thus, the merit of the conclusion of a DTA between Hong Kong and Australia will need to be evaluated through a balancing of the reduced tax claims with the desirable increase in certainty in tax claims.

3.3 Passive income

3.3.1 Interest income

The taxation of interest income in both jurisdictions would remain largely unchanged by the conclusion of a DTA but there are some notable points for consideration. Australia's tax claim on interest through its withholding tax regime is structurally very similar to that allowed by a DTA. In Australia, interest derived by non-residents is taxed at 10 percent (withholding on gross) unless it is connected to a PE in Australia.¹⁰⁶ If it is, then it is taxed by assessment. This is little different to what occurs under most DTAs except that there may be minor differences as to what constitutes a PE.¹⁰⁷ In these unusual circumstances the DTA may alter outcomes. One area in which a DTA may make a significant difference is when interest is sourced in Australia under common law principles but not subject to the withholding tax regime because it is not paid by an Australian or a non-resident's Australian establishment. While it is not often noted in Australian commentary, such interest still falls within the Australian tax base. This is because s 128D¹⁰⁸ only removes from the assessment regime interest that is dealt with by the withholding regime. An example of when this would occur is when a non-resident lends money to another non-resident (neither of which has an Australian PE) and the loan is concluded and funds provided in Australia. Such interest is likely to be sourced in Australia¹⁰⁹ but would not fall within the withholding tax regime. While these circumstances may appear to be odd, it should be noted that they may readily occur in private affairs when non-residents spend considerable time periods in Australia. In addition, it is possible that a person may have been a resident when the arrangement was made but has since become a non-resident. The DTA would prevent Australian taxation of these amounts of interest. Finally, given the uncertainty that surrounds the source of income in these circumstances, the DTA can again be seen to be creating certainty.

As noted in Section 2.1, bank interest is not taxed in Hong Kong. The only interest that may be taxed is that which forms part of a business profit. In these circumstances the factors discussed above in relation to business profits in Hong Kong should be considered. A DTA will only allow Hong Kong to tax interest when it is effectively connected to a PE in Hong Kong or paid by a Hong Kong resident. Will this always be the case in the limited circumstances that Hong Kong seeks to tax interest income? Based on the earlier analysis, arguably not. There is therefore again potential for a DTA to reduce Hong Kong's tax claim.

¹⁰⁶ *Income Tax Assessment Act 1936* (Cth) s 128B(2).

¹⁰⁷ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 11.

¹⁰⁸ *Income Tax Assessment Act 1936* (Cth).

¹⁰⁹ *Commissioner of Inland Revenue (NZ) v N V Philips Gloeilampenfabrieken* 10 ATD 435; *CIR v Lever Brothers & Unilever Ltd* (1946) 14 SATC 1.

3.3.2 Royalties

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

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

The final point above is something that Australia should consider carefully if it is going to conclude a DTA with Hong Kong and offer a low rate of withholding tax for royalties unconnected to Australian PEs. The reduced tax claim together with Hong Kong's narrow tax base means that a DTA with Hong Kong may create significant treaty shopping possibilities for residents of third countries who can structure their Australian involvement through Hong Kong. This would also mean that Australia would be likely to pay significant attention to anti-treaty shopping and limitation of benefits features in any DTA that it concludes with Hong Kong. It is submitted that Australia should carefully consider whether low rates of withholding tax on passive income under any Hong Kong DTA are desirable.

Hong Kong only makes a limited taxation claim in relation to royalties derived by persons. However, the following analysis indicates that, again, Hong Kong may still

¹¹⁰ *Income Tax Assessment Act 1936* (Cth) s 128B(2B).

¹¹¹ *Austria-Hong Kong Income and Capital Tax Treaty* (2010), Article 12(4).

¹¹² *FCT v United Aircraft Corporation* (1943) 68 CLR 525.

have to curtail its claims in relation to royalties derived by Australian residents if it concludes a DTA with Australia. Under s 15 of the *Inland Revenue Ordinance*, royalties as well as rents for moveable property are deemed to be business profits and sourced in Hong Kong if the property they relate to is used in Hong Kong. However, as outlined above, a DTA would restrict Hong Kong taxation of royalties derived by Australian residents to those paid by Hong Kong residents and those effectively connected to a PE in Hong Kong. This has significant potential to restrict Hong Kong's claim under s 15 in that the use of property in Hong Kong will not always be paid for by Hong Kong residents or be connected with a PE in Hong Kong. There are many possible circumstances where property such as intellectual property may be exploited in Hong Kong without these factors being present. A DTA will therefore restrict Hong Kong's taxation of royalty income. The taxation not collected by Hong Kong will likely be collected by Australia through the worldwide taxing of residents meaning that although taxpayers will have no difference in their total tax burden, Australia will benefit. Unlike with business profits above, royalties are unlikely to be exempt under s 23AH when earned by Australian resident companies as they are viewed as passive income and not entitled to the exemption.

3.3.3 Dividends

The taxation of dividends in Australia and Hong Kong will only be minimally impacted by the conclusion of a DTA. As discussed in Section 1.2, Hong Kong never taxes dividends and therefore there can be no restriction through a DTA. In Australia, dividends that are derived through a PE are taxed by assessment¹¹³ while those that are not are potentially subject to withholding tax. However, franked dividends¹¹⁴ and dividends paid out of conduit foreign income are not taxed under the withholding regime. Conduit foreign income is essentially income earned by Australian companies offshore. The remaining unfranked dividends are subject to a 30 percent withholding tax and it is these that will be impacted by the conclusion of a DTA, with a DTA likely to reduce this rate significantly. The highest rate that is likely to be contemplated is 15 percent while it is possible that a much lower rate or an exemption may be provided if Australia follows the practice of some recently concluded DTAs. A low rate will however raise the possibility of significant treaty shopping opportunities though Hong Kong and Australia would need to consider this very carefully in any treaty negotiation.

In relation to dividends derived through a PE, the DTA would make little difference as Australia now prescribes similar treatment under its domestic law by allowing for assessment of such dividends. There may be minor differences to current treatment in that the DTA definition of a PE is likely to differ from that currently used for Hong Kong residents. Finally, a DTA would prevent Australia's claim tax dividends paid by non-resident companies from profits sourced in Australia. This difficult to enforce claim is currently still made under s 44(1)b of the *Income Tax Assessment Act 1936* but a DTA would prevent any such taxation when Hong Kong residents derive dividends that are not paid by Australian companies. Thus it can be concluded that a DTA will provide some tax benefit to Hong Kong residents that derive dividends that

¹¹³ *Income Tax Assessment Act 1936* (Cth) s 128B(3E).

¹¹⁴ *Income Tax Assessment Act 1936* (Cth) s 128B(3)(ga).

are connected with Australia. Hong Kong would not collect the tax saved through Australia's reduced claim.

