Implementing and Interpreting Australia’s Tax Treaties

There have been some recent developments of general interest in relation to the implementation and interpretation of Australia’s tax treaties. This tax brief provides an outline of the developments and of the flow-on effects in relation to Managed Investment Trust (MIT) withholding tax.

Implementation of tax treaties

Until now tax treaties (including protocols) have been implemented by amending the International Tax Agreements Act 1953 (Agreements Act) with the insertion of a section that gives a particular treaty the force of law and of the treaty text in a schedule to the Act. While this is convenient to users of tax treaties as relevant material is gathered together in one place, there have always been some oddities in the process. If a new treaty is negotiated to replace an old treaty entirely, the relevant schedule is amended by deletion of the superseded treaty and replacement with the new treaty in the same schedule number but the force of law section for the old treaty is retained (as it will continue to operate for the period before the new treaty is in effect) and a new force of law provision inserted next to it for the replacement treaty. So in fact the Agreements Act may not contain all operative tax treaties at any particular point in time. Further, time limited tax sparing provisions in treaties were extended by exchanges of letters that were not inserted into the Agreements Act.

With the advent of Tax Information Exchange Agreements (TIEAs – the first with Bermuda was signed in 2005), the Agreements Act was amended so that such agreements took effect without their text being inserted into the Act. This apparently has been the common practice with treaties in other areas, although it means it is necessary to rely on the Treasury tax treaty website at http://www.treasury.gov.au/contentitem.asp?NavId=052&ContentID=625 or a similar source to check the status of particular TIEAs. The more recent practice of entering into limited tax treaties with countries prepared to sign a TIEA produced the odd outcome that the limited treaty was added to the Agreements Act as a schedule but the TIEA was not.

Given the above inconsistencies, the International Tax Agreements Amendment Bill (No 1) proposes to restructure the implementation of Australia’s tax treaties by deleting all the treaty schedules from the Act (with the exception of the Taipei agreement because of the unusual international status of Taiwan). It thus will be
necessary to source treaty texts from other places as is currently the case for TIEAs. The Bill will also repeal all of the force of law provisions in the modern form of giving tax treaties the force of law “according to their tenor” and replace them by a force of law list of current treaties. Superseded treaties force of law provisions are also removed and replaced by a force of law table for superseded treaties.

The older and more limited force of law provisions for some current treaties which were expressed to have effect “so far as those provisions affect Australian tax” (which is defined to mean Australian income tax and FBT) are retained, but this means these older (albeit current) treaties do not appear in the force of law list for current treaties in the Bill. The defined terms used to refer to the treaties are also systemised so that they appear in alphabetical order (which was not previously the case as drafting style in this regard had varied over the years). The intention is that this reordering will not affect the operation of any treaty from the way it currently operates. Despite the deletion of the treaty texts from the Agreements Act it is to be hoped that the commercial publishers will keep them in their versions of the income tax legislation.

Implementation of exchange of information agreements and reduced Managed Investment Trust (MIT) withholding

As part of the OECD efforts to deal with tax haven secrecy, it is well known that Australia (along with many other countries) has entered into a significant number of TIEAs and revised exchange of information articles in its comprehensive tax treaties in recent years. One flow-on effect is that the countries concerned become eligible to be placed by regulation on the list of Information Exchange countries for the purposes of their residents receiving the reduced 7.5% MIT final withholding rate instead of the generally applicable 30% rate. The MIT withholding regime applies in respect of distributions from Australian trusts that qualify as MITs. The 7.5% withholding rate only applies to distributions to a non-resident attributable to Australian sourced income of a MIT to the extent they do not represent dividends, interest or royalties (these categories of income remain subject to the withholding regimes generally applicable to them).

It is important to note that this flow-on effect is not automatic and requires a separate process before the country is added to the regulation on reduced MIT withholding. Subsequent to the TIEA or new information exchange provision entering into effect, appropriate controls and processes need to be put in place on both sides so that the Australian Government can be confident that the exchange of information protocols will occur in practice. Once the relevant part of Australian Treasury which monitors this process can confirm that the appropriate systems are in place, they make a recommendation to the Government that the country be included on the Information Exchange list by regulation.

How long this process is likely to take cannot be predicted in advance, as the efficiency of the information exchange process depends on the other country as
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well. Therefore, it could be a number of months or longer after the new information exchange agreement comes into effect before the country achieves reduced MIT withholding status. Moreover, it should be noted that it can take some time for the new agreement to come into effect and thus start the process of approval for reduced MIT withholding. After the agreement is signed, it has to be implemented into law in each country and then advice given to the other country that such implementation has occurred which itself can take some time after signing of the agreement.

