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PROTOCOL AMENDING THE TAX CONVENTION WITH AUSTRALIA

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Mr. LUGAR from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 107–20]

The Committee on Foreign Relations, to which was referred the Protocol Amending the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on September 27, 2001 having considered the same, reports favorably thereon and recommends that the Senate give its advice and consent to ratification thereof as set forth in this report and the accompanying resolution of ratification.

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I. PURPOSE

The principal purposes of the existing income tax treaty between the United States and Australia and the proposed protocol amending the existing treaty between the United States and Australia are to reduce or eliminate double taxation of income earned by resi-

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dents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The existing treaty and proposed protocol also are intended to continue to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

II. Background

The proposed protocol was signed on September 27, 2001. The proposed protocol would amend the existing income tax treaty between the United States and Australia that was signed in 1982.

The proposed protocol was transmitted to the Senate for advice and consent to its ratification on November 14, 2002 (see Treaty Doc. 107–20). The Committee on Foreign Relations held a public hearing on the proposed protocol on March 5, 2003.

III. Summary

The proposed protocol modifies several provisions in the existing treaty (signed in 1982) to make it similar to more recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol reduces source-country withholding tax rates under the existing treaty on dividends, interest, and royalties. First, the proposed protocol replaces Article 10 (Dividends) of the existing treaty with a new dividends article. This new article eliminates the withholding tax on certain intercompany dividends in cases in which an 80-percent ownership threshold is met. The new article preserves the maximum withholding tax rate of 15 percent on portfolio dividends, but provides a maximum withholding tax rate of 5 percent on dividends meeting a 10-percent ownership threshold. The proposed protocol replaces Article 11 (Interest) of the existing treaty with a new interest article that retains source-country taxation of interest at a maximum withholding tax rate of 10 percent, but allows a special zero rate of withholding for interest paid to financial institutions and governmental entities. The proposed protocol also retains source-country taxation of royalties under Article 12 (Royalties) of the existing treaty, but reduces the maximum level of withholding tax from 10 percent to 5 percent. In addition, the proposed protocol amends the definition of royalties to remove the portion of the definition related to payments for the use of "industrial, commercial or scientific equipment, other than equipment let under a hire purchase agreement." Thus, under the proposed protocol, leasing income is treated as business profits, taxable by the source country only if the recipient of the payments has a permanent establishment located in the source country.

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax former long-term residents whose termination of residency has as one of its principal purposes the avoidance of tax.

This provision allows the United States to apply special tax rules under section 877 of the Code as amended in 1996.

The proposed protocol amends Article 2 (Taxes Covered) of the existing treaty to include certain U.S. and Australian taxes. For U.S. tax purposes, the accumulated earnings tax and the personal holding company tax are covered taxes under the proposed protocol. In the case of Australia, covered taxes include the Australian income tax, including tax on capital gains, and the resource rent tax (although the United States would not be required to allow a foreign tax credit with respect to the resource rent tax).

The proposed protocol provides that, for purposes of Article 4 (Residence) of the existing treaty, a U.S. citizen is treated as a resident of the United States unless the U.S. citizen is a resident of a country other than Australia for purposes of a tax treaty between that third country and Australia. In such case, the U.S. citizen is precluded from claiming benefits under the U.S.-Australia treaty and can only claim benefits under the tax treaty between such third country and Australia. The proposed protocol also adds a new provision under Article 7 (Business Profits) of the existing treaty to clarify the treatment of fiscally transparent entities and beneficial owners of fiscally transparent entities. The proposed protocol clarifies that permanent establishment status flows through a fiscally transparent entity (and thus the beneficial owner is treated as carrying on a business through such permanent establishment).

The proposed protocol amends the shipping provisions under Article 8 (Shipping and Air Transport) and related provisions under Article 13 (Alienation of Property) of the existing treaty to more closely reflect the treatment of income from the operation of ships, aircraft and containers in international traffic under the U.S. model.