Income from real property and from the alienation of real property should be minimally impacted by the conclusion of a DTA between Australia and Hong Kong. A DTA is likely to allow the country where the real property is situated to retain full primary taxation rights over both rents and gains on disposal. As both Australia and Hong Kong are unlikely to exceed this jurisdiction under their domestic rules, this would not be a constraint. Australia generally only taxes gains made on Australian real property and rents from real property in Australia when these are derived by a non-resident. Under its Property Tax, Hong Kong only seeks to tax to rents on Hong Kong real property. It would be expected that gains on the disposal of real property that constitute a business profit would generally only be sourced in Hong Kong or Australia when the property is in the same jurisdiction. However, as noted above, there is the possibility that a business profit in relation to real property may be found to be sourced in one of these jurisdictions despite the fact that the land is not within the jurisdiction. Indeed the *Kwong Mile*¹¹⁵ case suggested such a possibility. In these circumstances a DTA would likely prevent such taxation by either Hong Kong or Australia. Again, the DTA can be seen to bring desirable certainty to inherently flexible common law source rules.

4. CONCLUSION

This article has discussed how a DTA would impact taxation in Australia and Hong Kong. Part 2 provided background and context, by comparing the key features of each country's tax system and then reviewing the DTA policy (including DTA history) of both countries. The strong trade and investment relationship between the two jurisdictions was established, increasingly the likelihood that a DTA would have a major impact in terms of both benefits and revenue losses. This impact was examined in depth in Part 3, which indicated that a DTA between Hong Kong and Australia would indeed have a significant impact bringing improvement in terms of certainty as well as a reduction in the tax base in many circumstances in both countries. This outcome may come as surprise in relation to Hong Kong given its generally narrow tax base. A major finding of the analysis is that both jurisdictions have a significant degree of uncertainty in their tax bases due to the retention of flexible common law concepts of source and, in Australia's case, residence. Notably, Australia retains these concepts in certain circumstances despite having replaced them in many circumstances with clearer regimes such as the withholding tax regime. This finding indicates that Australia and Hong Kong should consider the appropriateness of the retention of these tests in an increasingly global business and social environment that exacerbates the uncertainty in these concepts.

There is no doubt that the conclusion of a DTA would significantly reduce the tax claims of both Australia and Hong Kong. In Australia's case, the impact a DTA would have on the residence of taxpayers would need to be seriously contemplated due to the possibility of a very significant loss of revenue. A discussion of Australia's DTA history highlights the fact that the potential loss of revenue may be an impediment to entering into a DTA. Australia would also see its tax base reduced in relation to business profits and royalties. Hong Kong would have its tax base curtailed through a

¹¹⁵ 7 HKCFAR 275.

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

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

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

C. John Taylor*

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.

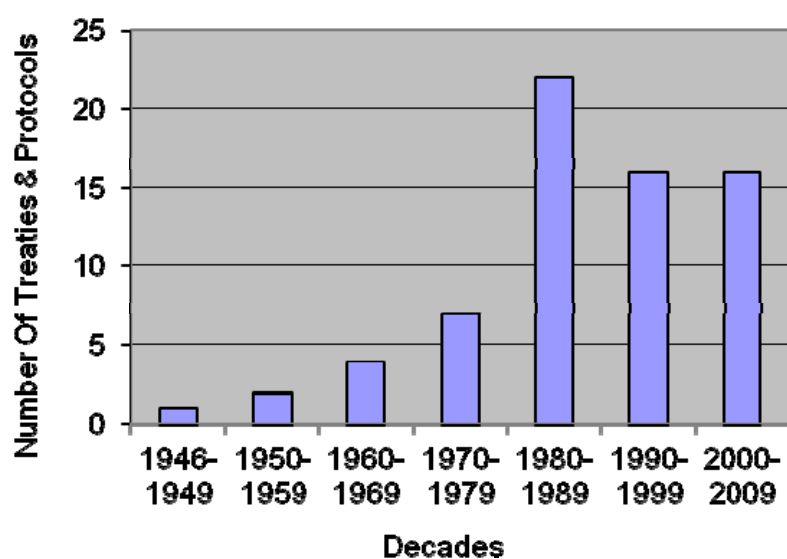
Chart 1: Australian treaties and protocols by decade

