New Australia UK Tax Treaty Commences Operation from 1 April 2004 are you Ready?

On 21 August 2003, the new Australia UK treaty ("2003 Treaty") was signed in Canberra following two years of negotiations. The treaty replaces the Australia UK treaty signed in 1967 and updated by a Protocol in 1980 ("1967 Treaty"). In fairly short order both Parliaments have been through the necessary procedures – with Australia shortening its usual treaty approval process. On the same day as the 2003 treaty was signed, there was an Exchange of Notes which elaborates and explains the operation of various provisions of the treaty. The amending legislation giving effect to the 2003 treaty includes the Exchange of Notes so that they have the force of law in Australia.

Summary

- Similar to US Protocol but is a complete new treaty
- Take care with commencement dates as they vary depending on the situation
- Special residence rule for dual listed companies
- Special rules for Australian limited partnerships
- Anti-avoidance rule in relation to construction PEs
- Reduced tax rates on dividends (although only relevant to unfranked dividends paid by Australian companies)
- Exemption from interest withholding tax for banks and financial institutions
- Royalty withholding tax reduced to 5%
- Equipment leasing no longer subject to royalty withholding tax but care needed
- CGT covered and preserves Australia’s domestic rules
- Special rules on FBT and share options
- Non-discrimination rules available to taxpayers
Obligation to review in 5 years

Commencement Dates

The 2003 treaty came into force on 17 December 2003. It comes into effect (that is, actually operates) from various dates starting on 1 April 2004 as follows:

- for UK corporation tax and Australian FBT from 1 April 2004
- for other UK income tax by assessment from 6 April 2004 (mainly individuals)
- for Australian and UK withholding taxes and Australian tax by assessment from 1 July 2004.

The implications of these rules need to be elaborated in more detail as they can be complex in operation.

Profits of Branches and Subsidiaries

Unless a UK branch or subsidiary of an Australian company has a substituted tax year in the UK, the 2003 treaty will apply for UK corporation tax purposes to the branch or subsidiary from 1 April 2004. If the branch or subsidiary is using the same tax year as the head office or parent uses in Australia (other than a year beginning in the period 1 April to 30 June 2004) the 2003 treaty will begin operation at the same time in both countries, generally 1 July 2004.

In the converse case of Australian branches or subsidiaries of UK companies, many will have a substituted accounting period (“SAP”) commencing on 1 April for Australian purposes. In this case the 2003 treaty will not commence for Australian tax by assessment until 1 April 2005 though it will begin for UK corporation tax purposes for the head office or parent on 1 April 2004.

Generally these differences in commencement dates between Australia and the UK will not have great significance as the taxation of branch profits and subsidiaries will not change a great deal under the 2003 treaty. There are some exceptions, such as the case of equipment leasing referred to below.

Employees

As FBT is covered by the 2003 treaty but not the 1967 treaty, the position for taxation of fringe benefits will change. As the FBT year in Australia begins on 1 April and the tax year for individuals begins in the UK on 6 April, the changes in relation to fringe benefits will, for many Australian companies, be the first change they have to confront.

Under the 2003 treaty, Australia is given the exclusive right to tax fringe benefits received by UK resident employees working in Australia for a branch, for an Australian resident company, or for more than 183 days. The fringe benefits will
New Australia UK Tax Treaty Commences Operation from 1 April 2004 are you Ready?

no longer be taxable in the UK. Conversely Australia will not be able to levy FBT on Australian residents working in the UK in similar circumstances. This is discussed more fully below.

Withholding Taxes

In both Australia and UK the new withholding rules for dividends, interest and royalties commence on 1 July 2004. One apparent anomaly relates to equipment leases which are excluded from the definition of royalty in the 2003 treaty. The royalty withholding tax in Australia will cease for equipment leased from UK resident lessors on 1 July 2004. The intention under the 2003 treaty is that often the rentals will be subject to tax in Australia on a net assessment basis as income of a permanent establishment.

