The Protocol to the Australia–United States tax Treaty: Part 2

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Part 1 of this article was published in the September issue of Australian Tax Review. This Part of the article discusses the amendments relating to the royalties, alienation of property, limitation on benefits and other income Articles. The amendments to the royalty Article are particularly significant because Australia has not previously agreed to a rate below 10%, and usually insists on treating equipment rentals as royalties. The amendments to the alienation of property Article are also significant because they reiterate Australia’s commitment to taxing the Australian source capital gains of non-residents, and contain some helpful provisions in relation to expatriates. The limitation on benefits Article is exceptionally complex and it remains to be seen how it will be applied in practice in Australia.

INTRODUCTION

In the introduction to Part 1 of this article the view was expressed that it was likely that the more residence-based focus of the Protocol1 to the Convention Between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1983 (US Treaty) would be reflected in the tax treaty being negotiated between Australia and the United Kingdom. After Part 1 went to press, Australia and the United Kingdom signed a new tax treaty which has many features in common with the Protocol.2 In particular, under the 2003 Australia–UK Treaty dividends are exempt from tax if paid to a company holding at least 80% of the voting power of the company paying the dividend if the shares of the company receiving the dividends are listed on a recognised stock exchange, or if the competent authority determines that the establishment, acquisition or maintenance of that company did not have as one of its principal purposes the obtaining of treaty benefits.3 Interest paid to financial institutions is exempt from tax subject to a back-to-back loan anti-avoidance rule,4 and royalties are to be taxed at a rate of 5%.5 Therefore, the Protocol is not just a one-off special deal with the United States, but rather manifests a quite fundamental shift in Australia’s treaty policy whereby significant elements of source country taxation are conceded where this is considered in an overall sense to be in Australia’s economic interests.

In this Part 2 of the article the technical discussion of the Protocol continues, with a focus on the royalty, alienation of property, limitation on benefits and other income Articles.

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ROYALTIES

The Protocol amended Art 12 of the US Treaty to reduce the tax rate on royalties from 10% to 5%, and to remove from the “royalty” definition payments for the use or right to use industrial, commercial or scientific equipment. The limb of the royalty definition dealing with payments for the right to use films or video or audio tapes has also been extended to treat as royalties payments for the right to use film, video or audio disks or any other means of image or sound recording. Further, this category of royalty is extended beyond the right to use in connection with television and radio to include use in connection with any other form of broadcasting. This would include, for example, broadcasting over the Internet.

The only other Australian treaty that has a royalty tax rate below 10% is the 2003 Australia–UK Treaty. Therefore, it might be attractive for residents of countries other than the United States or the United Kingdom to licence technology into Australia through back-to-back licensing arrangements involving interposed United States corporations. Unlike the new interest Article (Art 11), there is no specific rule targeting back-to-back transactions in the royalty article. However, the new limitation on benefits Article (Art 16) and Pt IVA of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) might preclude this strategy in many cases, particularly where the third country resident establishes a special purpose vehicle in the United States to enter into the back-to-back arrangement.

The removal of equipment rentals from the Art 12 “royalty” definition means that Australia’s right to tax such rentals will not be preserved by that Article. Consequently, payments for ancillary or subsidiary assistance furnished as a means of enabling the enjoyment or application of equipment will also fall outside the royalty Article. Article 11 will continue to apply to the interest component of hire purchase payments. However, for equipment leases that are not hire purchase agreements and do not otherwise give rise to rentals treated as interest under Art 11, source country tax will only be payable if the rentals are attributable to a permanent establishment in that country. In this context, Art 5(4)(b) of the US Treaty will continue to be relevant. Under that provision, a resident of one of the Contracting States is deemed to have a permanent establishment in the other State if it “maintains substantial equipment for rental or other purposes within that other State” for a period of more than 12 months. The precise scope of this provision is unclear. In addition to the usual

8 For example, if a Netherlands resident company licences technology to a United States corporation which sublicensees the technology to an Australian resident, the rate of withholding tax payable on the sublicense royalties would be 5%. Under Art 13, Convention Between the Kingdom of the Netherlands and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1993 (US–Netherlands Treaty) no United States tax would be payable on the royalties paid to the Netherlands company. Whether the zero rate would apply on the US–Netherlands leg would depend on whether the limitation on benefits Article in the US–Netherlands Treaty allowed the Netherlands company to enjoy the benefits of that Treaty. Also, the United States conduit financing regulations discussed in Part I of this article in connection with the interest Article (Art 11) apply also to leasing arrangements, and would apply potentially if the Netherlands company itself was part of a back-to-back structure: s 1.881-3(a)(2)(i), Title 26, Code of Federal Regulations 2003 (US) (Treasury Regulations) definition of “financing arrangement”.

7 The potential application of Pt IVA, ITAA 1936 to back-to-back licensing arrangements would be preserved by s 4(2), International Tax Agreements Act 1933(Cth), although there is a question as to whether a reduction in tax rate gives rise to a tax benefit under s 177C, ITAA 1936. It is unlikely that third country residents would attempt to utilise the US Treaty to licence intellectual property into the United States via Australia because zero royalty tax rates are already available under other United States tax treaties.

8 Under Art 12(4)(a), US Treaty, prior to its amendment by the Protocol, payments in respect of equipment let under a hire purchase agreement were excluded from the “royalty” definition. To the extent that such payments were treated as interest under domestic Australian tax law they would have been “assimilated to income from money lent” under the old Art 11(5) and would therefore have been dealt with under that interest Article.

9 The substantial equipment limb of the “permanent establishment” definition in Art 5(3) of the 2003 Australia–UK Treaty also treats the maintaining of substantial equipment for rental or other purposes for more than 12 months as a permanent establishment. Like the US Treaty, the 2003 Australia–UK Treaty also does not treat equipment rentals as royalties. By contrast, the Agreement Between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (Mexican Treaty), signed after the Protocol but before the 2003 Australia–UK Treaty, treats equipment rentals as royalties and the substantial equipment limb of the permanent establishment article refers only to the use of equipment in a Contracting State by, for or under contract, and not to its maintenance there (legislation implementing the Mexican Treaty is currently before Australian Parliament in the International Tax Agreements Amendment Bill 2003 (Cth)). It is not clear whether the “maintains” substantial equipment
question of whether equipment is substantial, it is not clear whether the requirement that a person “maintains” equipment is satisfied only where they have the obligation to physically maintain the equipment or whether it is used in the broader sense of keeping the equipment in Australia.

The concept of “maintenance” of something in a State is also used in Art 5(3) to describe certain circumstances in which a permanent establishment will not arise. There, the concept appears to have the broader meaning of keeping something in a particular State rather than the narrower meaning of carrying out maintenance activities. It may be inferred that “maintains” has a similar meaning in Art 5(4)(b). However, while a substantial equipment permanent establishment may arise in circumstances other than where the lessor retains the maintenance obligations, the “maintains” requirement must also operate as a limiting factor. If the mere leasing of substantial equipment were intended to create a permanent establishment, the US Treaty would surely have stated this to be the case. One possibility is that the concept of “maintains” introduces a requirement of dominion or control over the equipment such that a permanent establishment arises only where the enterprise has the ability to exercise control over the equipment. Another possible gloss is one of geographic limitation so that if the lease requires that the equipment be used only in Australia there may be a maintenance of equipment for rental in Australia, but if there is no such limitation, or if any geographic limitation involves not only Australia, there may be no such maintenance of equipment in Australia.

From a United States lessor’s perspective, the removal of equipment rentals from the royalty Article will cause some uncertainty because the position might have been taken that as long as royalty withholding tax is paid – generally by the lessee through a gross up mechanism – the ATO would not look too closely at whether the lessor has a permanent establishment in Australia. Consequently, the amendment might cause lessors and the ATO to focus more closely on whether the lessor has an Australian permanent establishment. This may not be particularly fruitful for the ATO because the lessor would be entitled to depreciation and interest deductions if it owned the asset, or to rental deductions if the lessor is itself a lessee. However, the ATO may focus on the permanent establishment question on the basis that it is better to collect some tax on net income than no tax at all. Lessors may, consequently, look at other alternatives such as structuring leases as hire purchase agreements – which are specifically excluded from the Art 5(4)(b) substantial equipment permanent establishment – or using Australian subsidiary leasing vehicles.

Section 4 of the International Tax Agreements Amendment Act (No 1) 2002 (Cth) inserted a new subs (5) into s 17A of the International Tax Agreements Act 1953 (Cth) (ITAA 1953) to provide that s 128B of the ITAA 1936 does not apply to royalties paid to a person resident in a State with which Australia has a tax treaty under which the amount is not treated as a royalty. This deals with the situation where equipment rentals derived by a United States resident are attributable to an Australian permanent establishment. Section 17A(4) of the ITAA 1953 provides no relief from royalty withholding tax in this situation because Art 12 of the US Treaty will not operate to exclude the rentals from the royalty Article. Rather, they are excluded by virtue of not being royalties for the ATO because the lessor would be entitled to depreciation and interest deductions if it owned the asset, or to rental deductions if the lessor is itself a lessee. However, the ATO may focus on the permanent establishment question on the basis that it is better to collect some tax on net income than no tax at all. Lessors may, consequently, look at other alternatives such as structuring leases as hire purchase agreements – which are specifically excluded from the Art 5(4)(b) substantial equipment permanent establishment – or using Australian subsidiary leasing vehicles.

permanent establishment formulation is considered by the Australian Taxation Office (ATO) to be broader or narrower than the more traditional “use by, for or under contract” formulation. In the author’s view, the “maintains” formulation is narrower because it excludes use that does not include the maintaining of the equipment in the other State, and it is likely that in negotiating the 2003 Australia–UK Treaty the United Kingdom sought this formulation, together with the removal of equipment rentals from the royalty Article, to limit Australia’s ability to tax such rentals.

Many of Australia’s tax treaties deem an enterprise of a State to have a permanent establishment in the other State if “substantial equipment is being used in that State by, for or under contract with the enterprise”; see, for example, Art 5(4)(b). Agreement Between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1999 (South African Treaty). The US Treaty and the 2003 Australia–UK Treaty are the only ones which refer to the “maintenance” of substantial equipment in the other State.

Under Art 5(3) an enterprise of one of the States is not regarded as having a permanent establishment in the other State solely as the result of the “maintenance of a stock of goods or merchandise … for the purpose of storage, display, delivery” or processing by another enterprise; the maintenance of a fixed place of business for the purpose of purchasing goods, or for collecting information or for the purpose of preparatory or auxiliary activities; or the “maintenance of a building site or construction, assembly or installation project which does not exist for more than 9 months”.

