

4 September 2008

INTERNATIONAL TAX AGREEMENTS AMENDMENT BILL (NO. 1) 2008

Second Reading

Mr BRADBURY (Lindsay) (10.29 a.m.) — I rise to add my comments to this debate and to speak in support of the International Tax Agreements Amendment Bill (No. 1) 2008. The bill, once enacted, will implement into Australian law the taxing rights and obligations set out in the convention entered into earlier this year between the Australian government and the Japanese government—the Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

This convention between Australia and another sovereign nation, Japan, is what is typically known as a double tax agreement. These arrangements are not only common for us as a nation to enter into but absolutely essential in the context of the global economy that we all now live within. What does a double tax agreement do? Essentially, a double tax agreement, or tax treaty, seeks to allocate taxation rights to the respective jurisdictions. Where gains are derived by individuals or entities, there will always be a desire on the part of a domestic jurisdiction to tax those gains. But in a global economy there needs to be some balancing of the desire of an individual jurisdiction to tax those gains and ensuring that individuals doing business across borders are not being taxed twice by two jurisdictions. A double taxation agreement is about the coming together of two nations to reach some agreement as to how gains derived by individuals and entities in those two contracting states are to be appropriately taxed so that individual taxpayers do not have to pay tax twice.

This is an essential element of having an open trading environment across the globe, and it is on that basis that we enter into many of these agreements on a bilateral basis. In most cases the terms of those agreements override the specific provisions of domestic taxation law in our country. It is worth noting that it is of particular importance in a case such as Japan that Australia modernise and update its arrangements with one of our most significant trading partners when it comes to taxation and our respective obligations and rights to tax individuals in respect of their gains. As a result of that recognition, the government has entered into that agreement and we are now implementing that agreement into domestic law through this bill.

As one of our key trading partners, Japan has been Australia's largest export market for over 40 years, with bilateral merchandise trade totalling \$54.5 billion in 2007. Japan is also Australia's third largest investor, with a total stock of investment worth \$51 billion at the end of 2006. It is also worth noting that Australia is the third largest exporter of food to Japan, and those exports are valued at more than US\$4 million. In trade terms our relationship with Japan is a significant one. But not only do we have a strong relationship in trading terms; we also have a strong relationship at the diplomatic level as fellow international citizens.

A tax treaty is not only about allocating taxation rights between contracting states; it is also about

ensuring that there is some mutual cooperation on stamping out practices that would challenge the integrity of revenue measures within each of those states. An essential part of this bill and the convention that it implements is that it strengthens some of those integrity measures. I think all members of this place would agree that that is a good thing.

I would now like to turn to some of the technical amendments contained within the convention. The new treaty provides that the dividends, interest and royalties paid from one country, which is defined as 'the source country', to a person who is a resident in the other contracting state will generally remain taxable in both countries but with limits on the tax that the source country may charge on the resident of the other country. In respect of withholding taxes relating to dividends, interest and royalties, a number of significant changes will be implemented as part of this convention.

In respect of dividends, under the existing treaty between the Australian and Japanese governments, which was signed back in 1969, the maximum withholding tax rate which may be imposed is 15 per cent. Under the new treaty, there are essentially four classes of dividends, which will be taxed in different ways depending on the nature of those dividends. No tax will be chargeable on intercorporate non-portfolio dividends where the recipient holds directly at least 80 per cent of the voting power of the company that is paying the dividend. This will be subject to certain conditions. There will be a five per cent rate limit, which will apply on all other non-portfolio intercorporate dividends where the recipient holds directly at least 10 per cent of the voting power in the company that is paying that dividend.

The treaty also contains a 15 per cent rate limit, which will apply to distributions from Australian real estate investment trusts. That 15 per cent limit will also apply to dividends which are paid by a Japanese company which is entitled to a deduction for dividends paid to its beneficiaries in calculating its taxable income in Japan where more than 50 per cent of that company's assets consist of real property in Japan.

The fourth category of dividend, which will essentially be all of those other dividends that do not fit into any of the above three categories, will be subjected to a withholding tax rate limit of 10 per cent. This is a significant reduction in the withholding tax rates that apply to dividends across the board. I think this will clearly facilitate greater cross-border investment, both outbound and inbound. Clearly, the rationale of this bill is to enhance the already very strong economic relationship that we have with Japan.

In respect of interest, the ability of a source country to tax residents of the other contracting state will continue to be limited to 10 per cent. However, there are some alterations. No tax will be chargeable in the source country on interest derived by a financial institution resident in the other country, a body performing governmental functions, including central banks, the Australian Export Finance and Insurance Corporation, any public authority that manages the investments of Australia's Future Fund, the Japan Bank for International Cooperation or Nippon Export and Investment Insurance. There are some safeguards that apply in respect of interest income earned from those particular entities.

In respect of royalties, the general limit for royalties will be reduced from 10 per cent to five per cent. This is a significant change that will drive much increased investment in Australia. The new treaty provides that amounts derived from equipment leasing—this area has been a matter of some uncertainty in the past—including certain container leasing, will be excluded from the royalty definition. They will be treated and dealt with under the international transport operations article, which is article 8, or under the business profits article, which is article 7.

In respect of the withholding tax that applies on royalties, intellectual property is one of the most significant assets to which royalties and royalty withholding tax will apply. We will see a greater capacity for our nations to share in some of the intellectual property that is generated and created in our respective states.

I would also just like to comment more specifically on some of the measures contained within the convention that seek to preserve the revenue base here in Australia. Specifically, the convention preserves our taxing rights over income from real property and income arising from activities related to our natural resources. There is a clarification of our boundaries in terms of resources. That is of particular significance in respect of resources contained within those expanded boundaries.