However, the 2003 treaty will not commence for UK companies with PEs in Australia until 1 April 2005 if they have obtained a SAP from the Australian Taxation Office (see above). As the 1967 treaty has no substantial equipment PE provision, it is likely that equipment leases from such UK lessors to Australian lessees will be exempt in the period 1 July 2004 to 31 March 2005 but will become taxable on a net basis from 1 April 2005. If the UK lessor does not have an SAP (generally because they do not have a branch under the 1967 treaty and so have not applied for an SAP), then they are likely to have a PE in Australia from 1 July 2004 as a result of the 2003 treaty and will be required to file a tax return for the year ending 30 June 2005.

Residence

The complex residence provisions of the 1967 treaty are swept away by the 2003 treaty in favour of Australia’s modern standard of basing treaty residence explicitly on definitions in domestic law. This is not the internationally standard way of defining residence and leaves questions, for example, of whether governments are residents of their country. The UK Protocol clarifies that the Australian government is a resident of Australia!

Companies

More importantly, the 2003 treaty adopts the modern tiebreaker for dual resident companies of the place of effective management. This does not cover all possibilities, for example, if a company incorporated in the UK carries on business in Australia and is controlled by Australian resident shareholders but is managed in another country, the company will be a resident of Australia and the UK and the tie breaker will not apply.

The place of effective management test presents significant difficulties for dual listed companies like Rio Tinto, BHP Billiton and Brambles. Accordingly the 2003 treaty has a special provision that the place of incorporation will govern in this situation, provided the primary stock exchange listing is in the country of
incorporation. This allows the Australian company in the arrangement to be a treaty resident of Australia and likewise the UK company to be a UK treaty resident. This provision in the 2003 treaty does not deal with dual listed companies for tax issues not covered by the treaty. The Australian government announced in the May 2003 Budget that in such cases the Australian definition of company residence will be changed to follow the result of a tie breaker in the treaty (the UK already has such a provision). Accordingly dual residence under domestic laws for non-treaty purposes will also be eliminated for dual listed companies when the Budget measure is enacted.

Partnerships

The 2003 treaty contains detailed provisions on partnerships. Limited partnerships are generally taxed as companies in Australia (but not in the UK), a fact which has caused a number of international tax problems that are being dealt with by legislation in Australia (on venture capital limited partnerships and foreign hybrids). The UK taxes limited partnerships on a flow through basis. The 2003 treaty provides that an Australian limited partnership taxed as a company is treated as a person. The provision might be thought to state the obvious but technically has the effect that the limited partnership is entitled to treaty benefits (for example, an Australian resident limited partnership receiving royalties from a UK company would be subject only to 5% withholding tax in the UK under the new royalties article).

Conversely, it is provided that the UK would not be prevented in such a situation from taxing any partner of the limited partnership which is resident in the UK but the UK will effectively be obliged to give a foreign tax credit for any Australian tax on the Australian limited partnership.

Permanent Establishment and Business Profits

PE Definition

The definition of permanent establishment in the 2003 treaty generally follows Australia’s norm of recent years, though there are some variations. The threshold period for construction sites is lifted from 6 months in the 1967 treaty to 12 months in the 2003 treaty. Anti-avoidance provisions are inserted to prevent splitting of the time thresholds by, for example, using different but related companies for different parts of a construction project. The preparatory/auxiliary exception to the PE rules is extended to agents (which is standard in the OECD Model but not Australia’s existing treaties). Delivery of goods of itself will no longer give rise to a PE as it can under the 1967 treaty.

Most importantly, a substantial equipment provision is inserted. This has been a standard part of Australia’s treaty policy for 50 years but has been resisted by the UK up until now (appearing in neither the 1946 nor the 1967 treaties). Rather than using the standard terminology of “substantial equipment used in that State by,
for or under contract with the enterprise", the 2003 UK treaty aligns with the US treaty, "[the enterprise] maintains substantial equipment for rental or other purposes within that other State (excluding equipment let under a hire purchase agreement) for a period of more than 12 months". The significance of this provision is discussed in relation to ships and aircraft and equipment leasing below. It seems to represent the new treaty position of Australia so far as substantial equipment is concerned.