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treaty purposes. Therefore, the effect of s 17A(5) of the ITAA 1953 is to ensure that equipment rentals attributable to an Australian permanent establishment of a US resident are subject to income tax rather than withholding tax.

To complete the picture of how rental income is treated under the Treaty, aircraft and ship rentals are specifically dealt with in Art 8. The general principle in that Article is that profits derived by a resident of one of the States from the operation in international traffic of ships or aircraft is to be taxed only in the State of residence. Profits from the lease of ships or aircraft on a “full basis” – that is, together with crew – are treated as profits from the operation of ships or aircraft in international traffic if the lessee operates the aircraft in international traffic and the lessor either operates aircraft otherwise than solely between places in the other State or regularly leases aircraft or ships on a full basis. Profits from “bare boat leases”, commonly known as “dry leases”, are treated as profits from the operation of ships or aircraft in international traffic if the lease is merely incidental to the operation by the lessor of ships or aircraft in international traffic and the leased ships or aircraft are used in international traffic. Article 5 of the Protocol removed the requirement in relation to bare boat leases that the ships or aircraft be operated in international traffic by the lessor. Therefore, if the bare boat leasing is incidental to the lessor’s business of operating ships or aircraft in international traffic, the rentals will not be subject to Australian tax even if the lessee operates the ship or aircraft domestically within Australia.12

With the removal of equipment rentals from the Art 12 “royalty” definition, Art 8 will have less work to do in relation to aircraft and shipping rentals. Before the Protocol amendments came into force, Art 8 displaced the operation of Art 12, and therefore exempted rentals from source country tax, where its requirements were satisfied. Now, the business profits Article (Art 7) will generally exempt the rentals from source country tax unless the lessor was “maintaining” the ship or aircraft in the other State for rental purposes. What Art 8 will do in this context is provide comfort in cases within the scope of that Article that source country tax is not payable even if the concept of maintaining equipment is interpreted broadly by the revenue authorities.

ALIENATION OF PROPERTY

Definition of “real property”

The Protocol amended Art 13 of the US Treaty by adding provisions dealing with the alienation of permanent establishment property, the taxation of gains derived by individuals on a change of residence and the taxation of capital gains. It also amended the provision dealing with the alienation of ships, aircraft and containers. The Protocol did not amend the definition of “real property” in Art 13(2)(b). That definition encompasses shares in a company the “assets of which consist wholly or principally of real property situated in Australia”. On the basis of FCT v Lamesa Holdings BV (1977) 77 FCR 597,13 this definition would not apply to shares in an Australian resident

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12 The question of when bare boat leasing will be merely incidental to the operation of ships or aircraft in international traffic is not discussed in the United States Treasury’s explanation of the US Treaty. The United States Internal Revenue Service (IRS) considered the operation of a similar provision in the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital 1980 (US–Canada Treaty) in Letter Ruling: 84-31-046. This Letter Ruling is summarised in the commentary concerning Art 8, OECD Model Convention with Respect to Taxes on Income and on Capital (OECD Model Convention) contained in Edwardes-Ker, M, The International Tax Treaties Service (In-Depth Publishing Ltd, subscription service, 1997) p 11. The Letter Ruling concerned a Canadian airline and a United States airline which leased surplus aircraft to each other. The leases from the Canadian airline were for a period of two years with the option to extend for two successive one year periods. The Canadian airline derived less than 2% of its gross receipts in the previous five years from the leasing of aircraft, and it was estimated that during the two year term of the lease, rentals would be around 1.4% of total gross receipts. The Letter Ruling concluded that the rentals were incidental to the operation by the Canadian airline of aircraft in international traffic because the arrangement was temporary and the amount of income from leasing was relatively minimal.

13 In Lamesa the Full Federal Court held that a similar “real property” definition in the Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1976 (Netherlands Treaty) did not permit tracing through chains of companies to ultimate real property interests. Consequently, the Court held that a gain derived by a Netherlands resident company in disposing of shares in an Australian resident company which, through a chain of subsidiaries, held an interest in gold mining leases, was not derived from an alienation of real property for the purposes of the alienation of property Article.
company which holds shares in another company which holds real property. However, where tax treaties given the force of law in Australia before 27 April 1998 contain a “real property” definition that includes shares in a real property owning company, s 3A of the ITAA 1953 extends the meaning of the definition to include shares in companies the value of whose assets is wholly or principally attributable, directly or indirectly, to real property. Section 3A ceases to apply where the relevant real property definition is amended or replaced. However, as the Protocol did not amend the Art 13(2)(b) definition, s 3A will continue to apply in relation to that definition. Interestingly, this interpretation does not appear to have found favour with the Australian and United States delegations to the Protocol negotiations. The Explanatory Memorandum accompanying the International Tax Agreements Amendment Bill (No 1) 2002 (Cth) (the Explanatory Memorandum) states at [2.73] that the existing Art 13(2)(b) is sufficient to deal with the alienation of shares in companies which indirectly hold real property. Further, the delegations considered that it was only necessary to clarify this by agreeing to the following note (still at [2.73]):

For purposes of subparagraphs (2)(b)(ii) and (iii) of Article 13 (Alienation of Property), both delegations agreed that assets which consist wholly or principally of real property situated in Australia include assets consisting wholly or principally of such real property which is held directly or indirectly, including through one or more interposed entities (e.g. through a chain of companies).

This note does not form part of the Protocol and therefore was not given effect for Australian domestic law purposes by the legislation giving domestic effect to the Protocol. Article 24(2)(d) of the US Treaty contemplates that the Australian and United States competent authorities may agree “to the same meaning of any term used in this Convention.” However, the note is an agreement of the negotiating delegations and not of the competent authorities. In some treaties, the competent authorities or relevant ministers are empowered in limited defined circumstances to modify the effect of the Treaty. This occurs particularly in tax sparing provisions where, through an exchange of letters, Ministers are able to extend the scope of the tax sparing relief.14 However, the provision in Art 24(2)(d) for the competent authorities to agree on the meaning of terms in the US Treaty does not confer an authority to alter the effect of the Treaty. In some countries official interpretations of a treaty provision may be binding on the courts.15 This is not the case in Australia. Once a tax treaty is incorporated into domestic Australian law, it is subject to the interpretation of the courts as with any other legislation enacted by an Australian Parliament.

Rules governing the interpretation of treaties are set out in the Vienna Convention on the Law of Treaties (No 2) (1974), Australian Treaty Series (Vienna Convention). Article 31(1) of the Vienna Convention provides that “a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.” Article 31(2) provides that the “context” for the purposes of interpreting a treaty includes “any agreement relating to the treaty which was made between … the parties in connexion with the conclusion of the treaty”. The note quoted above was an agreement made in connection with the negotiation of the Protocol, but the Protocol did not amend the real property definition in Art 13 of the US Treaty. Therefore, the note would not fall within the scope of Art 31(2) of the Vienna Convention because it was not made in connection with the conclusion of the US Treaty when it was originally negotiated. Article 31(3) provides that, together with the context, there shall also be taken

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14 See for example Art 18(3) of the Agreement Between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1999 (Singaporean Treaty) and Art 23(5)(b) of the Agreement Between the Government of Australia and the Government of the Socialist Republic of Vietnam for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1992 (Vietnamese Treaty). Another example, in a non-tax sparing context, is Art 16(6)(c) of the US Treaty. Under that provision, the competent authorities may agree to treat other stock exchanges as “recognised stock exchanges” for the purposes of Art 16.


16 Australian courts have recognised that those rules have application in interpreting Australia’s tax treaties: Thiel v FCT (1990) 171 CLR 338 at 349-350 and 356; FCT v Lamesa Holdings BV (1977) 77 FCR 597 at 604.
into account in interpreting a treaty “any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions.” The agreement referred to in the note should be a “subsequent agreement” of this type and therefore should be taken into account in construing the “real property” definition. However, Art 31(3) requires only that the agreement be taken into account and the position reflected in the note would therefore not necessarily prevail if the matter were dealt with by a court.17

The effect of an agreement of the type reflected in the note was considered in Commissioners of Inland Revenue v Commerzbank AG and Commissioners of Inland Revenue v Banco do Brasil SA [1990] 63 TC 218. The taxpayer banks in those cases were resident outside the United Kingdom but carried on business there through branches. In the course of their United Kingdom branch operations, both banks lent money to United States borrowers. Interest on the loans was subject to United Kingdom tax under United Kingdom domestic law, but the banks claimed that the interest was exempt from tax under Art XV of the Convention Between the United Kingdom of Great Britain and Northern Ireland and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income signed at Washington on 6 June 1946 (UK–US Treaty 1946). At the relevant time, that Article provided that interest paid by a corporation of one Contracting State is exempt from tax in the other State except where the recipient is a resident or corporation of that other State. On its face, Art XV applied to the interest earned through the United Kingdom branches, and there was no personal scope Article in the UK–US Treaty 1946 to restrict the benefits of the Treaty to residents of the Contracting States. Among other things, the United Kingdom Inland Revenue Department sought to rely on an agreement that they entered into in relation to Art XV in 1977 with the IRS under the mutual agreement procedure Article of the Treaty. Under the agreement both revenue authorities agreed that they would maintain their view that interest effectively connected with a permanent establishment ought to be treated as commercial profits of a permanent establishment that were dealt with under the business profits Article and not under Art XV. Mummery J held that the statement had no authority in the English courts. The fact that such an agreement was authorised under the mutual agreement Article was held not to confer any “binding or authoritative effect”18 on the agreement. Therefore, the note reproduced at [2.73] of the Explanatory Memorandum would have no binding effect as far as taxpayers or the courts are concerned, although it might be referred to as an interpretative aid if the “real property” definition was to be considered by a court.

Permanent establishment property

The inclusion of the Art 13(3) of the US Treaty provision dealing with the alienation of permanent establishment property is unremarkable and is typically now included in Australia’s tax treaties.19 The old Art 13(3), which dealt with gains from the alienation of ships, aircraft or containers operated in international traffic, has been replaced with a new Art 13(4) which is in similar terms to the old provision but does not include the previous language that preserved source country rights to tax income or gains derived on assets in relation to which depreciation deductions have been allowed. As the income from the use of ships, aircraft or containers in international traffic should be exempt from source country taxation under Art 8, this amendment should not be of great practical significance.

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17 While the note may not be binding on the courts, it may be binding on the Australian and United States competent authorities. The commentary to the OECD Model Convention provides that mutual agreements resolving interpretative issues are binding on the competent authorities as long as they do not agree to modify or rescind the agreement: commentary on Art 25 at [36].

18 Commissioners of Inland Revenue v Commerzbank AG and Commissioners of Inland Revenue v Banco do Brasil SA [1990] 63 TC 218 at 240.