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

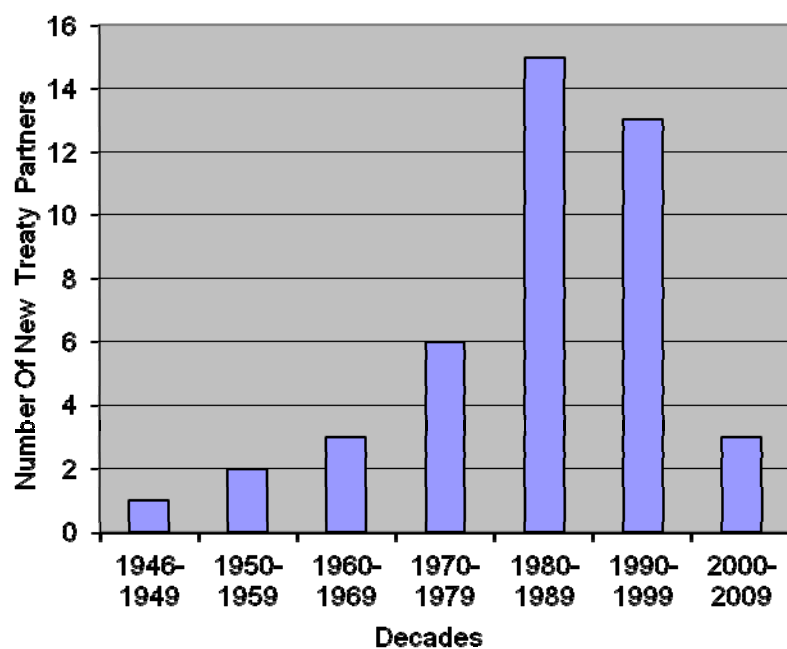
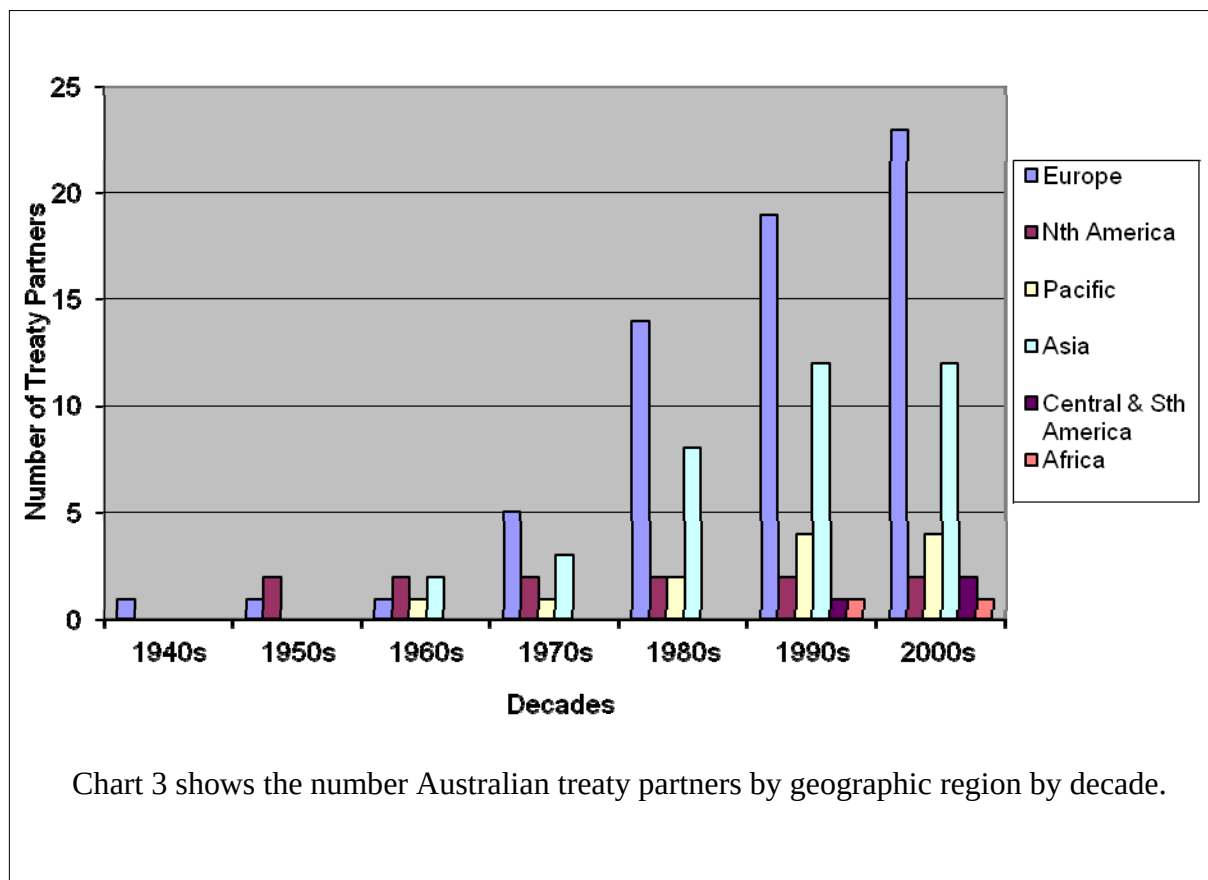
Chart 2: Australian new treaty partners by decade

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 Thiruchelyum. 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.

Recent changes in international taxation and double tax agreements in Russia

Evgeny Guglyuvatyy*

1. INTRODUCTION

The Russian Federation inherited a confusing and inefficient tax system after the breakup of the Soviet Union in 1991. However since then, the Russian tax system has been significantly reformed. In the 1990s, businesses and individuals were generally reluctant to pay taxes promptly, if at all.¹ The restructuring of the tax system was designed to rationalise the tax burden, improve the collection of taxes, and to generally align the system with those in developed market economies.

There are three levels of taxation in Russia: federal, regional and local. Major tax reform commenced in 1999 and resulted in a reduction of the number of official taxes from over 200 to approximately 40, in addition to setting out the administrative framework for the new system.² Currently, the principal taxes collected at the federal level are corporate tax (20% on worldwide income),³ capital gains tax,⁴ personal income tax (13% flat tax),⁵ social contribution taxes,⁶ value added tax (VAT) (standard rate 18%),⁷ excise taxes, securities tax (0.8% on nominal value), customs duties and fees, and federal license fees. The tax administration has constantly been improved which, in recent years, has resulted in tax revenue growth at almost 30 percent annually.⁸

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¹ For example, in 1996, 26 tax collectors were killed, six were kidnapped, and 41 had their homes burned down. In the first half of 1997, the government only collected 57% of its targeted tax revenues. Sodnomova S. K. 2008. Theory and history of taxation. Irkutsk: Publishing BGUEP.

² Panskov V. G. 2006. Tax and tax system of the Russian Federation. Moscow, Book World

³ From 1 January 2009, 2% of this rate is paid to the federal budget and 18% to the regional budgets (previously, the federal portion was 6.5%).

⁴ There is no separate capital gains tax in Russia. Capital gains are taxable as normal business income.

⁵ Income tax rate for non-residents is 30% (flat rate).

⁶ Social contribution are payable in connection with employee salaries by employers to the state pension, medical insurance and social insurance funds (34 % starting on January 1, 2011).

⁷ A 10% VAT rate is applied to food products, children's goods, and printed materials, such as schoolbooks.

⁸ Rosstat (Russian federal service of government statistics). Available at: <http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/finance/>

In the international context, the Russian tax code provides double taxation relief by way of a tax credit for foreign taxes paid on foreign sourced income, subject to a limit equivalent to the maximum sum of Russian tax payable on the same income. Any excess foreign tax credits may not be transferred to future or previous periods. Russia is also a party to a number of double taxation agreements (DTA) with various countries. In general terms, it is rather unproblematic to repatriate capital (particularly dividends, interests and royalties) from Russia to other countries. Similarly, it is relatively simple to invest in the Russian economy through low-tax countries (or tax havens – also referred to as ‘offshore zones’ in Russia)⁹ and international holding, financial, licensing and service companies and banks.⁹ The largest part of foreign direct investment (FDI) inflow comes from countries which have favourable tax treaties with Russia. Popular locations of offshore companies utilised when conducting international business with Russia include Cyprus, Holland, Switzerland, Luxembourg and the British Virgin Islands. However, the Russian government is currently attempting to tighten the tax law and in this vein, has been updating international tax law and the existing DTA network.

2. DOUBLE TAX AGREEMENTS

From 1970 until 1991, the USSR developed a DTA network including DTAs with India, Finland, Malaysia, the Netherlands, Denmark, Japan, France, the UK, Canada, Spain, Italy, Cyprus, Germany, Sweden, Austria and the USA.¹⁰ However, since there were (almost) no cross-border private businesses, the application of these treaties was relatively low. After the Soviet era, Russia became party to a number of DTAs, and has continued to extend its DTA network vigorously since then.¹¹ For example, in 1997, Russia had DTAs with 37 countries (including those inherited from the USSR),¹² and by 2010, had increased this number to 77.¹³ This includes DTAs with most European countries, Australia, China, the USA, Canada, Japan, India, and other countries important economically and politically.¹⁴

With some deviations, the treaties of the USSR resembled the Organisation for Economic Cooperation and Development (OECD) or United Nations (UN) model tax treaties of the time.¹⁵ The tax treaties to which the former USSR was a party are honoured by Russia, unless the other party to the treaty has rejected it. The Russian Tax Treaty Model (RTTM) was accepted in 1992 and in general follows the OECD model of that time.¹⁶ By and large, with some exceptions, Russian DTAs have been based on the updated OECD model. This approach corresponds to the general route of the country to join main international economic organisations, including the OECD. It is essential to emphasise that DTAs concluded by Russia with other jurisdictions are an integral part of domestic tax legislation. Russian tax law clearly indicates that if a

⁹ Zhidkova E. Y. 2009. Taxes and taxation. Moscow. Eksmo.