Elimination of Independent Personal Services Article

It should also be noted that the independent personal services article which has appeared in nearly all of Australia's treaties to date is dropped from the 2003 treaty and so such businesses (such as legal and accounting firms) are now dealt with under the PE definition and business profits article. This follows the similar change to the OECD Model in 2000. The Exchange of Notes makes it clear that the business profits article is intended to cover cases that were previously covered by the independent personal services article.

Calculation of Business Profits

The attribution and calculation of business profits of a PE follows the general pattern of Australia's recent treaties (which has some small deviations from the OECD wording), though some of the relevant material (for example, in relation to beneficiaries of trusts having PEs when the trust has a PE) is found in the Exchange of Notes. The 2003 treaty, like the 1967, preserves domestic rules for taxing non-resident insurers.

The UK recently changed its domestic law so that the calculation of the income of PEs is done on a separate enterprise basis (that is, the UK treats the PE like a separate company). Australia does not use this method for calculating business profits but rather allocates income and expenses and uses arm's length prices in making that allocation (see Ruling TR 2001/11). Both the Ralph Review of Business Taxation and the recent Board of Taxation Report on International Taxation have suggested that Australia move incrementally in the direction of separate taxation which the Government has accepted for financiers. The OECD is currently moving towards the separate enterprise approach as the international standard and in relation to the recent UK-US treaty it was agreed that those countries would use that approach in future. The 2003 treaty and Exchange of Notes is silent on this issue, so there is potential for more mismatches of treatment in the future leading to potential double taxation.

Ships and Aircraft

Transport Activities

Australia's practice in relation to this area has always departed significantly from international practice. The 2003 treaty brings the wording closer to the OECD international standard, but in substance maintains the Australian variations.
Specifically the OECD Model only applies to transport (that is, of goods or passengers) whereas the 2003 treaty (similar to Australia’s other treaties) is much broader than this (see below).

In respect of transport of goods or passengers, the 2003 treaty adopts residence only taxation for this situation except where the carriage is between places in the other state or to and from a place in the other state (for example, an ocean cruise to nowhere on a ship operated by a UK resident which starts and stops in Australia).

**Non-Transport Activities**

The 2003 treaty then has a paragraph which covers "profits from the operation of ships or aircraft" which is broader than the carriage of goods or passengers. It deems "the use of a ship or aircraft for haulage, survey or dredging activities, or for exploration or extraction activities in relation to natural resources" to be such profits and preserves source taxing rights "where such activities are undertaken in a Contracting State". Hence Australia and the UK are able to tax such activities undertaken in the respective countries. There is no need to demonstrate that the taxpayer has a PE to tax the profits. In particular the fact that the ship or aircraft is not in Australia for 12 months and so does not constitute a substantial equipment PE does not prevent Australia taxing the income earned if the ship or aircraft is used for haulage etc activities.

It is noteworthy that the title of the article "Shipping and air transport" which derives from the OECD Model belies the breadth of the article. Australia usually has the title "Ships and aircraft" to reflect the breadth of this article in its treaties. It is unlikely that the title in the 2003 treaty can be used to read down the article.

**Dividends**

**Reduction in Tax Rates for Direct Investment**

Although the 2003 UK treaty mirrors the 2001 US Protocol, the practical significance will be much less as the UK does not levy withholding tax on dividends and similarly Australia only levies the tax on unfranked dividends.

With several very important twists, the 2003 UK Treaty adopts the international standard for dividends – 5% for non-portfolio dividends paid to companies and 15% for other dividends. Most significantly, no dividend withholding tax will be levied if a beneficially entitled company resident in the other country holds at least 80% of the voting power (for a 12 month period prior to the date the dividend is declared) of the company paying the dividends, and satisfies some additional conditions. In the US Protocol, these conditions are found in the limitation of benefits (treaty shopping) article but as the 2003 UK treaty has no general treaty shopping article, they are instead incorporated in the dividend article.