19 See for example Art 13(2) of the Agreement Between the Government of Australia and the Government of the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2000 (Russian Treaty). A similar provision is also contained in Art 12 of the US Model Convention. If the operating profits of a permanent establishment are subject to tax in the State in which the permanent establishment is situated, it follows that profits from disposing of the permanent establishment, or of assets of the permanent establishment, should also be taxed in that State.
Temporary residents

The new Art 13(5) and (6) are designed to mitigate the effect of capital gains tax (CGT) event I1 for individuals who cease to be resident in Australia. In particular, they are targeted at United States expatriates who become resident in Australia and later leave, and cease to be resident, after working here for a period.\(^{20}\)

CGT event I1 occurs when a person ceases to be resident in Australia.\(^{21}\) Under this CGT event, capital gains or losses arise in relation to any assets of the person which do not have the necessary connection with Australia.\(^{22}\) Any individual who was resident in Australia for less than five of the 10 years preceding the time at which he or she ceased to be resident can choose to disregard the application of CGT event I1 in relation to assets that were owned before the individual last became resident in Australia, or were acquired because of someone’s death after the individual last became resident.\(^{23}\) If such an election is made, the asset is treated as having the necessary connection with Australia and capital gains or losses must be taken into account when the asset is eventually disposed of.

If an individual who ceases to be resident in Australia is a United States citizen, CGT event I1 potentially causes two problems. First, the individual may need to pay Australian tax in respect of the deemed disposal of the assets subject to CGT event I1, but as there is no actual disposal no cash is generated by the CGT event from which the tax liability can be funded. Secondly, the change of residence would not be recognised as a sale or exchange under United States domestic tax law and therefore would not generate a foreign tax credit in the United States or an adjustment to the United States tax basis of the assets held by the individual. Consequently, when the assets are ultimately disposed of, any appreciation during the period of Australian residence will be fully taxed again in the United States and no credit would be allowed in the United States for the Australian tax paid when the individual ceased to be Australian resident. If the individual is resident in Australia for less than five years and chooses to disregard CGT event I1, the timing mismatch between the recognition of gains for Australian and United States tax purposes will not arise. However, foreign tax credits are allowed in the United States only for foreign tax paid on foreign income.\(^{24}\) Gains on the sale or exchange of real property are treated as United States source income rather than foreign source income, the effect of the s 904(a) limitation is to deny a credit for any foreign tax paid on those gains.\(^{25}\) Therefore, if

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20 The provisions have potentially a broader scope than this. However, departing expatriates are the intended primary beneficiaries of Arts 13(5) and (6). Costello P, Press Release No 82: Taxation of expatriates, (15 October 2001) refers to the double taxation, cash flow and foreign exchange gain problems that can arise under CGT event I1 when expatriates cease to be resident in Australia, and indicates that this can raise the cost of employing skilled foreign workers in Australia. The Treasurer indicates that this problem will be addressed on a country by country basis through renegotiation of tax treaties. Subsequent to the signing of the Protocol, provisions equivalent to Art 13(5) have been agreed with Canada and Mexico: Art 13(6) of the Convention Between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1981 (Canadian Treaty) and Art 13(8) of the Mexican Treaty.). The 2003 Australia–UK Treaty does not contain a provision equivalent to Art 13(5) of the US Treaty, but does contain a provision that is equivalent to Art 13(6) of the US Treaty: see Art 13(5) of the 2003 Australia–UK Treaty.


22 Section 104-160(4), ITAA 1997. The circumstances in which an asset has the necessary connection with Australia are set out in s 136-25 of the ITAA 1997. The amount of the gain or loss is calculated as the difference between the asset’s market value at the time when the person ceases to be Australian resident and its cost base or reduced cost base.

23 Section 104-165(2), ITAA 1997.

24 Under s 904(a) of the Internal Revenue Code 1986 (US) (IRC) the foreign tax credit allowed under s 901 of the IRC is limited to an amount calculated by multiplying the amount of United States tax payable on worldwide income by a fraction calculated by dividing taxable income from sources without the United States by worldwide taxable income. If gains on the disposal of assets generate United States source income rather than foreign source income, the effect of the s 904(a) limitation is to deny a credit for any foreign tax paid on those gains.

25 Section 861(a)(5), IRC.

26 Section 1.861-7(c), Treasury Regulations. If the transaction is arranged in a particular manner for the primary purpose of tax avoidance, all relevant factors in relation to the transaction – including the negotiations, the execution of the agreement, the location of the property and the place of payment – are considered, and the gain is sourced where, in substance, the sale occurred.
the relevant assets are United States real property, or are personal property that is sold in the United States, any gain would be treated as United States source income and no foreign tax credit would be allowed for Australian tax paid on the gain. Arts 13(5) and (6) are intended to ameliorate these problems.

Article 13(5) deals with the situation where a person ceases to be resident in Australia and this triggers CGT event I1. This would be the case if the person does not choose, under s 104-165 of the ITAA 1936, to disregard CGT event I1, or is unable to make such a choice because he or she has been Australian resident for more than five years. CGT event I1 would also be triggered if the asset was acquired after the person became resident in Australia and it is not an asset that has the necessary connection with Australia. Article 13(5) provides that an individual who is treated as having alienated any property on ceasing to be resident in a State, and who is consequently taxed in that State, may elect to be treated for the purposes of taxation in the other State as if they had alienated and reacquired the property immediately before they ceased to be so resident for an amount equal to its fair market value at that time. By this mechanism it is intended that there will be a realisation of the relevant assets under both Australian and United States law with the consequence that double taxation can be resolved through the provision of foreign tax credits.

United States citizens are subject to United States tax on their worldwide incomes. Therefore, if the person ceasing to be resident in Australia is a US citizen, the Art 13(5) deemed alienation would trigger a potential United States tax liability. 27 Double taxation would then be avoided in accordance with Art 22 of the US Treaty. 28 If, for example, the asset consisted of a portfolio shareholding in a listed Australian resident company, Art 22(1) would require the United States to allow a credit for Australian tax paid on any gain arising from CGT event I1. If the asset consisted of United States property, the deemed disposal under Art 13(5) could give rise to non-Australian source income for the individual who is ceasing to be Australian resident. This would be the case, for example, if the asset was United States real property. 29 In this case, Art 22(2) would require Australia to allow the individual a credit for United States tax paid on the gain. 30 In both cases, the individual would thereafter have a fair market value basis in the assets for United States tax purposes.

If the individual ceasing to be resident in Australia is not a United States citizen, no United States tax would arise if an Art 13(5) election was made in relation to assets that would not generate United States source income in relation to an actual disposal. This would be the case if the individual was a long term Australian resident who moved to the United States and became tax resident there. If the relevant property was a portfolio shareholding in a listed Australian resident company, for example, no United States tax liability would arise as a consequence of an Art 13(5) election. However, the individual would obtain a market value basis in the shares for future United States tax purposes. If the relevant property would generate United States source income in relation to an actual disposal, the deemed alienation would potentially trigger a United States tax liability and Australia would be required under Art 22(2) of the US Treaty to allow a credit for the United States tax.

Article 13(6) applies where an individual who ceases to be resident in a State chooses to defer taxation on income or gains relating to property where that tax would otherwise be payable as a

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27 The deemed disposal would occur while the individual was still tax resident in Australia. However, Art 1(3) of the US Treaty provides that the United States may tax its citizens as if the US Treaty had not entered into force. Therefore, for a United States citizen the deemed alienation would potentially trigger a capital gain for United States and Australian tax purposes.

28 Article 1(4) of the US Treaty provides that the rule in Art 1(3) that the United States may tax its citizens as if the US Treaty had not entered into force, does not affect the benefits available under Art 22, the relief from double taxation Article. Therefore, the United States can still be required by Art 22 to allow foreign tax credits to its citizens who derive Australian source income.

29 Income derived in respect of the sale or exchange of real property is sourced in the United States if the real property is located in the United States: s 861(a)(5) of the IRC.

30 The credit would be allowed under s 160AF of the ITAA 1936. Section 160AF allows Australian residents a credit for foreign tax paid in respect of foreign income. The effect of an Art 13(5) of the US Treaty election is that the individual is treated as having disposed of the property immediately before ceasing to be resident in Australia. Therefore, the requirement that the individual be Australian resident in order to obtain a foreign tax credit under s 160AF of the ITAA 1936 would be satisfied. In the example given in the text, the gain arising from the notional sale of the United States property should also be foreign income for the purposes of s 160AF.
The consequence of the individual ceasing to be resident in that State. If the individual is resident in the other State at the time of actual disposal of the property, any income or gains from the subsequent alienation of the property are taxable only in that State. This provision would apply where an individual ceasing to be resident in Australia chooses under s 104-165(2) of the ITAA 1997 to disregard CGT event I1. Ordinarily, this would convert assets that do not have the necessary connection with Australia into assets that have such a connection, and Australia’s capital gains provisions would apply when the asset was ultimately disposed of. However, if the individual becomes resident in the United States, Art 13(6) would protect gains from the ultimate disposal of those assets from Australian tax. Where Art 13(6) applies, gains on assets acquired by a person who is resident in Australia for less than five years are effectively removed from the Australian tax base, where those assets were acquired before the individual became resident in Australia and do not have the necessary connection with Australia. For example, a United States resident individual who owned land in the United States before becoming resident in Australia could elect to disregard CGT event I1 if within five years of becoming Australian resident he or she ceased to be so resident. By operation of Art 13(6), the person would not subsequently be subject to Australian tax when the land is ultimately disposed of. Therefore, any appreciation occurring before, during or after the individual’s period of Australian residence would not be subject to Australian tax.

If, in their particular circumstances, an individual could choose between applying Art 13(5) or (6), it would generally be expected that they would choose to apply Art 13(6) because no immediate tax liability arises as a consequence of that provision. The Art 13(5) mechanism avoids double taxation but at the cost of an up-front tax on any accrued gains. One situation where an individual who is able to utilise either Art 13(5) or (6) may prefer to use the former is where they have accumulated capital losses or unrealised losses that will become realised by virtue of CGT event I1. In those circumstances, it may be preferable to realise the gains on the appreciated assets by applying Art 13(5) and to offset the accumulated capital losses against those gains. This would achieve a subsequent step up in the cost base of the appreciated assets with a reduced, or non-existent, Australian tax cost.