¹⁰ Sodnomova S. K. 2008, above n 1.

¹¹ Panskov V. G. 2006, above n 2.

¹² International Conventions of Russia. Available at: <http://www.taxpravo.ru/zakonodatelstvo/90278-int>

¹³ Panskov V. G. 2006, above n 2.

¹⁴ International Conventions of Russia, above n 12.

¹⁵ Sodnomova S. K. 2008, above n 1.

¹⁶ Resolution of the Government of the Russian Federation of 28 May 1992, No. 354, “On Conclusion of Inter-Government Tax Treaties on Avoidance of Double Taxation of Income and Capital”.

DTA provides other regulations than the law itself, the regulations of the DTA will prevail.¹⁷ Hence, it is of no surprise that tax treaties significantly influence Russian domestic tax law and fiscal authorities frequently rely on DTA provisions.

2.1 Residency

The relatively large number of DTAs concluded has forced the Russian fiscal authorities to embark upon the problems connected with the application of some their provisions. One of the major issues in the international taxation context relates to concept of residency. The key criterion of fiscal residency (for corporations) in Russia is the place of incorporation. The notion of a Russian/non-Russian tax resident for corporate tax purposes is at present not defined under domestic tax law. Despite the lack of definition, Russian tax law does distinguish between domestic and foreign enterprises. Domestic enterprises are those which are established under the laws of Russia and are taxed on their worldwide income. Foreign enterprises controlled and managed in Russia are subject to tax on profits derived from business activities carried on through a permanent establishment in the Russian Federation. Despite the fact that Russia is not an OECD member state, the definition of permanent establishment under Russian domestic law¹⁸ broadly follows the permanent establishment concept provided in the OECD Model Convention. Generally, foreign companies may have certain advantages in conducting business activities in Russia through a permanent establishment. Contrary to a Russian company, after-tax profit distributions from a permanent establishment to the head office of a foreign company are not subject to dividend withholding tax.¹⁹ Further, currently Russian “thin capitalisation rules” apply to resident borrowers only. This makes a permanent establishment an attractive form of business structure to enter the Russian market.

When determining profit attribution to a permanent establishment, the domestic tax code stipulates the indirect profit allocation method as a general rule. However, the majority of Russian DTAs use the direct profit allocation method. ‘Force of attraction’²⁰ clauses are present in a small number of tax treaties (with Indonesia, Kazakhstan, the Philippines, and Vietnam) but lacking in treaties with key investment and trade partners (the US, the UK, Cyprus, France, Germany, and the Netherlands). As noted above, international treaties prevail over the domestic law. For that reason, if a permanent establishment of a foreign enterprise utilises the direct profit allocation method, it cannot be forced to use the indirect method unless a relevant DTA stipulates the use of the indirect method.

Notwithstanding the Tax Code allowing the application of the indirect method, the Russian Tax Ministry recommendation²¹ stated that the attribution of a foreign enterprise’s profits to its Russian permanent establishment shall be founded on the relevant principles in DTAs. That is, the permanent establishment’s profit is

¹⁷ Russian Tax Code, Article 7. Available at: <http://www.info-law.ru/kodeks/12/>

¹⁸ Russian Tax Code, Article 306. Available at: <http://www.info-law.ru/kodeks/12/>

¹⁹ Polezharova L., A Permanent Establishment of A Foreign Company, Russian Tax Courier, May 2003.

²⁰ Generally, ‘force of attraction clause’ implies that one State may tax the business profits arising to a resident of the other State by virtue of a PE in the first state or otherwise.

²¹ Order of the Tax Ministry, No. BG-3-23/150, of 28 March 2003 “On Approval of the Methodological Recommendations for Tax Authorities on the Application of Certain Provisions of Chapter 25 of the Tax Code of the Russian Federation Taxation of Foreign Organisations”.

considered to be a profit made by a separate and independent enterprise. This resemblance between domestic law and the OECD Model illustrates that tax treaties have served as a conduit and influenced the development of Russian domestic tax law on the matter. This situation represented the first time a DTA principle has been officially recognised in domestic law. As a result, this DTA principle is now applied regardless of whether there is a DTA in existence.

2.2 Beneficial ownership

Recently, the Russian fiscal authorities have started focusing on tax avoidance issues involving the use of DTAs. One of the major issue in this context is treaty shopping. The notion of treaty shopping may be defined as an activity where a resident of a third country seeks to gain the benefit of a DTA between two other countries by establishing an entity in one of the countries that is a party of the DTA. Importantly, the unique difference between a 'treaty shopper' and an ordinary business is that in the instance of treaty shopping, economic ties linking the taxpayer and the treaty state are inadequate. In other words, the treaty shopper's occurrence in the treaty country lacks economic substance.

Clearly, treaty shopping is considered offensive to the spirit of tax law. As a result, a number of measures have been developed in international tax law to avert or reduce treaty shopping practices. The beneficial ownership concept is one such mechanism. Fundamentally, the beneficial ownership concept requires taxpayers to demonstrate genuine economic control over the income received so as to obtain the benefits under the DTA. The beneficial ownership mechanism mostly affects passive income, that is, dividends, interest and royalties.

Most Russian DTAs, as noted above, follow the OECD Model, and thus include the beneficial ownership concept. Nonetheless, the concept is rarely applied in practice, even though many Russian businesses utilise low-tax jurisdictions to reinvest their capital in Russia. Sporadically, Russian fiscal authorities have attempted to apply the beneficial ownership concept, but the impact on the business activities of both Russian and foreign investors were rather limited.²² Recently however, the Russian President ordered the government to develop measures counteracting treaty abuse. Following this order, the Finance Ministry proposed amendments to Article 7 of the Russian Tax Code concerning eligibility for treaty benefits.²³ Specifically, under the proposed amendments, the beneficial owner of certain Russian source income must be determined in order to receive benefits under a DTA. Formally, these amendments aimed to structure the legislative mechanisms necessary to counteract the exploitation of DTAs by the final beneficiary which is not a resident of either of the countries that is a party of the DTA. The amendments to Article 7 would essentially introduce the concept of beneficial ownership to Russian domestic law. However, the proposed provisions do not specify the criteria and mechanism to identify a foreign company as the beneficial owner.²⁴

²² Zhidkova E. Y. 2009, above n 9.