A company resident in Australia or the UK qualifies for the zero rate if the principal class of its shares is listed and regularly traded on a recognised UK or
Australian stock exchange. The principal class of shares will be the ordinary or common shares if they represent the majority of voting power and value of the company. A company may also qualify if it is directly or indirectly owned by one or more such listed companies. No level of ownership is specified but it seems to be that 100% must be traced back to such companies. Unlike the US Protocol, there is no requirement that interposed companies be resident in Australia or the UK.

The 80% test which is also found in the 2001 UK-US Treaty and the Australia-US Protocol apparently comes from the threshold in the US for consolidation of corporate groups for tax purposes, which might be thought to be a strange way to establish the threshold between Australia and the UK. If the 80% ownership test is satisfied, but the public listing requirement is not, the 2003 treaty provides also for no tax in circumstances where the competent authority in the source state determines that the relevant shareholder did not have as one of its principal purposes the obtaining of benefits under the Convention. The competent authorities must consult with each other before denying the zero rate in such cases.

The tax limit of 5% will apply for shareholding companies that hold at least 10% of voting power but cannot meet the 80% tests. Although Australia’s domestic provisions for defining such ownership are derived from UK law, they are not entirely the same so that the 10% test may apply differently in Australia and the UK as the source country of the dividend.

Anti-Abuse Rule

As already noted, treaty shopping type tests apply to the zero withholding tax rate for dividends. In addition the standard UK anti-abuse rule is included to the effect that no benefits are available under the article if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights to take advantage of the article by means of the creation or assignment. As dividend withholding tax will not apply under domestic law on the UK side and only to unfranked dividends on the Australian side, this rule will have limited practical application. However, an equivalent rule is also found in the interest, royalty and other income articles and for royalties it may need to be considered.

Removal of Imputation Benefits

The 1967 treaty provides for benefits under the UK imputation system to be available to Australian shareholders. Most of the benefit was effectively removed by changes to UK domestic tax law in the late 1990s. The 2003 treaty has no provision for cross border imputation benefits.
Interest

Reduction of Tax Rates on Finance Raised from Banks and Other Financiers

Source country withholding tax on gross interest will continue generally to be limited to 10%. No withholding tax will be levied on interest derived by a resident of the other country, which is:

- a government body (including a body exercising governmental functions);
- a bank performing central banking functions; or
- a financial institution unrelated to and dealing wholly independently with the payer.

The last of these is most important for the private sector. For this purpose, a financial institution is a bank or other entity substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance. This change means that an Australian company can borrow from a UK bank without being subject to Australian withholding tax. It thus offers an alternative to the exemption in s.128F for publicly offered debentures to obtain withholding tax relief. This provision is recognised by the OECD as a treaty variant in the interest article.

The exemption will be much relied on in practice but the terms of the 2003 treaty are very broad brush, as usual in a treaty, which leaves a number of issues open to interpretation. For instance, to what extent does the provision cover the finance leasing business, REPOs and other modern ways of providing finance? In the early days of the 2003 treaty it will often be wise to seek an ATO private ruling as to application of the exemption in Australia, although it is understood that the ATO is preparing a public ruling on the topic. The Exchange of Notes makes clear that a corporate treasury or a member of a corporate group performing financing services for the group will not qualify as a financial institution for the purposes of the exemption.

It is to be noted that the exemption is based on the status of the taxpayer as a financial institution. There is no requirement that the particular transaction be in the ordinary course of the finance business.

Anti-Abuse

There are effectively four transactional limitations on the financial institutions exemption:

- The parties must be unrelated and dealing at arm’s length.
- The interest paid to a financial institution must not be part of an arrangement which is effectively a back-to-back loan (interest paid under such arrangements will be subject to a tax rate limit of 10%). The Explanatory
Memorandum indicates that parent guarantees of loans will not normally be enough to give rise to a back to back arrangement.