Article 13(6) applies where an election is made under s 104-165 of the ITAA 1997 to defer taxation of income and gains relating to property that would otherwise be taxed in Australia. In these circumstances, the individual is taxed on income or gains from the alienation of “that property” only in the United States. The second reference to “property” in Art 13(6) appears to be a reference to property in respect of which income or gains had accrued at the time when the individual ceases to be resident in Australia. This is because it goes back to the initial reference to property in the provision, and that reference is to property in relation to which there were income or gains. A s 104-165 election applies to all assets other than those that already have a necessary connection with Australia. Such an election would therefore apply to assets with accrued gains and to assets with accrued losses. However, if Art 13(6) applies only to the assets with accrued gains, any assets with accrued losses would be subject to Australian capital gains tax on subsequent realisation. This could be significant if the value of such an asset subsequently increases. It would be surprising if this were the intended effect because s 104-165 applies collectively to all assets without the necessary connection with Australia. Article 13(6) must also apply on this collective basis.

Legislation was introduced into Federal Parliament in May 2002 which, if it had been enacted, would have narrowed the scope of CGT event I1 in the case of persons who are “temporary residents” immediately before they ceased to be resident in Australia. Generally, a “temporary resident” was defined as an individual who has been Australian resident for not more than four years and who was not resident in Australia at any time in the ten years before they last became Australian resident. This further limitation on CGT event I1 would not apply to portfolio shareholdings in Australian

31 Schedule 3, item 10, Taxation Laws Amendment Bill (No 4) 2002 (Cth). This Bill contained a package of concessional measures in relation to the taxation of temporary residents. Other amendments involved a provision which would disregard capital gains or losses of temporary residents in relation to assets which do not have the necessary connection with Australia, and the extension of the visitor exemption in the foreign investment fund rules to any person who holds a temporary visa and has not applied for a permanent visa.

32 Sch 3, item 13, Taxation Laws Amendment Bill (No 4) 2002 (Cth).
tax resident companies.\textsuperscript{33} The amendments in relation to temporary residents were not enacted because of concerns expressed in the Senate that they would have provided tax cuts for wealthy individuals.\textsuperscript{34} If these measures are ultimately enacted, CGT event I1 would not apply to an individual who has been resident in Australia for less than four years. Consequently, such individuals would not need to rely on Art 13(5) to avoid double taxation or on Art 13(6) to avoid Australian taxation under CGT event I1.

**Taxation of capital gains**

The Protocol inserted a new Art 13(7) which provides that except as otherwise provided in Art 13, each State may tax capital gains in accordance with the provisions of its domestic law. As the US Treaty is a pre-CGT Treaty, it is clear that the inclusion of a provision reserving Australia’s right to tax capital gains was a critical issue for the team that negotiated the Protocol for Australia. In evidence before the Joint Standing Committee on Treaties in relation to the Protocol, Mrs Ariane Pickering, an Assistant Commissioner of the ATO, said:\textsuperscript{35}

Another key driver for this renegotiation was to ensure that we had protected Australia’s capital gains tax …

There is … the issue for us that the existing treaty does not deal with capital gains tax. It is our belief that we are nevertheless able to impose our capital gains tax because it is not dealt with by the treaty, so we would continue to impose our domestic capital gains tax regime. But that is an issue that is likely to be challenged in court. We would certainly have a good deal of revenue at risk if we had an adverse decision against us on that issue. So for us it is important that we clarify our taxing right and protect our taxing right.

In an attachment to the Treasury letter\textsuperscript{36} it is stated that without the capital gains reservation provision an estimated amount of $70 million to $105 million of revenue could be annually at risk.\textsuperscript{37} The concern in this context, highlighted in Taxation Ruling TR 2001/12, is that capital gains could be protected from Australian tax under the business profits Article.\textsuperscript{38} From a policy perspective, the insistence on the taxation of capital gains in relation to shares is somewhat inconsistent with the acceptance of a zero or 5% tax rate on dividends paid to United States resident companies. Where is the logic in taxing a capital gain earned by a United States shareholder in connection with a sale of shares in an Australian resident company with significant retained earnings while permitting those retained earnings to be distributed to the same shareholder free of tax? The behavioural response to this inconsistency is obvious.

Provisions similar to Art 13(7) have been included in other recent Australian treaties in an attempt to ensure that the business profits Article does not prevent Australia from applying its capital gains tax regime. Those provisions typically state that nothing in the treaty “affects the application of a law of a Contracting State relating to the gains of a capital nature derived from the alienation of property.”\textsuperscript{39} On the basis that gains of a capital nature are dealt with in the alienation of property

\begin{footnotesize}
\textsuperscript{33} Sch 3, item 10, s 104-165(1B), Taxation Laws Amendment Bill (No 4) 2002 (Cth).
\textsuperscript{34} Australia, Senate, Debates, No 6 (27 June 2002), pp 2982-2984. The temporary resident measures were subsequently reintroduced to Parliament in the Taxation Laws Amendment Bill (No 7) 2002 (Cth). Those measures were again rejected by the Senate, and that Bill was enacted ultimately as the Taxation Laws Amendment Act (No 2) 2003 (Cth) without the temporary resident measures.
\textsuperscript{35} Australia, Joint Standing Committee on Treaties, Debates, (13 May 2002) at TR 35 and 37.
\textsuperscript{37} Treasury letter, n 36.
\textsuperscript{38} ATO, Taxation Ruling TR 2001/12, paras [111] – [124]. In TR 2001/12 the ATO takes the position that pre-CGT treaties do not apply to capital gains. This position is somewhat controversial: see Hon Justice Gzell, “Treaty Application to a Capital Gains Tax Introduced after Conclusion of the Treaty” (2002) 76 ALJ 309.
\textsuperscript{39} See, eg Art 13(5) of the Agreement Between Australia and Romania for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2001 (Romanian Treaty).
\end{footnotesize}
Article when this language is included in a tax treaty, it is intended that they will not be protected from Australian tax by the business profits Article. Explanatory Memoranda to Bills introduced to give domestic effect to recent tax treaties also indicate that it is significant in this context that the title of the alienation of property Article in recent treaties is “Income, profits or gains from the alienation of property.”40 This is said to “put beyond doubt that a gain from the alienation of property which in Australia is income or a profit under ordinary concepts” (emphasis in original) will be dealt with under the alienation of property Article and not the business profits Article.41

The Explanatory Memorandum states at [2.85] that “capital gains” in Art 13(7) has the same meaning in Australia as “gains of a capital nature”, and that the taxation of revenue gains, including revenue gains taxed under the capital gains provisions, will not be governed by Art 13(7). Therefore, revenue gains that are not specifically dealt with under Art 13 will be dealt with under the business profits Article or under the other income Article. Profits of a revenue nature would include profits of the type derived in Thiel v FCT (1990) 171 CLR 338, where the profit arose under an isolated transaction entered into with the purpose of making a profit. Consequently, Art 13(7) will not reserve for Australia the right to tax gains of the type that arose in Thiel.42 By contrast, the language used in other recent treaties potentially allows Australia to tax revenue gains because it allows Australia to apply “its law” relating to gains of a capital nature – although the better view is that this language is also limited in scope to gains that are capital gains on first principles.43

LIMITATION ON BENEFITS

The Protocol replaced Art 16 of the US Treaty with a new, more comprehensive, limitation on benefits Article.44 Limitation on benefits Articles are a feature of all tax treaties entered into by the United States after 1979.45 These Articles reflect a United States concern that benefits granted by the United States under its treaties should not be obtained by residents of third countries where “treaty shopping” is involved.46 “Treaty shopping” in this context is taken to mean “the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to

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40 See, for example, Art 13, Romanian Treaty.
41 Explanatory Memorandum accompanying the International Tax Agreements Amendment Bill (No 1) 2000 (Cth) at [1.110]. This Bill was introduced into Parliament to give effect in Australian domestic law to the Romanian Treaty.
42 Also, if “capital gains” in Art 13(7) means gains of a capital nature in the ordinary sense, they would not appear to encompass notional gains which can arise under the capital gains rules. An example of a notional gain would be a capital gain which arises under s 104-175 of the ITAA 1997 in respect of CGT event J1. This is where a company to which an asset has been transferred in reliance on the group roll-over provisions of Subdiv 126-B of the ITAA 1997, ceases to be a member of the same group as the company which transferred the asset to it. However, as such notional gains do not generate profits, there would be no basis upon which they could be treated as business profits which are protected from Australian tax under Art 7, US Treaty.
44 The old limitation on benefits Article provided that a person other than an individual was entitled to treaty benefits if it was more than 75% owned by residents of one of the States; if it was a company in “whose principal class of shares there [was] substantial and regular trading on a recognized stock exchange” of one of the countries; or if the establishment, acquisition or maintenance of the person did not have as one of its principal purposes the purpose of obtaining treaty benefits. The new Article is significantly more detailed, and contains additional provisions dealing with headquarters companies and entities carrying on active businesses. The approach to more detailed limitation on benefit Articles was first adopted in the US–Netherlands Treaty. The United States Congress Joint Committee on Taxation, in its Explanation of Proposed Income Tax Treaty (and Proposed Protocol) between the United States and the Netherlands, states that “the proliferation of detail” reflects in part a diminution in the ability of the IRS and the courts to resolve interpretative issues adversely to a person claiming treaty benefits, and also a desire to provide guidance to taxpayers which might be absent in other treaties: CCH Editorial Staff, Tax Treaties (CCH, subscription service, 2003) at [36,463].
45 The Convention Between the Government of the United States of America and the Government of the Hungarian People’s Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1979 (US–Hungary Treaty) was the last United States Treaty not to have a limitation on benefits Article.
obtain the benefits of a tax treaty between the United States and the other Contracting State. In terms of this policy, “treaty shopping” does not arise where a third country resident had “substantial reasons” for establishing an entity in a state with which the US has a treaty, and those reasons are unconnected with the obtaining of treaty benefits.

The United States’ concerns in relation to “treaty shopping” are not unique, and the commentaries on Art 1, OECD Model Convention suggest a number of ways in which countries might address “treaty shopping” in their treaties. Most countries, including Australia, do not include comprehensive anti-treaty shopping provisions in their treaties. Australia has limited anti-treaty shopping provisions in its treaties with China, Vietnam and Russia. The 2003 Australia–UK Treaty does not contain a limitation on benefits Article, but does contain a number of provisions throughout the Treaty that limit the availability of certain benefits. Art 10(3) of the 2003 Australia–UK Treaty provides that dividends paid by a company resident in one state to a company resident in the other state that holds shares representing 80% or more of the voting power in the company paying the dividend are exempt from tax in the state in which that company is resident. Like Art 10(3) of the US Treaty, this exemption applies only if the beneficial owner of the dividends has its principal class of shares listed and regularly traded on a recognised stock exchange or if the competent authority of the State in which the company paying the dividends is resident determines that the establishment, acquisition or maintenance of the company that is the beneficial owner of the dividends, and the conduct of its operations, did not have as one of its principal purposes the obtaining of treaty benefits. The dividend, interest, royalty and other income Articles of the 2003 Australia–UK Treaty also contain a provision to the effect that relief is not available under the relevant Article if it was a main purpose, or one of the main purposes, of any person concerned with the creation or assignment of the shares, debt-claim or rights in respect of which the payments are made, to take advantage of the Article. In any event, even though Australian tax treaties other than the US Treaty do not contain a limitation on benefits Article, or do not contain the specific limitation rules of the type in the Treaties with China, Vietnam, Russia and the United Kingdom, the general anti-avoidance provisions of Pt IVA of the ITAA 1936 potentially apply where a structure is explicable primarily by reference to a “treaty shopping” purpose.