The approval process is also likely to be affected by the activities of the Global Forum on Transparency and Exchange of Information for Tax Purposes. Currently the Global Forum is carrying out a two stage peer review process of exchange of information law (first stage) and practice (second stage) of all the countries involved in the new information exchange system which includes all major countries and virtually all tax havens. Australia has passed both stages of this peer review with the report on Australia released in January 2011 but a number of other countries have stumbled at the first stage and will have to improve their law before the second stage peer review can occur. The current state of play of peer reviews is available on the OECD website at http://www.oecd.org/dataoecd/11/57/46084660.pdf.

One of the significant countries from Australia’s perspective currently in the queue for obtaining approval as an Information Exchange country (and so reduced MIT withholding) is Singapore. The protocol to the Australia Singapore treaty updating the exchange of information article came into effect on 22 December 2010 but Singapore is not yet on the Information Exchange list. Singapore was due to have its first stage review by the Global Forum in the second half of 2010 but the report on it has not been released to date. The second stage peer review for Singapore is due in 2012. Singapore is likely to provide a good test case for how long it takes to be placed on the list for reduced MIT withholding.

Interpretation of treaties: Russell’s case

Coincidentally while the change to the implementation of treaties is occurring the Full Federal Court seems to have shifted the interpretation goal posts for tax treaties considerably in Russell’s case [2010] FCAFC 10. Australia now has a wealth of cases explaining the interpretation approach to tax treaties. It has been accepted at least since Thiel’s case in 1990 that tax treaties, and treaties generally, are to be interpreted in accordance with international law principles of interpretation, not domestic law principles of interpretation. Thiel also established that the OECD Commentaries were a very important source of assistance in interpretation.

This approach that in effect international interpretation norms displace domestic interpretation norms in the tax treaty area has been repeated in nearly all Australian tax cases on treaties since 1990. As usual with a specialist area like taxation the references are mostly to previous tax treaty cases rather than treaty cases more generally (although there have been exceptions). What Russell
makes clear is that the general position of the High Court of Australia on the interpretation of treaties shifted in 2006 and the shift is equally relevant to tax treaties (and the OECD Model and its Commentaries).

Dowsett J (with whom the other two judges, Edmonds & Gordon JJ, agreed without further comment on the treaty issue) explains the position in this way:

the [High] Court emphasized the primary position of the words used in Australian legislation and the Australian rules of statutory interpretation in construing legislation which gives effect to international obligations, including treaties. … the approach adopted … appears to require care in referring to material concerning international instruments. I see no reason for applying a different approach to model agreements. The approach is of some importance in the present case. Mr Russell’s primary criticism of the decision is that his Honour relied upon “OECD rulings or pronouncements”. … I do not accept that the primary Judge’s consideration of the NZ Agreement focussed upon the material concerning the OECD model to the exclusion of the wording of the Tax Agreements Act and the NZ Agreement. … his Honour records his view as to the effect of the wording of the NZ Agreement. In subsequent paragraphs he discusses the international material, concluding that it supports that view. In any event, I propose to focus upon the terms of the Tax Agreements Act, including the NZ Agreement.

This suggests that the authority of the OECD Commentaries in Australia has slipped considerably as a result of the shift in emphasis away from using international interpretation norms in relation to treaties incorporated in and acting through domestic law – true to his word, Dowsett J’s analysis of the tax treaty in the case makes no reference to the OECD Commentaries and the other material relied on by the primary judge, just the text of the relevant legislation, including the treaty.

Another consequence of the shift is that a literal approach to interpretation of a tax treaty text is likely to be preferred to a purposive or intentional approach. Many Australian tax treaty cases have concerned provisions that do not appear in the OECD Model and the approach in those cases has been very much in a literal vein with little emphasis being given to the broad purpose of the treaty. The judgment in Russell suggests that the same approach will be applied to treaty text based on OECD Model provisions as well.

The particular treaty issue in Russell involved a conflict in attribution of income between Australia and New Zealand. A New Zealand resident company called Ancath provided accounting and financial services to an Australian company under a contract between the companies. Mr Russell, who is an Australian tax resident, controlled Ancath and it was he in fact who provided the services to the Australian company very much like an employee would. New Zealand attributed the income to Ancath and taxed it. Australia attributed the income to Mr Russell under the personal services income regime in Income Tax Assessment Act 1997.
Divisions 84-87 and excluded it from the income of the company. Accordingly, Australia taxed Mr Russell on the income.