- The anti-abuse rule commonly found in UK treaties and referred to in the discussion of dividends above is included.
- General anti-avoidance rules are preserved by the treaty. Australia has a rule on withholding tax avoidance in Part IVA.

The last two of these limitations also potentially apply to the general 10% limit in the treaty. In Australia, denial of the treaty 10% rate is not a concern as the standard tax rate in domestic law for interest withholding tax is 10%.

The standard provision which denies the benefits of the article for excessive interest payments in transfer pricing terms is included in the article. The real impact for interest of transfer pricing is the potential to deny interest deductions between related parties where the interest rate is excessive. The Exchange of Notes expressly preserves the operation of the domestic rules on transfer pricing.

### Debt and Equity Rules

The definition of "interest" in the 2003 treaty consists of three parts. The first part provides that interest means interest from debt claims of every kind, whether or not secured by mortgage and even if profit participating, including government securities, bonds, debentures or any other form of indebtedness. The second part refers to income subjected to the same treatment as income from money lent by the law of the Contracting State in which the income arises. From the Australian viewpoint this encompasses items of income such as premiums or discounts on securities, and payments under certain hire purchase and lease agreements treated as interest for interest withholding tax purposes. Thirdly, the definition excludes income dealt with in the dividend article.

The reference to profit participating debt (which is standard OECD Model language) and the exclusion of dividends raises the issue, like the 2001 US Protocol, of how the definitions interact with Australia’s 2001 debt and equity rules. The definition of dividend under the 2003 UK treaty comprises three elements: (i) income from shares or other rights, not being debt-claims, participating in profits, (ii) as well as income from other corporate rights subjected to the same tax treatment as income from shares in the country of residence of the company, (iii) and also includes any other item which, under the laws of the country of residence of the company is treated as a dividend of a company. Because of the way that the debt and equity rules work, there was an argument under the US Protocol that dividends on redeemable preference shares were subject to the dividend article, not the interest article even though the shares are a debt interest. This argument is laid to rest for both the US, UK and any future treaties with similar wording by an amendment to the International Tax Agreements Act 1953. The dividend article is not to apply to a return on a debt interest. The Federal Government announced on 1 March 2004 that the debt/equity distinction would also be extended to s.128F so that an exemption
from interest withholding tax for dividends onredeemable preference sharespayable to the UK will be possible either under s.128F or under the 2003 UK treaty if their conditions are satisfied.

For the purposes of the dividend and interest articles, withholding tax onsecurities issued by UK companies will generally be characterised under the UK debt and equity borderline, not the Australian rules.

**Royalties**

**Rate Reduction**

The limit on withholding tax on royalties will be reduced to 5% by the 2003 UK treaty as in the 2001 US Protocol. The rate in the 1967 UK treaty is 10%. The 5% tax limit does not apply to natural resource royalties, which are income from real property for treaty purposes and remain taxable in the country of source without limitation on the tax that may be levied. This change received a lot of press coverage suggesting that it was extracted by the US from Australia unwillingly. As the Treasurer’s Press Release accompanying the 2003 UK treaty makes clear, it is now accepted policy in Australia. It can be expected that other major European countries will seek similar treatment from Australia in current and upcoming treaty negotiations.

**Equipment Leasing**

Rentals in relation to equipment leasing will be excluded from the “royalty” definition for the purposes of the 2003 UK treaty as in the 2001 US Protocol. Rentals derived in relation to equipment leasing will generally be treated as “business profits” and accordingly will only be subject to tax to the extent that the rentals are attributable to a permanent establishment. Such tax will need to be net of deductions under the business profits article.

As noted above the 2003 UK Treaty follows the existing US treaty, and not Australia’s common provision in relation to substantial equipment PEs. Since the US Protocol became public it appears that the ATO has shifted its ground on leasing from the US. Previously the ATO applied the royalty article and argued that it excluded the PE substantial equipment rule by implication. Now it seems that the ATO will apply the PE rule to many equipment leases. Presumably the same approach will be applied by the ATO to the 2003 UK treaty. This is a matter that requires close attention in the future.