The mechanism for dealing with “treaty shopping” adopted under the US Model Convention, and in the new Art 16 of the US Treaty, is to lay down a series of specific rules designed to define the circumstances in which a person will be considered to have a real business purpose for the

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47 US Treasury Explanation, pp 21-22. The United States has also attacked this problem through its domestic law: see discussion of United States conduit financing rules under the heading, “Rate of tax” in the discussion of the new Art 11 (Interest article) in Part 1 of this article.


49 OECD Model Convention, n 12, commentary on Art 1 at [7] – [21]. The commentators suggest a range of possible solutions, including a rule that looks through to underlying ownership of entities, together with rules that ensure that treaty benefits are not disallowed in “bona fide” situations. These include situations where a company is engaged in substantive business operations in the State in which it is resident, where the company’s principal class of shares is listed on a stock exchange in one of the States or where the company is established in the State for sound business reasons and does not have the primary purpose of obtaining treaty benefits. Each of these are reflected in recent US Treaty limitation on benefits Articles as “bona fide” situations in which treaty benefits are made available.

50 Article 8 of the Agreement Between the Government of Australia and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1990 provides that the benefits of the interest, dividends and royalties Articles are not available to any company which has become a resident of a Contracting State for the principal purpose of enjoying benefits under that Treaty. Article 23(7)(c) of the Vietnamese Treaty provides that the tax sparing credits provided under that Treaty are not available where an Australian resident enters into a scheme with the purpose of using Vietnam as a conduit for income, or as a location of property, in order to evade or avoid Australian tax through the exploitation of Australia’s foreign tax credit provisions. Article 23 of the Russian Treaty is a limitation of benefits Article, but it has a narrower focus than Art 16 of the US Treaty. It provides that Treaty benefits do not apply to income or profits from activities such as banking, shipping, financing, insurance or internet activities, headquarter or coordination centre activities, activities giving rise to passive income or other activities, the performance of which does not require substantial presence in the State of source, where such income is preferentially taxed and information in relation to such activities is accorded confidential treatment beyond the usual level of protection provided to tax information.

51 The operation of Pt IVA in a tax treaty context is specifically preserved by s 4(2) of the ITAA 1953 and by s 177B(1) of the ITAA 1936.
structure adopted or will be considered to have a sufficiently close connection with the relevant State to justify the availability of treaty benefits. The competent authorities are then given the authority to grant treaty benefits if they are not available by virtue of the operation of the specific rules. The general rule in the new Art 16 is that a resident of Australia or the United States that derives income from the other State is not entitled to the benefits of the Treaty unless it is a “qualified person”. Individuals, government bodies and entities organised under the laws of one of the States and established in that State exclusively for a religious, charitable, educational or scientific purpose are qualified persons. Other entities are treated as qualified persons if certain requirements as to ownership, treatment of income or activities are satisfied. These requirements are considered in more detail below.

Listed companies

Under Art 16(2)(c), a company is a qualified person if it satisfies a stock exchange listing requirement. That requirement is satisfied if the principal class of the company’s shares is listed on a recognised stock exchange and is regularly traded on one or more recognised stock exchanges. The listing requirement is also satisfied by a company if at least 50% of the aggregate voting power and value of the shares in the company is owned directly or indirectly by companies whose principal class of shares satisfy the recognised stock exchange listing and trading test. Indirect ownership is only taken into account for this purpose if each intermediate owner is resident in Australia or the United States.

The concept of a company’s “principal class of shares” is not defined in the Treaty. The Explanatory Memorandum states at [2.92] that the “principal class of shares of a company is the class that accounts for more than half of the voting power and value of the company”. If no single class accounts for more than half of the voting power or value of the company, the Explanatory Memorandum states that the listing and trading requirements must be satisfied for each class of a group which, taken together, account for more than half of the voting power and value of the company. A class of shares is to be taken to account for more than half of the voting power of a company if it conveys more than half the number of votes that can be cast on a poll at a general meeting as regards all questions that can be submitted to a poll.

If the capital structure of the shareholding company consists primarily of ordinary shares, it would be expected that those shares would usually constitute the company’s principal class of shares. If the shareholding company has a more complex capital structure consisting of ordinary and preference shares, with the ordinary shares carrying the majority voting power but the preference

52 Article 22(4) of the US Model Convention provides that a resident of a Contracting State who is not otherwise entitled to treaty benefits may be granted such benefits if the Competent Authority of the State from which benefits are claimed so determines. The new Art 16(5) of the US Treaty is more specific, and therefore potentially narrower in its scope, where it provides that such relief may be granted if the relevant Competent Authority determines that the establishment, acquisition or maintenance of the person, and the conduct of its operations, did not have as one of its principal purposes the obtaining of benefits under the US Treaty.
53 Article 16(1), US Treaty.
54 Article 16(2), (a), (b) and (e), US Treaty.
55 Article 16(2)(c)(i), US Treaty. The concept of a “recognised stock exchange” is defined in Art 16(6) as meaning the NASDAQ system and any stock exchange registered with the United States Securities and Exchange Commission as a national securities exchange under the US Securities Exchange Act 1934 (US), and, in the case of Australia, the Australian Stock Exchange and any other Australian Stock Exchange recognised as such under Australian law. There is also provision for the competent authorities to agree on other stock exchanges. The concept of a “recognised stock exchange” is more broadly defined in the Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains 2001 (UK–US Treaty) as meaning not only the United States and London exchanges but also the Irish Stock Exchange, the Swiss Stock Exchange, and the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto and Vienna: Art 23(7)(a), UK–US Treaty.
56 Article 16(2)(c)(ii), US Treaty.
57 This explanation of “principal class of shares” is similar to the definition of that term contained in the UK–US Treaty in relation to the listed company test in the Treaty’s limitation on benefits Article: see Art 23(2)(c)(i), UK–US Treaty.
shares carrying the majority of the value, the ordinary and preference shares would be aggregated and treated as one class under this test. The listing test would be satisfied if both the ordinary and preference shares were listed and regularly traded on a recognised stock exchange.58

If a company has a special voting share on issue that carries super voting rights, that share would be of a different class to the company’s ordinary shares.59 Such shares are not listed and therefore, on the interpretation adopted in the Explanatory Memorandum, would not be taken into account in determining whether the test in Art 16(2)(c)(i) is satisfied. However, this would not be of significance if, as would be expected, the company’s ordinary shares independently satisfied the listing and trading requirements and represented more than one half of the voting power and value of the company.

Two other requirements of Art 16(2)(c)(i) are that the company’s “shares” be listed on a recognised stock exchange and that the shares be “regularly traded”. Both of these terms are defined in the UK–US Treaty but not in the US Treaty. In the UK–US Treaty “shares” is defined as including “depository receipts thereof or trust certificates thereof”.60 Therefore, the test would be satisfied if the company’s American depository receipts (ADRs) were listed, and regularly traded, on a recognised exchange. Since an ADR is an interest in a share rather than a share,61 there is a question as to whether Australia would treat those instruments as shares for the purposes of Art 16. The ITAA 1936 and ITAA 1997 specifically refer to an “interest in a share” where it is intended to apply to interests held by persons who are not the registered shareholders.62 Consequently, it may be inferred that where the legislation refers only to “shares” it does not apply to interests in shares.63 However, it would be surprising if such a narrow interpretation were adopted, and the better view, given the intention of the provision, is that Australia would treat ADRs as shares for the purposes of Art 16(2)(c)(i).

There is no definition of “regularly traded” in Art 16. The Explanatory Memorandum states at [2.94] that for Australian purposes the expression will be interpreted in accordance with domestic law. However, there is no domestic tax law concept of regular trading of shares, and the concept is not relevant for general corporations law purposes or for Australian Stock Exchange listing purposes. For the purposes of the UK–US Treaty, shares of a particular class are considered to be “regularly traded” on one or more recognised stock exchanges [for] a particular chargeable or taxable period if the aggregate number of shares … of that class traded on such stock exchange or exchanges during the twelve months ending on the day before the beginning of that … period is at least six percent of the average number of shares … outstanding in that class during that twelve-month period.64

58 Explanatory Memorandum accompanying the International Tax Agreements Amendment Bill (No 1) 2002 (Cth) at [2.92] (the Explanatory Memorandum).
59 Such shares are a feature of dual listed company structures. Each of the listed companies participating in the structure typically issues a special voting share to a special purpose entity. That share carries voting rights that enable the votes of the shareholders in the other listed company to be reflected at a general meeting of the company which issued the share. See generally: Bowler I, Walkington L and Tucker K, “BHP Billiton: How to achieve a DLC merger”, (2001) 12 International Tax Review 11.
60 Article 23(7)(b)(ii), UK–US Treaty.
61 The ADR would be an interest in a share because the actual shares are held by the depository rather than by the holder of the ADR.
62 For example, ss 136-25 and 175-95 of the ITAA 1997 refer separately to shares and interests in shares. Also, see the old s 159GZG(1)(a), ITAA 1936 prior to its repeal by the Taxation Laws Amendment (Company Law Review) Act 1998 (Cth).
63 Article 23(7)(c), UK–US Treaty.
This rule is in the nature of a safe harbour so that if the 6% threshold is attained in the preceding period the requirement is satisfied, but if it is not attained it would still be possible to satisfy the requirement if the 6% trading threshold is attained in the current year.65

The US Treasury Explanation states at p 25 that for United States purposes “regular trading” is to have the meaning it has under s 1.884-5(d)(4)(i)(B) of the Treasury Regulations. That regulation provides that shares are regularly traded for the purposes of the branch profits tax provisions of s 884, IRC66 if trades, other than in de minimis quantities, are effected on the market on at least 60 days during the year and the aggregate number of shares traded during the year is at least 10% of the average number of shares outstanding in the relevant class of shares during the year. Often, this should not be difficult for Australian resident listed companies to satisfy in the ordinary course of events. However, problems could arise if a substantial part of the trading was on exchanges that were not recognised exchanges for the purposes of the US Treaty.67 Also, in cases where a majority shareholding is held by a single shareholder, it might be difficult to satisfy the 10% trading requirement. As there is no equivalent rule that will apply from an Australian perspective, United States listed companies would need to be able to demonstrate frequent trading in their shares over the course of the relevant year if they are to satisfy the regularly traded test. It may be that the ATO would follow the United States approach of accepting that trading on 60 days of the year is sufficiently frequent.