The proposed protocol makes further amendments to Article 13 that allow income or gains from certain business property of a permanent establishment to be taxed in the country in which the permanent establishment is located. The proposed protocol also amends Article 13 to address Australia's imposition of its mark-to-market regime on individuals who expatriate to the United States.

The proposed protocol replaces Article 16 (Limitation on Benefits) of the existing treaty with a new article that reflects the limitation on benefits provisions included in more recent U.S. income tax treaties.

The proposed protocol also replaces Article 21 (Other Income) of the existing treaty with an article that more closely represents the provision included in the U.N. model tax treaty.

Article 13 of the proposed protocol provides for the entry into force of the modifications made by the proposed protocol.

IV. Entry Into Force and Termination

A. Entry Into Force

The proposed protocol will enter into force upon the exchange of instruments of ratification. The effective dates of the protocol's provisions, however, vary.

With respect to the United States, the proposed protocol will be effective with respect to withholding taxes on dividends, royalties and interest for amounts derived by a non-resident on or after the later of the first day of the second month next following the date on which the proposed protocol enters into force or July 1, 2003. With respect to other taxes, the proposed protocol will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

With respect to Australia, the proposed protocol will be effective with respect to withholding taxes on dividends, royalties and interest for amounts derived by a non-resident on or after the later of the first day of the second month next following the date on which the proposed protocol enters into force or July 1, 2003. With respect to other Australian tax, in relation to income, profits or gains, the proposed protocol will be effective for any year of income beginning on or after the first day of July next following the date on which the proposed protocol enters into force.

The article provides a special rule for certain Real Estate Investment Trust (REIT) dividends received by a Listed Australian Property Trust (LAPT). This rule is intended to protect existing investments in REITs by LAPTs. For REIT shares owned by an LAPT on March 26, 2001 or acquired by the LAPT pursuant to a binding contract entered into on or before March 26, 2001 ("grandfathered REIT shares"), dividends from the grandfathered REIT shares are subject to the provisions of Article 10 (Dividends) as in effect on March 26, 2001. Thus, the dividends from the grandfathered REIT shares will be subject to a maximum withholding tax rate of 15 percent, regardless of the ownership of the LAPT. REIT shares acquired by the LAPT pursuant to a reinvestment of dividends (ordinary or capital) from grandfathered REIT shares are also treated as grandfathered REIT shares.

B. TERMINATION

The existing treaty, as amended by the proposed protocol, will remain in force until terminated by either country. Either country may terminate the treaty by giving notice of termination to the other country through diplomatic channels. In such case, a termination is effective with respect to those dividends, interest and royalties to which Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) respectively apply, and which are paid, credited or otherwise derived on or after the first day of January following the expiration of the 6 month period following notice of termination. A termination is effective with respect to all other income of a taxpayer for the taxpayer's years of income or taxable years, as the case may be, commencing on or after the first day of January following the expiration of the 6 month period following notice of termination.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed protocol with Australia (Treaty Doc. 107–20) on March 5, 2003. The hearing was chaired by Senator Hagel.[1] The Committee considered the proposed protocol on March 12, 2003, and ordered the proposed protocol with Australia favorably reported by a vote

[1] The transcript of this hearing will be forthcoming as a separate Committee print.

of 19 in favor and 0 against, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty.

VI. COMMITTEE COMMENTS

On balance, the Committee on Foreign Relations believes that the proposed protocol with Australia is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed protocol and believes that the following comments may be useful to the Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. ZERO RATE OF WITHHOLDING TAX ON DIVIDENDS FROM 80-PERCENT-OWNED SUBSIDIARIES

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (paragraph 3 of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, the United States has signed a proposed treaty with the United Kingdom and a proposed protocol with Mexico that include zero-rate provisions similar to the one in the proposed protocol.

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 (Dividends)). Under the existing U.S.-Australia treaty, these dividends may be taxed at a 15 percent rate.