**Satellite and Cable Broadcasts and Spectrum Licences**

Another change to the royalty definition, reflecting Australia’s general treaty practice, extends it to a greater variety of methods of transmission of sound and visual images. The 1967 treaty definition refers to “motion picture films, film or video tapes for use in connection with television or tapes for use in connection with radio broadcasting.” The 2003 treaty refers to “films or audio or video tapes
or disks, or any other means of image or sound reproduction or transmission for use in connection with television, radio or other broadcasting.”

This change is designed to more closely match the Australian domestic definition of royalties which was amended in 1992 to include satellite and cable transmission. Although the 2003 treaty wording, like the 2001 US Protocol, effectively combines paragraphs (da), (db) and (e) in the definition of royalties, it seems intended to be coextensive with them. The Australian Explanatory Memorandum to the Bill enacting the 2001 US Protocol states that it was agreed during negotiations that this change does not include cases where the reception of sound and/or images is for the personal use of the taxpayer. Thus if an Australian television station takes a satellite feed from a US resident and then broadcasts it in Australia, any payment by the Australian television company to the US resident will be a royalty. If, however, an Australian resident consumer pays a US broadcaster for a satellite feed for viewing at home in Australia, it will not be a royalty under the Protocol. We do not know whether a similar interpretation was agreed upon between Australia and the UK but it is in line with the general OECD approach for other royalties to which both Australia and the UK adhere.

The other recent addition to the domestic definition on royalties relating to the use of spectrum under spectrum licences is not reflected in the definition in the 2003 UK treaty, similar to other recent treaties. However, under the International Tax Agreements Act there is a deemed PE and hence such payments will be taxed as business profits. It is a condition of obtaining a spectrum licence that the licencsee be a resident of Australia or have a PE in Australia. The tax deeming rule thus only applies when the non-resident holder of the licence breaches this PE condition. Australia and the UK have agreed in the Exchange of Notes that this PE treatment will be applied under the 2003 treaty.

Anti-Abuse

Like the interest article, the royalty article in the 2003 treaty includes the standard OECD provision on excessive payments of royalties, and the UK standard anti-abuse provision on creation or assignment of rights to take advantage of the article. Because Australia otherwise charges 30% withholding tax on royalties, both these provisions may need to be considered when seeking to rely on the reduced rate of tax in the royalties article for royalties sourced in Australia.

Alienation of Property (Including Capital Gains)

Taxes Covered

Unlike the 2001 US Protocol, the article dealing with taxes covered in the 2003 UK treaty does not include in the case of Australia a specific reference to the CGT, even though there is such a reference on the UK side (which is standard UK practice as their CGT is in a separate taxing statute). The ATO view is that the CGT is not a covered tax in Australia’s pre-CGT treaties but is a covered tax.
in its post-CGT treaties even though the same words "income tax" are used in both cases. Hence the alienation of property article will clearly cover CGT, but it is not generally confined to CGT as it applies to "income or gains" (which the Exchange of Notes indicates also includes "profits").

**Australian Norm Adopted**

The 1967 treaty does not have a provision dealing with alienation of property. The provision in the 2003 treaty reflects Australia's recent practice, consistent with the Government's rejection in the 2003 Budget of the Board of Taxation recommendation that Australia move to the OECD standard in this area (that is, residence only taxation for items not specifically covered as compared to Australia's preservation of source taxing rights). The UK generally follows OECD practice in this area, and under UK domestic law there is only very limited taxation of capital gains of non-residents, not even land held by non-residents in the absence of a PE. Essentially Australia will be able to apply its "law relating to the taxation of gains of a capital nature" in the future without limit from the treaty, except in relation to change of residence.