If a company’s shares are not listed, it is still treated as a qualified person under the listing rule in Art 16(2)(c)(ii) if at least 50% of the aggregate voting power and value of its shares is owned, directly or indirectly, by five or fewer companies which satisfy the listing test in Art 16(2)(c)(i). Where shares are owned indirectly, each intermediate entity must be resident in Australia or the United States. Article 16(2)(c)(ii) ensures that it is not necessary for listed companies to directly hold shares in companies resident in the other country. For example, an Australian resident subsidiary of an Australian listed company would as a consequence of Art 16(2)(c)(ii) be a qualified person under the listing test.

Other listed entities
The qualified person status of listed companies provided by Art 16(2)(c) is mirrored for other listed entities by Art 16(2)(d). Under that provision, persons other than individuals or companies are qualified persons if their principal class of units is listed or admitted to dealings on a recognised stock exchange, and is regularly traded on one or more of such exchanges. An entity other than a company is also a qualified person if the direct or indirect owners of at least 50% of the beneficial interests in that person are qualified persons under the listed companies rule in Art 16(2)(c)(i) or under the listed entities rule in Art 16(2)(d)(i).68

On its face, Art 16(2)(d) should apply to listed Australian unit trusts. However, the US Treasury Explanation states at p 26 that such trusts would generally be regarded as companies for US tax purposes and, therefore, would be dealt with under para (c) rather than under para (d). This is potentially beneficial because if these trusts were not treated as companies for US tax purposes, the unit holders would potentially need to establish that they were entitled to treaty benefits. Non-Australian resident unit holders could not therefore enjoy the benefits of the Treaty. Also, even if it were acceptable for the trust to claim treaty benefits, a trust is resident in Australia for the purposes of the Treaty under Art 4 only in relation to income that is taxed to the trust or to any beneficiary as

66 Section 884(a) of the IRC imposes a branch profits tax on foreign corporations of 30% of the amount deemed equivalent to a dividend: see discussion in Part 1 of this article published in the September edition of this journal under “Branch profits tax”. That rate is reduced for “qualifying residents”, which includes foreign corporations whose shares are regularly traded on an established securities market.
67 This problem may be dealt with in some cases by the competent authorities, under Art 16(6)(c) of the US Treaty, agreeing to treat other stock exchanges as recognised exchanges.
68 The Explanatory Memorandum states at [2.96] that for an entity to qualify on the basis of at least 50% ownership of beneficial ownership by entities which satisfy the listing and trading tests, that ownership must be held by five or fewer entities which satisfy those tests. This appears to be a mistake because there is no limitation in Art 16(2)(d)(i) on the number of entities which may be taken into account in determining whether the 50% ownership test is satisfied.
income of an Australian resident. Therefore, if the unit trust were treated as a trust for United States tax purposes it would only be treated as Australian resident when the United States applied the Treaty to the extent that its unit holders were Australian resident. By contrast, as the trust would in fact be treated as a company for United States tax purposes it would potentially be entitled to full treaty benefits if it satisfied the requirements of Art 16(2)(c).

**Pension funds**

Article 16(2)(f) provides that entities organised under the laws of Australia or the United States to provide pension or other similar benefits to employed and self employed persons are qualified persons if more than 50% of the beneficiaries or members are residents of Australia or the United States. The extent to which benefits are similar to pensions is not clear from Art 16. However, the US Treasury Technical Explanation to the US Model Convention indicates that it is intended to encompass benefits such as health and disability benefits. It is unlikely that schemes providing lump sum benefits will be regarded as providing equivalent benefits to pension funds. Also, schemes that are not established to provide benefits for employees or the self employed would not fall within Art 16(2)(f).

**Ownership and base erosion test**

Under Art 16(2)(g), a person other than an individual is a qualified person if an ownership test and a tax base erosion test are satisfied. The ownership test requires that for at least half of the days of a taxable year persons who are qualified persons under paras (a), (b), (c)(i) or (d)(i) of Art 16(2) own, “directly or indirectly, at least 50 percent of the aggregate vote and value of the shares or other beneficial interests in the person”. The tax base erosion test requires that “less than 50 percent of the person’s gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not resident” in Australia or the United States, other than certain permitted payments to third country residents, in the form of tax deductible payments. Payments to third country residents are permitted, however, where they are at arm’s length and are made in the ordinary course of business for services or tangible property, or are in respect of obligations to a bank. Payments to banks resident in third countries are only acceptable for this purpose if they are attributable to a permanent establishment of the bank in Australia or the United States.

Article 16(2)(g) will apply to companies and trusts which do not satisfy the listing and regular trading test in Arts 16(2)(c) and 16(2)(d). Therefore, it will apply to unlisted companies and trusts which are not at least 50% owned by listed companies or trusts. The assumption underlying Art 16(2)(g) is that at least 50% ownership of an entity by residents of either or both countries is generally a sufficient connection with the entity’s State of residence to justify the availability of treaty benefits. The base erosion test is essentially an anti-avoidance rule dealing with the situation where a significant portion of the income derived by the entity is on-paid to residents of third countries other than in connection with the specified arm’s length transactions. The provision is based on Art 22(2)(f) of the US Model Convention but incorporates modifications adopted in Art 23(2)(f), UK–US Treaty. In particular, the allowance of payments to third country residents for services or

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70 Article 23(2)(f) of the UK–US Treaty contains a similar provision: CCH Editorial Staff, n 44 at [44,505-18]. However, that Treaty also contains a “derivative benefits” provision under which United Kingdom or United States companies which are owned as to 95% by “equivalent beneficiaries” are qualified persons if a base erosion test is satisfied: see Art 23(3) of the UK–US Treaty. Equivalent beneficiaries are persons who are resident in a member State of the European Community or European Economic area, or in a party to the North American Free Trade Agreement Between the Government of Canada, the Government of the United Mexican States, and the Government of the United States of America 1994 (North American Free Trade Agreement), and who are entitled to the benefits of the Treaty between the country of their residence and the country from which the benefits of the UK–US Treaty are claimed. By way of example, a United Kingdom incorporated company which is owned by a Netherlands resident would be owned by an equivalent beneficiary if the Netherlands resident was a qualified person under the limitation of benefits Article in the US–Netherlands Treaty. The theory underlying derivative benefit provisions of this type is that third country residents who own entities in one of the Contracting States are not “treaty shopping” if they could obtain the same benefits by investing directly in the Contracting State.
tangible property was an innovation in the UK–US Treaty that has been adopted in Art 16(2)(g) of the US Treaty. By contrast, the US Model Convention provision allows such payments only if they are received by the third country resident in connection with a permanent establishment in one of the Treaty States.

If the relevant entity is a company, the requirement in the ownership limb of the test is that qualified persons within the meaning of paras (a), (b), (c)(i) and (d)(i) own directly or indirectly at least 50% of the aggregate vote and value of the shares in the company. This would allow private companies owned as to 50% or more by Australian or US resident individuals to be treated as qualified persons. Where private companies are owned by other private companies, the reference to indirect ownership is intended to allow tracing through interposed companies to identify whether any qualified person shareholders can be identified. The reference to qualified persons under paras (c)(i) and (d)(i) allows ownership by listed companies and listed unit trusts to be taken into account without having to trace through those entities. While companies and trusts that are, respectively, at least 50% owned by listed companies or listed trusts are qualified persons under paras (c)(i) and (d)(i), para (g)(i) deals with a situation where the level of ownership by such listed entities is less than 50%. For example, an Australian resident company owned as to 20% by an Australian resident listed company and as to 30% by Australian resident individuals would satisfy the requirements of para (g)(i).

Indirect ownership is to be traced through companies or trusts which are qualified persons other than under paras (c)(i) and (d)(i). Assume, for example, that an Australian resident company (Ausco 1) is 50% owned by another Australian resident company (Ausco 2) which is in turn owned as to 50% by Australian resident individuals and as to 50% by non-residents. Ausco 2 would be a qualified person under Art 16(2)(g) if it satisfied the base erosion test. To determine whether Ausco 1 is a qualified person, it would be necessary to trace through Ausco 2. Consequently, the Australian resident shareholders in Ausco 2 would be treated as owning indirectly 25% of the shares in Ausco 1. Article 16(2)(g) does not contain the restriction in Art 16(2)(c)(ii) that intermediate entities can be traced through only if they are resident in Australia or the US. Consequently, it would be permissible to trace through entities resident in third countries to determine ultimate ownership for the purposes of Art 16(2)(g).

To satisfy the ownership limb of the test, at least 50% of the “aggregate vote and value” of shares or beneficial interests must be held by qualified persons. If a company has both ordinary shares and non-voting preference shares on issue, it would be necessary to establish that residents of the US or Australia had at least 50% of the aggregate votes and value attaching to those shares. Article 16(4) is relevant in this context. This is essentially an anti-avoidance measure dealing with tracker shares. It would apply, for example, if an Australian resident company which derived US source income issued a separate class of shares to residents of a third country where the holder of those shares was entitled to a disproportionate share of the United States source income. In these circumstances, benefits would not be available under the Treaty in relation to the disproportionate part of the income unless 50% or more of the voting power and value attaching

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71 It is not necessary to trace through a company or trust which satisfies paras (c)(i) or (d)(i) because such entities are qualified persons and tracing is therefore not necessary to identify a qualified person. The Explanatory Memorandum states at [2.101] that tracing can only be undertaken through entities which are qualified persons. However, this limitation is not apparent from para (g)(i), and the US Treasury Explanation does not suggest such a limitation. If such a limitation did exist, it would not be possible, for example, to trace through companies resident in third states.

72 This possibility is not referred to in the Explanatory Memorandum or in the US Treasury Explanation, but is specifically referred to in the US Treasury’s Technical Explanation of the equivalent provision in the US–Netherlands Treaty: CCH Editorial Staff, n 44 at [36,628].

73 For example, assume that an Australian resident company has on issue one million ordinary shares with an aggregate value of $5 million, 60% of which are held directly or indirectly by Australian resident individuals. Assume also that the company has on issue one million $1 non-voting preference shares with an aggregate value of $1 million, all of which are held by non-residents. In this example, by virtue of the 60% ordinary shareholding, Australian residents would hold 60% of the aggregate voting power and 50% of the aggregate value.

74 There is no equivalent provision in the US Model Convention, but Art 23(5) of the UK–US Treaty is in similar terms: CCH Editorial Staff, n 44 at [44,505] – [44,519].
to the tracker shares was held by qualified persons. Consequently, even if a company satisfies the ownership and base erosion test in Art 16(2)(g), treaty benefits could be denied if it has on issue tracker shares that effectively allow the streaming of United States source income to third country residents.