²³ The draft federal law "On Amending Part I of the RTC for Counteracting Treaty Shopping when Carrying out Operations with Foreign Companies and Individuals" prepared by the Russian Ministry of Finance, in accordance with paragraph 39 of the Russian President's Budget message 2009.

²⁴ Ibid.

As noted above, a number of DTAs concluded by the Russian Federation include requirements to apply preferential withholding tax rates to dividend, interest and royalty payments only if they are being paid to the actual beneficial owners (see for example, the payment of dividends under the Russia – Cyprus DTA). However, the treaties do not specify a mechanism to facilitate the identification of the actual beneficial owner of certain income. Therefore, the proposed amendments to Article 7 of the Russian Tax Code would not solve the problem. Some jurisdictions adopt a mechanism and specific criteria in domestic law for identifying beneficial ownership status. For example, in the US, the beneficial ownership test is rather extensive: questionnaires must be completed and information provided on the foreign income beneficiary. The Russian tax authority is likely to apply the OECD approach, suggesting that a company cannot be regarded as the beneficial owner if it acts as an agent, nominee or a ‘conduit’ company for another person, who is the actual recipient of the benefit.²⁵ However, OECD principles are not mandatory in Russia which could easily lead to ambiguous interpretation of the amendments to Article 7.

The Russian fiscal authorities are also likely to experience difficulty obtaining information on the identity of the ultimate beneficiary of dividends, interest and royalties. Hence, the proposed amendments would be of limited assistance to the Russian government in combating tax avoidance and treaty shopping. Instead, the Russian government should introduce an explicit regulation specifying the beneficial ownership test. This regulation should not be subject to the discretion of the tax authorities. However, even if the current proposal is significantly improved in Russia, it may take more than one amendment to create the necessary legislative structure. As at November 2011, the amendments to Article 7 of the Tax Code have not been submitted to the State Duma (Russian Parliament), and it is therefore unclear when the draft law will be enacted. For the time being, the Russian fiscal authorities have to rely on tax treaties to counteract treaty shopping.

3.0 TAX AVOIDANCE AND DTAs

In many OECD countries, fiscal consolidation practices, controlled foreign corporation (CFC) rules and transfer pricing legislation all aim to restrain the use of offshore international financial centres (OIFCs). Generally, these mechanisms counteract tax avoidance practices such as retaining untaxed profits in the taxpayer’s foreign subsidiaries, pricing international sales in an attempt to maximise profits in low-tax countries, and mixing foreign profits and losses in the taxpayer’s home jurisdiction to reduce tax payments. Such anti-avoidance mechanisms are immature in Russia. For example, there are no general anti-avoidance provisions in Russian tax law. Further, there are no CFC rules, tax consolidation is restricted to very limited circumstances and the transfer pricing regulations are ineffective, although new regulations may be introduced in 2011-2012.²⁶ Russian courts have attempted to

²⁵ OECD Model Tax Convention on Income and Capital 2010, Commentary to Article 10/12 and Art. 11/4.

²⁶ In 2010 the Russian Ministry of Finance proposed a draft law on transfer pricing. The key amendments include the introduction of: 1) an “arm’s length” concept (the existing rules are based on more than a 20 % deviation from market prices); 2) “functional analysis” as a key method for defining which transactions are relevant for comparison purposes; 3) the option of “advance pricing agreements” with the tax authorities, to avoid disputes and increase certainty and some other important amendments. Additionally, a consolidated group treatment is proposed to allow corporate groups to consolidate

combat tax avoidance through the development of the so-called ‘unjustified tax benefit’²⁷ concept. However, there are no structured administrative or legal regulations concerning the application of this concept and other anti-avoidance provisions to tax treaties.

As already mentioned, Russian investors often utilise OIFC companies for business activities in Russia or abroad. Normally, foreign asset income will be locally taxed but profits collected by the OIFC company may linger untaxed as a result of the lack of CFC regulations, given that they are not repatriated to Russia. Similarly, the indulgent Russian transfer pricing rules permit a large amount of the profit inbuilt in the imported goods to be collected by an intermediate OIFC company. Furthermore, if a Russian investor reinvests capital to Russia²⁸ through an intermediary company in one of the OIFCs that has a favourable DTA with Russia, the remittance of Russian profits, royalties or interest will be taxed at a minimum level. It is not surprising then, that in the 1990s many Russian banks set up branches in Cyprus, in support of schemes to expatriate Russian capital and profits. Subsequently, the Netherlands, Luxemburg, Malta and Gibraltar became popular for the same reasons.²⁹ Nowadays, Russian holding companies are established in a wide range of OIFCs.

An investor from one of the countries that has a DTA with Russia may invest directly in Russia, and rely on the DTA to diminish Russian withholding taxes on dividends, interest or royalties. Typically, withholding tax rates are in the range of five to 15 percent on dividends, and zero to ten percent on interest or royalties. Examples of OIFC countries that have DTAs with Russia include Cyprus and Luxembourg. Under the Russian-Cyprus DTA, the rate of withholding tax on dividends is five percent if the investment was greater than US\$100,000 and ten percent if not, whereas the rates for interest and royalty payments are zero.³⁰ Under the Russia-Luxemburg DTA, the rate of withholding tax on dividends is ten percent for a greater than 30 percent ownership of the company paying the dividend, and 15 percent in all other cases. The withholding tax rates on interest and royalty payments is zero. Generally, Cyprus and Luxembourg are not high tax jurisdictions. Moreover, if a non-resident is a beneficial owner of the holding company he is not taxed at all in these countries. Thus, it is no surprise that Cyprus appears to be a very popular place to establish a holding company for Russian businesses.

profits and losses earned by different subsidiaries. For the detailed discussion see: Variychuk, E. 2011. Russia – In Search of Effective Regulation: Draft Bill on Transfer Pricing. *Bulletin for International Taxation* Vol. 65 (2).

²⁷ The ‘unjustified tax benefit’ concept means that tax benefits (tax deductions, tax refunds or lower tax rates) may be rejected if application of those benefits is the only or one of the main reasons of the activities of a taxpayer.

²⁸ At present, many Russian companies reinvest capital to Russia.

²⁹ For example, only in January and February of 2011, a net outflow of capital from Russia amounted to US\$ 17 billion. *Vedomosti*, 16 March 2011. Available at: http://www.vedomosti.ru/finance/news/1232209/iz_rossii_prodolzhaet_utekat_kapital

³⁰ Agreement between the Government of the Russian Federation and the Government of the Republic of Cyprus from 05.12.1998 on “The Avoidance of Double Taxation with Respect to Taxes on Income and on Capital” Available at: http://www.taxpravo.ru/zakonodatelstvo/statya-90420-soglasenie_mejdu_pravitelstvom_rf_i_pravitelstvom_respubliki_kipr_ot_05121998

As noted above, the Russian government is attempting to update domestic tax law to counteract tax avoidance. Also, more anti-abuse provisions have been included in the more recent Russian tax treaties. Such provisions can be seen in the Russia-Cyprus DTA, and it is therefore worth discussing this treaty in greater detail.