Mr Russell argued that the business profits article of the 1995 Australia New Zealand treaty prevented Australia from taxing him on the income because it was profits of the enterprise carried on by Ancath which did not have a permanent establishment in Australia and therefore could only be taxed in New Zealand under the treaty.

At first instance the judge rejected the argument on the basis that the business profits article was only concerned with juridical taxation issues, that is, it dealt with taxation of the enterprise carried on by Ancath but not with the taxation of Mr Russell who was a separate taxpayer. He reached this conclusion based on the text of the treaty, but also referred to parts of the OECD Commentary which suggested a juridical approach, to Vogel’s well known treatise and to two court decisions from Finland and France on whether tax treaties override CFC legislation.

As noted above Dowsett J did not rely on any of this material. For him the matter was concluded by the terms of the Australian legislation implementing the treaty and Australian domestic tax legislation, although he made some comments on the treaty text. The core of his reasoning is that Australia did not tax Mr Russell on Ancath’s profits. Section 3(2) of the Agreements Act says that profits in a treaty means taxable income under domestic law and domestic tax law indicated that Australia’s attribution rules were to be used in applying the treaty. Australia attributed the income to Mr Russell, not Ancath, and the business profits article did not prevent the taxation of Mr Russell.

The centrality given by Dowsett J to section 3(2) has at least one important possible consequence, apart from its significance in the decision itself. The ATO has taken the view that the provision does not have the effect that the business profits article applies only to business profits and not to business losses and the OECD has expressed the same view. If section 3(2) is taken as the exclusive meaning of profits in the business profits article, then business losses (and presumably their use) will not be covered by Australian treaties.

Similarly, Dowsett J noted that the provision implementing the tax treaty in question only gave it the force of law "so far as those provisions affect Australian tax" which is the older form of force of law provision for some current treaties noted above. As it was Australian income tax that was in question in Russell, this limit did not prevent the treaty potentially applying to prevent taxation of Mr Russell in Australia. It has, however, potentially far-reaching consequences in relation to exchange of information, as a request from a foreign tax authority for information will usually be for the purposes of that country’s tax which is not Australian tax.

In other words it is possible that this limitation meant that Australia could not exchange tax information unless it had a tax interest and that many exchanges in the past could have been challenged under Australian law. This problem with
exchange of information was quietly corrected by the legislation which also gave authority for Australia to enter into TIEAs in 2006 referred to above. Many exchanges before then may have been invalid because of this limitation of the implementation of treaties into domestic law only for the purposes of Australian tax. As noted above the older language referring to Australian tax is retained in the restructuring of the Agreements Act. The Explanatory Memorandum expresses the view, “Arguably, some of the existing ‘force of law’ provisions contained in the Agreements Act 1953 qualify, to some extent, the force of law given to a treaty.” After Russell this issue is hardly arguable any longer – it clearly acts as a limitation.

One suspects that the judges in the case did not fully realise what a significant departure this approach is from the former methods used to interpret Australian tax treaties. The attribution issue has been reduced almost exclusively to one of the law implementing the treaty and domestic tax law. A further result may be that Australian CFC rules are not affected by tax treaties (as the same reasoning would apply – Australia just attributes the tainted income of a CFC to a resident controller while excluding from such attributable income any income of the CFC that is directly taxed under Australian tax law). But the result flows from Australian domestic law implementing tax treaties and domestic attribution rules, and not from interpretation of treaties as such.

More broadly, the approach in the decision potentially throws into doubt the relevance of OECD views on attribution of income under tax treaties, at least in the business profits context. This may have significance in relation to partnership cases which are a sore issue in Australia at present. The ATO has recently released a draft public ruling on private equity, which uses OECD views to solve important issues in the limited partnership context, TD 2010/D8. It would be highly unfortunate if the decision in Russell were to mean that Australian courts reject international views in this area.

For further information, please contact

Sydney

Andrew Mills  Simon Clark
Director  Director
61 2 9225 5966  61 2 9225 5957
mailto:andrew.mills@gf.com.au  mailto:simon.clark@gf.com.au
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Greenwoods & Freehills Pty Limited (ABN 60 003 146 852)
Sydney  Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia
Ph +61 2 9225 5955, Fax +61 2 9221 6516

Melbourne  101 Collins Street, Melbourne VIC 3000, Australia
Ph +61 3 9288 1881 Fax +61 3 9288 1828