If the entity is a trust, at least 50% of the beneficial interests in the trust must be held by the relevant qualified persons. If this test is construed narrowly, discretionary trusts would not qualify because the beneficiaries would not have an interest in the trust on at least half of the days in the taxable year. The US Treasury Explanation states at p 28 that beneficial interests in a trust are determined on the basis of the beneficiaries’ actuarial interests in the trust. If it is not possible to determine actuarial interests, the US Treasury Explanation (still at p 28) states that the ownership test cannot be satisfied unless all possible beneficiaries of the trust are persons entitled to benefits under the Treaty under other paragraphs of Art 16. Therefore, if a discretionary trust had a defined class of beneficiaries, all of whom were resident in Australia, it appears that for United States purposes the ownership test would be treated as satisfied. However, if one of the beneficiaries was not resident in Australia or the United States it appears that the trust would not satisfy the test.

The analysis in the preceding paragraph proceeds on the basis that Art 16(2)(g) is applied at the trust level. This is supported by the definition of “resident” in Art 4 that treats a trust as resident in the United States or Australia to the extent that the income of the trust is taxed to United States or Australian residents. As the trust is the resident for the purposes of the Treaty, it follows that the limitation on benefits Article should be applied at the trust level. However, if the income of a trust is taxed to the beneficiaries, the limitation on benefits Article should logically be applied at the beneficiary level. Consider, for example, a unit trust where the units are owned as to 40% by Australian resident individuals. Under Art 4, the trust would be treated as Australian resident in relation to 40% of the trust income. If the test in Art 16(2)(g) is applied at the trust level, the ownership test would not be satisfied because the trust would have 60% non-Australian resident ownership. Consequently, no treaty benefits would be available unless another provision in Art 16 applied. If the test were instead applied at the unit holder level, treaty benefits would be available in relation to the 40% share of the trust’s income that is taxed to Australian resident individuals. This more sensible outcome would be achieved by applying Art 16(2)(g) at the beneficiary level when the income is taxed to the beneficiary, and at the trust level when the income is taxed to the trustee.

The ownership test must be satisfied on at least half of the days of the taxable year. Where a company or trust is established during a year it may not be possible to satisfy this requirement if it is in existence for less than half of the year. Similarly, the winding up of an entity during a year would potentially result in it ceasing to satisfy the ownership test for that year.

The base erosion test in Art 16(2)(g) looks to whether 50% or more of an entity’s gross income is paid in a tax deductible form to residents of countries other than Australia or the United States. “Gross income” is undefined in the US Treaty. The US Treasury Explanation states at p 28 that in determining whether a person deriving income from the US is entitled to treaty benefits, “gross income” will have the same meaning as in s 61 of the IRC and the Regulations under that section. Section 61(1) provides that “gross income” means all income from whatever source. In relation to business income, the Regulations provide that “gross income” means the total sales less cost of goods sold, plus any income from investments and from incidental or outside operations or sources. The Explanatory Memorandum states at [2.103] that for Australian purposes “gross income” will be taken to mean gross receipts less cost of goods sold.

75 The disproportionate part of the income would be the part of the United States source income distributed to the holders of the separate share class that would not have been so distributed if not for the special terms or other arrangements attaching to the shares that entitle the holders to a distribution of a disproportionate part of the United States source income: see Art 16(4)(a) of the US Treaty.
76 Gartside v Inland Revenue Commissioners [1968] AC 553.
77 See Art 4(1)(a) and 4(2)(b)(ii), US Treaty.
78 Section 1.61-3(a), Treasury Regulations.
79 In a capital gains context, this should be taken to mean the net capital gain; ie capital proceeds less cost base.
The test requires a calculation of the amount “paid or accrued” in the form of “payments” to third country residents. As accrued expenses are referred to, it appears that it is not necessary for the payment to be made during the year in which it accrued and was treated as deductible. The test focuses on payments in order to exclude deductions for capital allowances like depreciation. Payments are treated as base eroding if they are paid or accrued “directly or indirectly” to a third country resident. This may apply to some back-to-back transactions. For example, consider an arrangement under which a Netherlands resident company licenses intellectual property to a United States corporation (US Co1), US Co1 sub-licenses the property to another United States corporation (US Co2), and US Co2 sub-sub-licenses the property to an Australian resident. The sub-license payments made by US Co2 are to a United States resident. However, if equivalent amounts were then on-paid by US Co1 to the Netherlands licensor it is likely that for the purposes of the base erosion test US Co2 would be regarded as having made payments indirectly to a resident of a third country. The position would be less clear if US Co1 also licensed intellectual property to other parties and earned a margin on its licensing activities. In these circumstances, it would be more difficult to argue that US Co2 is making indirect payments to the Netherlands company.

According to the US Treasury Explanation, the objective of the base erosion test in the US Model Convention is to determine whether income derived from one of the Treaty States is subject to tax in the other State. Therefore, payments to residents of the State in which the entity deriving the income is resident are permitted, and payments to residents of third countries where the payment is derived in connection with a permanent establishment in the entity’s State of residence are also permitted. The policy reflected in Art 16(2)(g)(ii) of the US Treaty and in the equivalent provision of the UK–US Treaty, has moved beyond this because it permits payments to third country residents under arm’s length transactions whether or not the payments are derived in connection with a permanent establishment in the payer’s State of residence. The underlying policy in this context is presumably that the arrangements have not been structured with “treaty shopping” in mind if they are made on arm’s length terms. A further aspect to para (g)(ii) is that it focuses only on deductible payments. Non-portfolio dividends derived by Australian resident companies can flow through to non-resident shareholders free of Australian tax. Generally, this would not provide significant structuring opportunities for third country residents because the ownership test must also be satisfied. This would ordinarily result in leakage of at least 50% of the income to Australian residents. The possibility of avoiding that leakage through the use of tracker shares, where the distributions are linked to the amount of United States source income derived by the company, is specifically targeted by Art 16(4).

The US Treasury Explanation states that trust distributions will be treated as deductible payments to the extent that they are deductible from the tax base. Therefore, amounts included in the assessable income of a beneficiary of an Australian trust would likely be treated as deductible payments from a United States perspective. If the beneficiary made deductible payments to a resident of a third country, for example by way of interest on amounts borrowed to fund a unit subscription, the trust could be treated as making deductible payments indirectly to the third country resident. From an Australian perspective, the fact that an amount is included in the income of a beneficiary or a partner would not as a technical matter be treated as a trust or partnership deduction under the ITAA 1936. However, given the objective of Art 16(2)(g) it may be that such amounts will be viewed as deductions for the purposes of that provision.

Headquarters companies

“Recognised headquarters companies” are treated as qualified persons under Art 16(2)(h). A similar provision is also contained in the US–Netherlands Treaty, but is not routinely included in United

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81 This would be the case whether or not the licence to US Co1 was at arm’s length because the arm’s length payment exception in Art 16(2)(g)(ii) applies only to payments for services and for tangible property.
82 Non-portfolio dividends are exempt from tax under s 23AJ of the ITAA 1936 to the extent that they are exempting receipts. Non-portfolio dividends from listed countries, including the United States, are treated as exempting receipts. These dividends can be on-paid to non-resident shareholders free of withholding tax if the requirements of the foreign dividend account regime are complied with: see ss 128S to 128TF of the ITAA 1936.
States tax treaties. Given the Australian Government’s focus on establishing Australia as a regional headquarters centre, it is likely that this provision was included in the Article at Australia’s request. The requirements that must be satisfied are quite onerous and it is unlikely that this test will be satisfied in many cases.

Seven requirements must be satisfied by a company to attain recognised headquarters company status. In broad terms, the requirements seek to identify true headquarters operations by focusing on the type of activities conducted by the company, what the company carries out those operations in relation to, the nature of the income that is derived by the company and the nature of the group that it supervises. The intention is also to ensure that the group that the headquarters company is part of is truly multinational.

The first and fifth requirements focus on the activities conducted by the company. The first requirement is that the company must provide in its State of residence “a substantial portion of the overall supervision and administration of a group of companies”. It is not necessary that the company own shares in the companies which it supervises. The activities can include group financing but cannot consist principally of group financing. The group may be part of a larger group of companies. Therefore, an Australian subsidiary of a United Kingdom-based multinational, for example, may qualify if it supervises the activities of other companies. The requirement that the company provide a “substantial portion” of the overall supervision and administration of the group means that the company must have employees able to carry out such functions. Further, it recognises that supervision and administration may also be carried out by other companies in the group.

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84 The limitation on benefits Article in the UK–US Treaty signed shortly before the signing of the Protocol does not have a headquarters company provision. Similarly, other recent United States treaties do not contain such a provision: see, for example, the limitation on benefits Article in the Convention Between the Government of the United States of America and the Government of the Republic of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital 1999 (US–Venezuela Treaty).

85 In a paper published by the Liberal Party in connection with the 2001 Federal Election campaign it was stated that the government would as a matter of priority review Australia’s international tax rules to determine, among other things, whether they act as an impediment to the location of holding and conduit companies in Australia: Liberal Party of Australia, The Howard Government – Putting Australia’s interests first: Election 2001, p 17, http://www.liberal.org.au/policy/securing.PDF viewed 22 May 2003. The Treasurer’s Press Release announcing a review of Australia’s international tax rules by the Board of Taxation also singled out the treatment under those rules of “conduit income” and their impact on the establishment of regional holding companies in Australia: Costello P, Press Release No 21: Review of international tax arrangements (2 May 2002).

86 With a view to making Australia more attractive as a location for holding companies and regional headquarters, the Board of Taxation recommended a general exemption for foreign non-portfolio dividends, a capital gains tax exemption for foreign non-portfolio shareholders in Australian companies where the underlying gain has a foreign source: Costello P, Press Release No 32, Review of international taxation arrangements (13 May 2003), Attachment C.

87 Article 16(2)(b)(i), US Treaty.

88 No clarification is provided in Art 16 as to how it will be determined whether financing is the principal activity. In para [XVIII] of the Memorandum of Understanding entered into between the United States and the Netherlands in relation to the US–Netherlands Treaty, it is stated that whether group financing is a company’s principal activity is not determined by reference solely to the amount of gross income derived from its different activities: CCH Editorial Staff, n 44 at [36,640]. By way of example of other factors that will be relevant in this context, the US Treasury’s Technical Explanation to the US–Netherlands Treaty states that the payroll expense attributable to each of the company’s headquarters functions would also be relevant: CCH Editorial Staff, n 44 at [36,639].