3.1 Russia-Cyprus DTA

The DTA between Russia and Cyprus was signed in 1998.³¹ This DTA was one of the major causes of the massive flow of Russian investment through the Mediterranean island in the past two decades. Cyprus is a leader in terms of investments in Russia. At the peak of investment in 2008, Cyprus' investments in Russia reached US\$56.9 billion.³² This represents more than 20% of all foreign investments in Russia.³³ Most of these investments, however, are repatriated Russian capital.

The Cyprus Government was successful in building a favourable offshore tax regime, with nearly 50,000 offshore companies being registered in Cyprus since 1975.³⁴ Nevertheless, in 2004, Cyprus joined the European Union (EU) which signified a reform of their tax regime. Cyprus has the lowest corporate tax in the EU, with resident companies paying ten percent tax. (This is similar to non-resident companies, but income from foreign sources is exempt for non-residents).³⁵ Interestingly, Cyprus has signed DTAs with many OECD states (around 50 in total) including major high-tax countries.³⁶ This is unusual for an offshore financial centre and distinguishes Cyprus as a convenient place for establishing holding and investment companies intended for developing markets.

Many large Russian businesses utilise Cyprus holding companies in some way.³⁷ For example, Aleksei Mordashov controls Severstal³⁸ through the Cyprus company Frontdeal Ltd. Another Russian oligarch, Viktor Rashnikov, holds 87 percent of the shares of MMK³⁹ through two Cyprus companies – Mintha Holding Ltd and Fulnek Enterprises Ltd. Realising that businesses often use Cyprus companies in tax structuring arrangements, the Russian government added Cyprus to a 'blacklist' in 2008, on the basis that it was an 'uncooperative territory'.⁴⁰ The black list was introduced through an amendment to the Russian tax code.⁴⁰ It provides a tax

³¹ Ibid.

³² Rosstat (Russian federal service of government statistics)

<http://www.gks.ru/wps/wcm/connect/rosstat/rosstatsite/main/enterprise/investment/foreign/index.html>

³³ Ibid.

³⁴ Cyprus Company Formation. Available at:

<http://www.ukincorp.co.uk/s-O8-offshore-cyprus-company-formation.html>

³⁵ Ibid.

³⁶ Ibid.

³⁷ Zaharov A. 2009. How Cyprus will exchange of tax information? Available at:

http://www.taxpravo.ru/analitika/statya-72030-kak_kipr_budet_obmenivatsya_nalogovoy_informatsiey

³⁸ Sverstal is a Russian steel and mining company. As of 2009, it is the largest steel company in Russia according to the Metal Bulletin. Severstal revenue in 2009 was US\$ 13.01 billion.

³⁹ MMK is abbreviation for Magnitogorsk Iron and Steel Works company. MMK produced 21.8 million tonnes of steel and steel products in 2010. MMK revenue in 2009 was US\$ 5.081 billion.

⁴⁰ The list was published on June 18, 2007 and included 59 jurisdictions, such as the offshore Caymans, Maldives, British Virgin Islands and others countries. Similar list was earlier issued by the Bank of Russia (Directive 1317-Y of the Bank of Russia of August 7, 2003).

exemption on the repatriation of dividends from foreign subsidiaries of Russian businesses, but excludes Russian subsidiaries founded in countries on the blacklist. Some countries, (for example, Ireland, Luxembourg and Switzerland), lobbied the Russian government and were excluded from the blacklist.⁴¹ However, Cyprus continually failed to provide information to the Russian tax authorities and thus has stayed on the blacklist.

In April 2009, Russia and Cyprus initiated a revision of double taxation treaty, with the amending protocol to the Russia-Cyprus DTA⁴² signed during a visit to Cyprus by Russian President Dmitry Medvedev in October 2010. The Russian President suggested that the new protocol would provide business transparency and confirmed that Cyprus would be removed from the Russian blacklist. The importance of this DTA for Russia necessitates exploring the treaty amendments to identify its major developments.

3.1.1 Amendments to the Russia – Cyprus DTA

The new protocol to the Russia-Cyprus DTA is intimately in line with the latest version of the OECD Model and commentaries thereto. Several protocol provisions are especially significant for the development of the Russian international tax regime. One of the key developments is that the term ‘permanent establishment’ (Article 5) was further clarified in the protocol to the DTA.⁴³ The term was extended by including the following supplementary conditions:

- provision of services through an individual, if such individual is present in Russia for more than 183 days during any 12-month period, and income from such services constitutes more than 50% of the Cyprus company’s income from active business activities during the relevant period; or
- provision of services, in respect of one or connected projects, through one or more individuals, for a period exceeding 183 days (in aggregate) during any 12-month period.⁴⁴

The Russian fiscal authorities, like many other countries, want to increase their revenues. However, instead of increasing the tax base of Russian companies that pay management fees to Cypriot companies, the protocol redefines fees earned by Cypriot companies for the provision of management services as Russian sourced income. According to the protocol, a Cypriot company cannot provide management services if they lack the presence of representatives in Russia. Hence, a Cypriot company providing management services and charging the relevant fees to a Russian company is considered to have a representative in Russia, and thus having a permanent establishment in Russia. In other words, the protocol specifies that the provision of

⁴¹ Zhidkova E. Y. 2009, above n 9.

⁴² Protocol to the Agreement between the Government of the Russian Federation and the Government of the Republic of Cyprus on the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital Available at:

<http://www.taxpravo.ru/zakonodatelstvo/statya-90417->

[protokol_k_soglasheniyu_mejdu_pravitelstvom_rossiyskoy_federatsii_i_pravitelstvom_respubliki](http://www.taxpravo.ru/zakonodatelstvo/statya-90417-protokol_k_soglasheniyu_mejdu_pravitelstvom_rossiyskoy_federatsii_i_pravitelstvom_respubliki)

⁴³ Ibid.

⁴⁴ Ibid.

management services gives rise to a permanent establishment in Russia. This is a novel provision for Russian DTAs, and implemented specifically to increase permanent establishment exposure. Additionally, the 183 days test relates specifically to presence and not provision of services, meaning the provision of services for less than 183 days may be sufficient to create a permanent establishment. However, it is surprising that the wording of the protocol does not cover Cyprus companies with managers based in Russia.