**Change of Residence**

The 2003 UK treaty, like the 2001 US Protocol, deals with the special rules that Australia has for dealing with capital gains on a change of residence. When a capital gain arises in Australia on a change of residence by a taxpayer from Australia, the treaty allows an individual taxpayer to use the elections to defer taxation on a change of residence that are available in Australia to avoid Australian CGT altogether. The 2003 treaty effectively provides that when such an election is made and the taxpayer becomes a resident of the UK, Australia is thereafter precluded from taxing the gain. This will be of particular interest to UK expatriates who come to work in Australia and Australian individuals who move to the UK.

Unlike the US Protocol, there is no provision for the taxpayer to elect for UK tax purposes to treat the change of residence as a disposal and to obtain an uplifted cost base to avoid double taxation. The 2003 treaty preserves for 6 years the tax which the UK levies on former residents who realise assets after departure from the UK where the assets were held while the taxpayer was a UK resident.

**Employment Income**

The 2003 treaty and Exchange of Notes have a number of novelties in this area, in addition to the standard treaty provisions.

**Fringe Benefits Tax Covered**

The 2003 treaty is the only treaty apart from New Zealand to deal expressly with the FBT. Effectively, if Australia has a right to tax employment income of a UK resident on a source basis, it will have the exclusive right to tax the fringe benefits (as defined in the Australian legislation) of that employee with respect to the employment period in Australia. The UK will not be able to apply its normal rules...
taxing the employee on fringe benefits under its income tax. Conversely, Australia will not be able to levy FBT with respect to an Australian resident employee for fringe benefits in respect of periods of employment in the UK, if the UK has a source right of tax over the employment income. This will not make a change to the present situation if the UK wages are exempt under s.23AG (which requires 91 days in the UK) and the employee has no Australian source employment income in the relevant income year as no FBT is payable in such a case. If however, an employee is seconded to the UK for a short period, FBT may be excluded for this period.

**Employee Share Options**

The 2003 treaty provides rules for the troubling area of employee option schemes. It will be recalled that the latter issue was discussed in the Review of International Taxation and the Australian Government has undertaken to obtain international solutions to the problems. Under the Exchange of Notes it is agreed that share option schemes are covered by the employment article.

Further, unless the facts indicate otherwise the period of employment to which the option relates is the period between grant of the option and satisfaction of all conditions for exercise of the option. In that event the taxing rights over the option are effectively pro rated according to the days of employment in that period spent in the UK and Australia. This broadly reflects the position in the revised draft report on option schemes recently released by the OECD.

**No Special Rules for Directors, Teachers and Professors**

The 2003 treaty does not include a separate article on fees received by directors of companies. Instead the usual treaty rules for employment income are applied.

It also does not contain an article on professors and teachers, unlike the 1967 treaty. The transitional provisions for the move from the 1967 to the 2003 treaty expressly provide that any relevant period commenced before the 1967 treaty terminates will have the protection of the 1967 treaty for the part of that period after termination.

**Non-Discrimination**

For the first time in an Australian treaty the 2003 treaty includes a fully operative non-discrimination article. The similar article in the US treaty is not given the force of law in Australia and hence may not be relied on by taxpayers as a defence to an assessment, and only operates as a government to government agreement. Under the 2003 UK treaty, taxpayers will be able to rely directly on the non-discrimination article.

**Prohibited Discrimination**

The text of the article is largely in standard OECD form but it contains a number of additions not found in the OECD Model which reflect Australia’s desire to ensure that certain parts of domestic tax law are not overridden by the article.
Paragraph 1 prevents discrimination on the basis of nationality, but this will have limited application in practice. Most countries do not base the operation of their tax law on nationality. Paragraph 2 prevents discrimination against PEs compared to local companies. Paragraph 3 prevents disallowance of deductions on the basis of the payment being made to a non-resident, except in relation to transfer pricing adjustments made in accordance with the arm’s length principle. Paragraph 4 prevents tax discrimination on the basis of foreign ownership of a resident company. Paragraph 5 ensures that Australia is not required by the article to extend personal allowances, reliefs and reductions to UK resident individuals (for example, the spouse or medical rebate).