It is also worth noting that this convention enhances information exchange provisions which allow tax administrations of both of the jurisdictions to share tax information. This is an essential part of maintaining integrity in our respective tax systems but, importantly, those provisions will be extended more broadly to take into account the goods and services tax, which of course was not anticipated by anyone back when the original treaty was entered into.

All in all, there are a range of integrity measures that are included within the convention. The measures go a long way towards ensuring not only that we are bringing down some of those potential double-taxation barriers that exist and might act as a disincentive to further investment between the two countries but also protection and preservation of our revenue base.

There are a number of other features of the convention that are worth noting. Apart from expanding the list of taxes covered, there is a refinement of the definition of 'permanent establishment', including prescribed time limits for the creation of PE, permanent establishment, where an enterprise is engaged in the exploration for or exploitation of natural resources. A significant element of the convention is the provisions that relate to comprehensive alienation of property, which broadly align the capital gains tax treatment with OECD practice whilst preserving our taxing rights over Australian assets that have that physical connection with Australia. This is particularly important in relation to mining rights and other interests related to Australian real property.

There are special provisions that relate to a particular type of arrangement that exists with Japan involving sleeping partners—an expression that relates to the nature of the entities for taxation purposes and nothing else—which clarify the situation and take into account some peculiarities that exist in the legal and taxation arrangements within Japan. Importantly—and this will be an issue that provides much greater certainty to taxpayers in both countries—a time limit of seven years will be enshrined for the commencement of transfer pricing audits. But, ensuring the integrity of the system, there will be no such limit in the case of fraud or evasion, which is a very common carve-out in relation to time limitations in taxation matters. Fraud or evasion should never be matters that are protected by a time limitation.

Importantly, the convention also creates new rules to prevent tax discrimination against nationals and Australian businesses operating in Japan and vice versa. There is also a comprehensive limitation-on-benefits article to prevent abuse of the treaty—specific integrity provisions that seek to ensure that taxpayers are not able to avoid their obligations by relying upon these particular provisions within the convention.

That is a summary of some of the specific technical amendments that are contained within the convention. But it is worth reflecting more generally on the benefits of entering into this convention. Apart from the fact that, by reducing withholding tax, we are reducing the interest burden on Australian borrowers of Japanese debt—and I think we would all agree that that will certainly assist some of our companies looking to make inroads into various markets—there will be an expected increase in economic activity between Australia and Japan. That will be a natural by-product of streamlining the taxation processes and arrangements with respect to the two countries. That is a great thing and it will benefit our economy and much of the industry within it.

The cost of borrowing from Japanese lenders for Australian businesses will reduce, which will also assist many Australian businesses. The increased economic activity that is anticipated will lead to greater tax receipts in the long run. Taxation is one of those wonderful tools where, sometimes by reducing it and delivering a benefit to the economy, the revenue is able to recoup some of those reductions by way of additional tax receipts as a result of the benefit of that investment.

The benefits of encouraging foreign direct investment are plain to see for all of us. The introduction of new technologies, governance standards and management concepts will directly flow from the updating of this particular treaty. There will also be training and skill upgrading, improved productivity, increased imports and exports, increased competition, more efficiency and lower consumer prices. It is a fallacy to think that higher withholding taxes are in the end borne by the nonresident from the other contracting state. We all know that they are very quick to pass on the additional costs to the consumers. Many of those consumers are people in Australia securing those goods and services.

Regarding the impact of lower dividend withholding tax on foreign direct investment, the flows of foreign direct investment are highly sensitive to country tax rates. Therefore, we can expect an increase in foreign direct investment as a result of this legislation. OECD research shows that a one per cent reduction in tax rates leads to a 4.28 per cent increase in foreign direct investment inflows, which is a significant additional investment that we would expect to flow from some of the reductions that have occurred.

The benefits of a revised tax treaty include having a more modern and updated instrument that dictates these matters. That in itself is an end that should be supported. This particular convention removes some of the existing impediments to investment and trade between the two countries. Withholding tax removal prevents a lockup of profits offshore. As a result of these changes, we will see more Australian businesses doing business in Japan and vice versa. The benefits of that will be great for our national economy.

I want to reflect briefly on the press release issued by the Assistant Treasurer in relation to consultation regarding Australia's tax treaties. Whilst the consultations involved tax treaties more generally, it is worth noting that a number of the comments that came back through the various stakeholders that contributed to this debate were very much in support of and praised the elements of the Australia-Japan tax treaty, particularly in relation to the need for lower dividend and royalty withholding tax rates. Clarification has been brought about by the provisions that deal with real estate investment trusts, or REITs. There is also the treatment of capital gains and bringing that treatment into line with OECD practice and the issue of transfer pricing and imposing a time limitation with the exception of where



cases of fraud or evasion are to be considered.

In concluding, I want to bring this debate back to my local community and acknowledge the very strong friendship that the Penrith City Council has with a number of city councils and cities in Japan. Fujieda City in the Shizuoka Prefecture and Penrith City signed a sister city agreement back in 1984. A long and very strong friendship has emerged as a result of that agreement, which involves yearly student exchange programs—with more than 200 exchange students during the time since the agreement—and regular citizen exchanges. This has been of great benefit to both cities.

In addition, the Penrith City Council has a relationship with Hakusan City in the Ishikawa Prefecture. This friendship agreement was signed in 1989, extending beyond friendship and involving increasingly developed and closer economic ties between the two countries. No doubt these great relationships and Australia's great trading relationship with Japan will only improve as a result of this convention.