Another important amendment to the Russia – Cyprus DTA concerns the taxation of income from immovable property (Article 6).⁴⁵ Tax structuring has frequently involved utilising mutual funds for property investments.⁴⁶ Article 10 of the DTA has been amended, and provides that payments on shares of ‘mutual funds or similar forms of collective investment’⁴⁷ shall be treated as dividends and, consequently, are subject to either five or 10 percent Russian withholding tax. The amendments to Article 6 specify that income of mutual funds ‘investing only in immovable property’ shall be treated as income from immovable property and, as a result, subject to 20% Russian withholding tax. Apparently, the intention of the Russian fiscal authorities is to characterise such income as income derived from immovable property. In this case, Article 6 rather than Article 10 is applied and income distributed by Russian real estate mutual funds to Cypriot investors is subject to 20% withholding tax in Russia. Nonetheless, the protocol does not provide clear definitions of mutual funds or similar forms of collective investment and whether income from Russian real estate mutual funds will fall within the scope of income from immovable property.⁴⁸ Thus, the scope of these amendments will need to be further clarified by the fiscal authorities of the DTA parties.

The amendment to the taxation of income from international traffic (Article 8) corresponds to that in the OECD Model Tax Convention. Under the previous version of the DTA, income from international traffic (by ships, aircrafts or road vehicles in certain circumstances) was exempt from Russian withholding tax if the recipient was a resident in Cyprus. The Amended version of the DTA stipulates that the recipient of such income is exempt only if they have their place of effective management in Cyprus.⁴⁹

The protocol has also broadened the definitions of dividends (Article 10) and interest (Article 11). The dividend taxation regime has been extended to:

- income from depositary receipts (though it is not clear if this means income received by the nominee holder of shares or income received by the beneficial owners of shares);
- any payments on shares of mutual investment funds or similar collective investment vehicles, and

⁴⁵ Ibid.

⁴⁶ Zaharov A. 2009, above n 37.

⁴⁷ Protocol to the Russia-Cyprus DTA, above n 42.

⁴⁸ Protocol to the Russia-Cyprus DTA, above n 42.

⁴⁹ Protocol to the Russia-Cyprus DTA, above n 42.

- interest which, in accordance with domestic laws of the source State, is treated⁵⁰ as dividends.

The new amendments imply that income from mutual funds or similar investment vehicles will be deemed to be dividends (with the exception of income from such mutual funds investing only in immovable property as discussed above). This amendment also clarifies the question as to whether interest deemed as dividends under Russian tax law should still qualify as interest under the DTA or whether the treaty should follow the domestic law characterisation.⁵¹ However, it is not clear whether other Russian DTAs will be amended to overcome the above ambiguity. Further, interest income would continue to enjoy an exemption from withholding tax. However, this exemption does not apply to interest which constitutes a constructive dividend under Russian thin capitalisation rules.⁵² The definition of interest has been extended to embrace interest on profit-participating loans, premiums and prizes associated with government securities, bonds and debentures. Nevertheless, penalty charges for late payment are not included in the definition of interest and are therefore likely to be considered as 'business profits' or 'other income'.

A further significant amendment relates to the taxation of gains from the alienation of property (Article 13).⁵³ Specifically, the rules on the taxation of capital gains were modified in accordance with the OECD Model Tax Convention. According to the protocol, income from the alienation of shares deriving more than 50 percent of their value from Russian real estate is subject to 20 percent Russian withholding tax. However, in the following three cases, there is an exemption from Russian withholding tax:

- alienation of shares in the course of corporate reorganisation;
- alienation of shares listed on a recognised stock exchange; and
- alienation of shares by a pension fund, a provident fund or the government of Cyprus.⁵⁴

A similar provision for the alienation of shares exists in the Russian Tax Code.⁵⁵ However, that provision does not specify the mechanism of paying withholding tax for a non-resident company that is lacking a presence in Russia. Further, the provision does not cover the indirect possession of Russian immovable property through a chain of Russian or Cypriot companies. It also excludes the alienation of interests in a Cypriot business holding more than 50 percent of immovable property assets in Russia and owned through a branch. As a result, this amendment appears to focus on direct

⁵⁰ Protocol to the Russia-Cyprus DTA, above n 42.

⁵¹ This approach was confirmed by Russian arbitration court in the cases involving the tax treaties with Germany and the Netherlands. See Decision of the North-Western Federal District Arbitration Court No. A 6-19 78/2006 of 9 April 2007 and Decision of the Moscow Federal District Arbitration Court No. KA-A 0/6616-0 of 2 July 2005.

⁵² Russian Tax Code. Article 269(2). Available at: <http://www.info-law.ru/kodeks/12/>

⁵³ According to the previous version of Article 13 of the DTA, income of Cyprus companies from the sale of shares in Russian companies is exempt from Russian tax.

⁵⁴ Protocol to the Russia-Cyprus DTA, above n 42.

⁵⁵ Russian Tax Code. Article 214 (1). Available at: <http://www.info-law.ru/kodeks/12/>

real estate ownership structures only and is unlikely to affect indirect holdings. These loopholes may be addressed in the future, considering that this provision will not come into effect until January 1, 2014 at the earliest. This delay is intended to allow Russia to adjust its current DTAs with other countries.

Other amendments to the Russia-Cyprus DTA that are worthy of discussion include Articles relating to mutual agreement, exchange of information, and reciprocal assistance. According to Article 4 of the, the resident status of a company is to be defined by its place of management (the tax residency criterion in Cyprus) or place of registration (the tax residency criterion in Russia).⁵⁶ Thus, if the company is a tax resident of both States, the place of effective management is a key factor to determine residency. The protocol has introduced a mutual agreement procedure (Article 25) in the case that the place of effective management cannot be determined.⁵⁷ However, it appears that the protocol wording does not specify the mutual agreement procedure for a situation where one state questions whether the place of effective management was the other state. The introduction of a mutual agreement procedure is still a positive development, as taxpayers are now allowed to present their case to the fiscal authority⁵⁸ of either State within three years if they believe that a state is in breach of the DTA. The previous version of the DTA permitted a taxpayer to apply only to the fiscal authority of the state where he was a resident.

Another key provision of the DTA is the exchange of information article (Article 26).⁵⁹ Article 26 uses the identical wording as the OECD Model Tax Convention. Similar amendments were also introduced to Russia's DTAs with the Czech Republic and Germany (in effect from 1 January 2010).⁶⁰

Specifically, the adjustments to the provision on exchange of information are:

- information exchanges are no longer limited to taxes covered by the DTA;
- information requests are permitted where it is 'necessary for carrying out the provisions of the agreement', and also where it is 'foreseeably relevant' for the 'administration and enforcement of domestic laws';
- information requests would need to be processed, even where the requested information is held by a bank, nominee or a person acting in an agency or fiduciary capacity or relates to the identity of the owners of the company.⁶¹

The revised provision broadens the scope of information that can be requested. In particular, either State may request information concerning taxes not only covered by the DTA (as provided in the previous DTA) but also information concerning domestic taxes. A state is obligated to provide information even though it 'may not need such information for its own tax purposes'.⁶² These amendments demonstrate the increasing

⁵⁶ Protocol to the Russia-Cyprus DTA, above n 42.