Benefits and costs of adopting a zero rate with Australia

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit, withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Australia, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since both the United States and Australia currently impose withholding tax on some or all direct dividends as a matter of domestic law (albeit only on "unfranked" dividends in the case of Australia), the provision would provide immediate and direct benefits to the United States as both an importer and an exporter of capital. The overall revenue impact of this provision is unclear, as the direct revenue loss to the United States as a source country would be offset in whole or in part by a revenue gain as a residence country from reduced foreign tax credit claims with respect to Australian withholding taxes.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed treaty is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

Committee conclusions

The Committee believes that every tax treaty must strike the appropriate balance of benefits in the allocation of taxing rights. The agreed level of dividend withholding for intercompany dividends is one of the elements that make up that balance, when considered in light of the benefits inuring to the United States from other concessions the treaty partner may make, the benefits of facilitating stable cross-border investment between the treaty partners, and each partner's domestic law with respect to dividend withholding tax.

In the case of this protocol, considered as a whole, the Committee believes that the elimination of withholding tax on intercompany dividends appropriately addresses a barrier to cross-border investment. The Committee believes, however, that the Treasury Department should only incorporate similar provisions into future treaty or protocol negotiations on a case-by-case basis, and it notes with approval Treasury's statement that "[i]n light of the range of facts that should be considered, the Treasury Department does not view [elimination of withholding tax on intercompany dividends] as a blanket change in the United States' tax treaty practice."

The Committee encourages the Treasury Department to develop criteria for determining the circumstances under which the elimination of withholding tax on intercompany dividends would be appropriate in future negotiations with other countries. The Committee expects the Treasury Department to consult with the Committee with regard to these criteria and to the consideration of elimination of the withholding tax on intercompany dividends in future treaties.

B. INCOME FROM THE RENTAL OF SHIPS AND AIRCRAFT

The present treaty includes a provision found in the U.S. model and many U.S. income tax treaties under which profits from an enterprise's operation of ships or aircraft in international traffic are taxable only in the enterprise's country of residence.

The present treaty and the proposed protocol differ from the U.S. model in the case of profits derived from the rental of ships and aircraft on a bareboat basis (i.e., without crew). Under the proposed protocol, the rule limiting the right to tax to the country of residence applies to such rental profits only if the lease is merely incidental to the operation of ships and aircraft in international traffic by the lessor. If the lease is not merely incidental to the international operation of ships and aircraft by the lessor, then profits from rentals on a bareboat basis generally would be taxable by the source country as business profits (if such profits are attributable to a permanent establishment).

In contrast, the U.S. model and many other treaties provide that profits from the rental of ships and aircraft operated in international traffic on a bareboat basis are taxable only in the country of residence, without requiring that the lease be incidental to the international operation of ships and aircraft by the lessor. Thus, unlike the U.S. model, the proposed protocol provides that an enterprise that engages only in the rental of ships and aircraft on a bareboat basis, but does not engage in the operation of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that, under the proposed protocol, profits from the use, maintenance, or rental of containers used in international traffic are taxable only in the country of residence, regardless of whether the recipient of such income is engaged in the operation of ships or aircraft in international traffic.

Committee conclusions

The Committee notes that the proposed protocol, while not entirely consistent with the U.S. Model, moves the treatment of income from shipping and air traffic closer to the U.S. Model than the present treaty by providing that profits from the use, maintenance or rental of containers used in international traffic are taxable only in the country of residence.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed protocol is estimated to cause a negligible change in Federal budget receipts during the fiscal year 2003–2012 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed protocol between the United States and Australia can be found in the pamphlet of the Joint Committee on Taxation entitled Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Australia (JCS-5-03), March 3, 2003.

IX. Text of Resolution of Ratification

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Protocol Amending the Convention Between the Government of the United States of America and the Government of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on September 27, 2001 (Treaty Doc. 107–20).