Qualifications

The qualifications to this basic standard are several. It is provided that the article does not apply to certain provisions in domestic tax law:

- measures directed to tax avoidance or evasion
- limitations on rollovers which prevent assets being removed from the tax jurisdiction (most of Australia’s CGT rollovers are so limited)
- consolidation of corporate groups except that Australian resident companies owned by UK residents can access consolidation on the same basis as other Australian resident companies
- R&D deductions (which preserves the Australian limitation to companies incorporated in Australia)
- measures agreed not to be covered in Exchanges of Notes.

In relation to the first of these exceptions, the Exchange of Notes indicates that measures directed to tax avoidance or evasion include provisions on thin capitalisation, dividend stripping, transfer pricing, CFCs, FIFs, transferor trusts and conservancy procedures (for example, freezing assets in the jurisdiction). Further and specifically in relation to the non-discrimination article, the Exchange of Notes indicates that it does not apply to allow tax rebates or credits in relation to dividends received by residents of the other Contracting State, that is, the limitation of the Australian imputation system to Australian resident companies and individuals is preserved (likewise for the UK tax credit on dividends).

Source of Income

Australia is an oddity internationally in including source of income articles in its treaties. The UK apparently does not like such provisions and so the sourcing article in the 2003 treaty is more limited than Australia’s standard provision. It only applies to Australia and gives an Australian source to income which Australia may tax under the treaty. This then feeds into domestic law so that the income is assessable as ordinary or statutory income. Hence we still have the problem that Australia may end up taxing income which in the absence of the 2003 treaty does not have a source in Australia.
One effect of this limitation of the sourcing rule is that s 23AH may not be operative to exempt income of a UK branch of an Australian resident. For the exemption to apply the income must be "derived from sources in a foreign country". If, under Australian case law, income of a UK PE which the UK taxes is sourced in Australia, no exemption will be available in respect of the UK tax. However, a foreign tax credit will be available under the 2003 treaty as the income will be treated as UK source for the purpose of the credit article in the treaty by an express provision in that article.

**Obligation to Review in Five Years**

Reflecting the recent recommendation of the Board of Taxation, the 2003 treaty for the first time obliges Australia and the UK to consult at least every five years on the terms, operation and application of the Convention to ensure that it continues to serve the purpose of avoiding double taxation and preventing fiscal evasion. Although this could be read relatively narrowly, it is likely in practice to allow the negotiation of one or more Protocols to deal with emerging issues on a regular basis. The first such consultation must occur before the end of the fifth year of the treaty coming into force. It is also to be noted that both countries are obliged to ensure that the 2003 treaty continues in force for a five year period.

Already it is possible to foresee what may be involved in these regular consultations. The 2003 treaty does not contain an assistance in collection provision, even though one was recently added to the OECD Model. This was one issue raised for consideration by Australia in the Review of Business Taxation in 1999.

**Concluding Comments**

The 2003 treaty is long overdue. The 1967 treaty was negotiated before Australia joined the OECD and has a number of oddities and omissions by modern standards. In the areas of dividends, interest, royalties and capital gains, the 2003 treaty largely reflects the 2001 US Protocol. The main novelties are in the areas of dual listed companies, partnerships, employment and non-discrimination. In a number of respects, however, Australia is still a long way from the OECD Model, particularly in relation to international transport, equipment leasing and capital gains.
New Australia UK Tax Treaty Commences Operation from 1 April 2004 are you Ready?

For further information, please contact

Sydney   Ernest Chang
         Ernest.Chang@gf.com.au
         +61 2 9225 5965

G&F document ID 510039501_15.docx

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Liability limited by a scheme approved under Professional Standards Legislation

Greenwoods & Freehills Pty Limited (ABN 60 003 146 852)
www.gf.com.au

Sydney   ANZ Tower, 161 Castlereagh Street, 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
Perth   QV.1 Building, 250 St Georges Terrace, Perth WA 6000, Australia
         Ph +61 8 9211 7770 Fax +61 8 9211 7755