⁵⁷ Protocol to the Russia-Cyprus DTA, above n 42.

⁵⁸ Protocol to the Russia-Cyprus DTA, above n 42.

⁵⁹ Protocol to the Russia-Cyprus DTA, above n 42.

⁶⁰ These DTAs are available at: <http://www.taxpravo.ru/zakonodatelstvo/90278-int>

⁶¹ Protocol to the Russia-Cyprus DTA, above n 42.

⁶² Protocol to the Russia-Cyprus DTA, above n 42.

attention of the Russian fiscal authorities to the factual substance of Cypriot companies. Some commentators suggest that the basis for this exchange of information was the newly revised legislation of Cyprus, including the law ‘On the Assessment and Collection of Taxes’.⁶³ The new Article 26 also provides that both States should follow procedures of collecting information in accordance with their domestic laws. According to the Cypriot Law the Director of the Inland Revenue should provide information to the other State only if foreign fiscal authorities have provided extensive details about the taxpayer along with the justification for the request of information.⁶⁴ This clause exists to prevent foreign fiscal authorities from engaging in ‘fishing expeditions’ lacking any genuine evidence against the concerned taxpayer.⁶⁵ In relation to Russia, it is not clear how the exchange of tax information with other jurisdictions will be performed in practice since, at present, there are no appropriate arrangements in the Russian tax authorities’ systems.⁶⁶

A further appealing aspect of the new Russian-Cyprus DTA is the development of the institution of reciprocal assistance in tax collection (Article 27).⁶⁷ The scope of assistance in the collection of taxes will be extended to allow tax authorities to verify the legitimacy and amount of the tax requirements of one State in the courts and administrative bodies of another State. The request for assistance in collection however, may be refused on various grounds - for example, if the requested measures are contrary to the domestic laws of a State. The new version of Article 27 enters into force as soon as the appropriate legal foundation is implemented by Cyprus.⁶⁸

The Russian fiscal authorities are aware that a number of Russian taxpayers use Cypriot companies for tax avoidance, but until now they rarely challenged DTA benefits on these grounds. A new provision on the limitation of benefits (Article 29) provides a mechanism to combat treaty shopping. Similar provisions are quite widespread in international tax practices. For example, many US DTAs include a limitation of benefits provision, but there are only a few of its kind in the Russian DTA network. The Australia-Russia DTA is one of these, containing a limitation of benefits clause in Article 23. The new provision implies that a treaty benefit will not be granted to a resident of a Contracting State if the competent authorities of Russia and Cyprus establish that “the main purpose or one of the main purposes of the creation or existence of such resident was to obtain the benefits under this Agreement that would not otherwise be available”.⁶⁹ The scope of application of this article is somewhat limited: it will only be applicable to companies that are registered outside of a contracting State. However, the provision applies to companies that establish a tax residency in Cyprus (that is, a company that has its place of management and control in Cyprus).

⁶³ Zaharov A. 2009, above n 37.

⁶⁴ Ibid.

⁶⁵ Ibid.

⁶⁶ The Department of International Cooperation and Information Exchange at the Federal Tax Service of Russia used to deal with the exchange of information requests but as a result of restructuring of the tax service it was suspended.

⁶⁷ Protocol to the Russia-Cyprus DTA, above n 42.

⁶⁸ Zaharov A. 2009, above n 37.

⁶⁹ Protocol to the Russia-Cyprus DTA, above n 42.

Interestingly, Article 29 is not meant to apply to resident individuals. Rather, this provision appears to target corporate tax residents of Cyprus that were incorporated elsewhere and afterward acquired tax residency in Cyprus by moving their place of management and control. In this context it is worth noting that there is Russian case law dealing with non-Cypriot incorporated residents that have effectively claimed benefits under the DTA.⁷⁰ These structures are considered to be offensive by the Russian fiscal authorities and consequently, it is logical that this provision target identical arrangements.

It is also worth noting that a probable rejection of DTA benefits can only arise as a result of mutual agreement between Russia and Cyprus about the offensive character of the exploitation of tax residence in the case in question. This approach differs considerably from the approach taken in other Russian DTAs. For instance, the Russia–US DTA provides certain criteria for the availability of treaty benefits and the taxpayers can only apply to the fiscal authorities to confirm that these criteria are applicable in their particular cases. Additionally, Article 29 does not specify the applicability of the DTA where the fiscal authorities of Cyprus and Russia disagree in a certain case. A taxpayer may be deprived from the DTA benefits only if the fiscal authorities of both countries regard the taxpayer's case to be offensive. Consequently, neither DTA party may invoke this provision unilaterally, which critically limits the application of Article 29.

4.0 CONCLUSION

Russian international tax law may be characterised as rather fractional and curtailed. However, the Russian tax system is in the process of reform, and recent updates in the rules related to tax avoidance as well as provisions preventing misuse of tax treaties represent a positive advancement. Unfortunately, the proposed draft regulation integrating the beneficial ownership concept into Russian tax law is not comprehensive enough to cover all the related issues. The proposed amendments will provide little assistance to the Russian government in combating treaty shopping and tax avoidance in the international arena. Clear guidelines and procedures should be set out instead, with comprehensive regulations specifying a mechanism and criteria for the beneficial ownership test. Without the introduction of such regulations, and imposing a legal responsibility on individuals for the reliability of disclosed information, international tax schemes will not be eliminated. Nonetheless, this draft law and other observed efforts of the Russian government represent the ongoing shift to the 'substance over form' standard in Russian domestic and international tax law.

It is debatable that the Russian government has implemented a tougher approach to the applicability of the benefits available under the Russia-Cyprus DTA. The growing level of business activities between the two countries provides reasonable incentives to the Russian authorities to maximise their revenues by extensively restricting the scope of the DTA. However, the discussed loopholes of the protocol considerably weaken this restrictive power. Considering that the ratification of some of the protocol provisions have been delayed, the Russian fiscal authorities should clarify ambiguities

⁷⁰ See, for example, Decision of the Ninth Circuit Arbitration Court of Appeals No. 09AII-1 269/2007-AK of 1 October 2007.

found under the DTAs provisions. This may have a profitable impact on tax revenues. Notwithstanding initial concerns caused by the amendments to the Russia Cyprus DTA, it remains one of the most beneficial Russian DTAs. On the other hand, the amendments clearly indicate that the Russian tax authorities are starting to focus on the actual business rationale behind Cypriot structures. In this sense, the protocol provides Russian fiscal authorities with new instruments to confront tax-driven business structures.