89 The extent to which the supervision and administration activities carried out by the company would be substantial where another company also performs such activities would be a question of fact. Paragraph XVIII of the Memorandum of Understanding in relation to the US–Netherlands Treaty provides an example of how the substantial activities test is to be applied in relation to that Treaty: CCH Editorial Staff, n 44 at [36,440]. The example involves a Japanese corporation which establishes a Dutch headquarters company for its European and North American operations and also has two other headquarters.
Administration would involve head office-type functions like accounting, financing, treasury, human resources and legal. Supervision refers more to management control and would require the location of regional management within the headquarters company. This first requirement should be read together with the fifth requirement that the company has and exercises, “independent discretionary authority” to carry out the supervisory and administrative functions.90 This would require some degree of delegation to the company’s employees so that they do not require head office approval to carry out their supervisory and administrative activities.91 Presumably, this requirement will be applied in a way that recognises that all regional headquarters companies act under constraints imposed by the ultimate group holding company, and that acting in accordance with those constraints will not result in the test being failed. Where a headquarters company exercises independent discretionary authority in relation to some matters but not in relation to others, only the matters in respect of which independent authority is exercised will be taken into account in applying cl 2(h)(v).92

The second, third, fourth and seventh requirements lay down rules in relation to the income derived by group members and by the headquarter company, and the second requirement also prescribes the number of countries in which the group must operate. The second requirement is that the group supervised by the headquarters company consists of companies resident, and engaged in an active business, in at least five countries or groupings of countries, and the business activities conducted in each of those countries, or groups of countries, generate at least 10% of the gross income of the group.93 The requirement for geographic diversity is presumably to ensure that it is not possible to establish a holding company for the sole purpose of supervising the activities of subsidiaries resident in the other State. If the company supervises group members in at least five States this suggests that it has not been established for the purpose of obtaining benefits under the US Treaty. The requirement that the supervised companies carry on active businesses confirms genuine headquarters company status because it means that the headquarters company has something to supervise. There is no indication as to how countries should be grouped. Therefore, it would be possible to group countries as required to achieve the 10% gross income threshold without regard to any geographic proximity between the countries.94 It would also be possible to count the country in which the headquarters company is resident so that an Australian headquarters company, for example, would qualify if it supervised an Australian group member and group members in four other countries or groups of countries. The requirement that each of the companies or groups generate at least 10% of the gross income of the group is to ensure that it is not possible to satisfy the test by establishing companies in a number of countries with only minor business activities in order to satisfy the five country test. If the 10% threshold is not achieved in a particular year, the test can still be satisfied if it is achieved on an averaging of the gross income of the preceding four years.

The third requirement places a cap on the amount of income that can be generated in any one country by requiring that the business activities carried on in any one country other than the companies in relation to its Asian and African operations. The Japanese parent sets the guidelines for the worldwide group, and ensures that those guidelines are adhered to in each of the regional groups. The Dutch company supervises most of the pricing, marketing, internal auditing, internal communications and management of its group, and monitors and controls the way in which the guidelines established by the Japanese parent are carried out. The capital and pay-roll devoted by the Japanese parent to these activities in relation to the group supervised by the Dutch company are small relative to the capital and pay-roll devoted to those activities by the Dutch company. In these circumstances, it is concluded in the Memorandum of Understanding that the Dutch company will be considered to provide a substantial portion of overall supervision and administration of the group it supervises.

90 Article 16(2)(h)(v), US Treaty.
91 The US Treasury Explanation states at p 31 that where the headquarters company is nominally responsible for group financing, pricing, marketing and other management functions, but merely implements instructions received from another entity, it would not be considered to have and exercise independent discretionary authority with respect to those functions.
93 Article 16(2)(h)(ii), US Treaty.
94 The US Treasury Explanation confirms at p 30 in Example 1 that countries can be grouped as required to achieve the 10% threshold. That example also illustrates that it is permissible for the make up of a grouping of countries to change from year to year.
headquarters company’s State of residence generate less than 50% of the gross income of the group.\textsuperscript{95} The fourth requirement is that no more than 25% of the company’s gross income is derived from the other Contracting State.\textsuperscript{96} The company’s income would likely consist of management fees, dividends and interest if the company carries on group financing activities. The level of income generated from the operating companies could vary from year to year. Therefore, if the 50% or 25% thresholds are exceeded in any year, the tests can be reapplied by reference to average numbers calculated for the four preceding years.

The fifth requirement, that the company has and exercises independent authority, is discussed above together with the first requirement. The sixth requirement is that the headquarters company be “subject to generally applicable rules of taxation in its country of residence”.\textsuperscript{97} The US Treasury Explanation states at p 32 that this means that the company must be subject to the income tax rules that a company engaged in the active conduct of a business would be subject to. Therefore, a concessionary headquarters company taxation regime could result in the fifth requirement not being satisfied, but the application of rules of general effect, like Australia’s foreign dividend account regime, should not disqualify a company. Australia does permit, under s 82CB of the ITAA 1936, deductions for capital expenses incurred in connection with the establishment of a regional headquarters company in Australia. This more favourable treatment could disqualify a regional headquarters company under Art 16(2)(h) of the US Treaty in any year in which such deductions are permitted.

The seventh requirement is that the income derived in the other Contracting State is derived in connection with, or is incidental to, the active business referred to in the second requirement.\textsuperscript{98} Therefore, for an Australian headquarters company, for example, its United States source income must be incidental to the business carried on in the United States by the operating company that is supervised by the Australian company. Management fees for management services provided by the Australian company to the United States operating company should be incidental to the underlying business. Dividends paid out of profits generated from that business should also qualify, as would interest on any debt funding provided by the Australian company to the operating company.

**Active conduct of trade or business**

Article 16(3) contains an active trade or business test that can allow residents of Australia or the United States that are not qualified persons under Art 16(2) to enjoy benefits under the Treaty. Article 16(3)(a) provides that a resident of one of the States is entitled to benefits in relation to an item of income derived from the other State if it is engaged in the active conduct of a trade or business in its State of residence and the income derived from the other State is derived in connection with, or is incidental to, that trade or business. A business of making or managing investments for the resident’s own account does not satisfy this test unless the activities are banking, insurance or securities activities carried out by a bank, insurance company or a licensed or authorised securities dealer. Further, Art 16(3)(b) provides that for an item of income to qualify for benefits under this rule the trade or business activity in the State of residence must be substantial in relation to the trade or business activity in the source State. Under an attribution rule, in determining whether a person is engaged in the active conduct of a trade or business the activities of a partnership in which the person is a partner, and the activities of any connected person, are deemed to be conducted by the person.\textsuperscript{99}

Article 16(3)(a) refers only to “income” and, consequently, for Australian purposes may not apply to capital gains.\textsuperscript{100} The test is applied on an item of income by item of income basis. Therefore,

\textsuperscript{95} Article 16(2)(h)(iii), US Treaty.
\textsuperscript{96} Article 16(2)(h)(iv), US Treaty.
\textsuperscript{97} Article 16(2)(h)(vi), US Treaty.
\textsuperscript{98} Article 16(2)(h)(vii), US Treaty.
\textsuperscript{99} Article 16(3)(c), US Treaty.
\textsuperscript{100} The distinction in the amended Art 9 between income and capital gains suggests that a reference elsewhere in the US Treaty only to income is intended to exclude capital gains. The policy underlying the exclusion of capital gains is presumably that, as it is the conduct of an active business that qualifies the person for treaty benefits, it is only amounts derived in respect of the conduct of that business, which would typically not be capital gains, that should receive treaty benefits.
it is conceivable that some items will satisfy the test, and will be entitled to treaty benefits, while others will not. In relation to the trade or business requirement, the Explanatory Memorandum states at [2.108] that for Australian purposes the domestic tax law meaning of “trade or business” will apply. As there is no domestic tax law concept of a trade or business in Australia, it is likely that it will be taken to have the same meaning as “business”. For United States purposes, trade or business is taken to have the meaning that it is given in the Regulations under s 367(a) of the IRC.\(^\text{101}\) Under those Regulations, a trade or business is defined as a “specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit.”\(^\text{102}\) Further, the Regulations state that the activities must ordinarily include every operation that forms part of, or a step in, a process by which income or profit may be earned, although it may be permissible for some of the activities to be carried out by independent contractors under direct control of the company.\(^\text{103}\) A corporation is taken under the Regulations to actively conduct a trade or business if its officers and employees carry out substantial managerial and operational activities.\(^\text{104}\) It is permissible for this purpose for incidental activities of the trade or business to be carried out by independent contractors. Also, if officers or employees of related entities are seconded to the company, and the salaries are paid by or reimbursed by the company, they are treated as officers or employees of the company for the purpose of determining whether the trade or business is actively conducted.

For Art 16(3) to apply, the income in relation to which treaty benefits are sought must be derived in connection with, or be incidental to, the conduct of its trade or business. The US Treasury Explanation contains a discussion of this element of Art 16(3).\(^\text{105}\) That Explanation states that an item of income, profit or gain is to be considered as derived “in connection with” an active trade or business if the activity generating the income in the other State “is a line of business that forms a part of or is complimentary to the trade or business” conducted in the entity’s State of residence.\(^\text{106}\) The line of business carried on in the State of residence may be upstream, downstream or parallel to that carried on in the other State. A business is upstream, for example, if it involves providing inputs to a manufacturing process that occurs in the other State. An example in the US Treasury Explanation of a downstream business is selling the output of a manufacturer that is resident in the other State. An example provided of a parallel business is selling in one State the same sorts of products that are sold by the trade or business carried on in the other State. The Explanation states at p 35 that an item of income, profits or gains derived from a State will be considered “incidental” to the trade or business conducted in that State, but the production of the item facilitates the conduct of that business. An example of an incidental item of income is interest income earned from the short term investment of working capital of a resident of one State in securities issued by persons in the other State.

For example, consider an Australian resident mining company which is wholly owned by a United Kingdom resident company. If the Australian company established a United States resident company to market minerals that it extracts from its mining operations in Australia, the United States business would be downstream to that of the Australian business and would therefore be complimentary to the Australian business. Consequently, any dividends paid on the United States

\(^\text{101}\) US Treasury Explanation, p 33.  
\(^\text{102}\) Section 1.367(a)-2T(b)(2), Treasury Regulations.  
\(^\text{103}\) Section 1.367(a)-2T(b)(2), Treasury Regulations.  
\(^\text{104}\) Section 1.367(a)-2T(b)(3), Treasury Regulations. The US Treasury Explanation states at p 33 that a company which functions solely as a headquarters company will not satisfy this requirement because it would be in the business of managing investments and this does not involve the conduct of an active trade or business.  
\(^\text{105}\) US Treasury Explanation, pp 33-35. That discussion replicates a discussion in the Exchange of Notes in relation to the UK–US Treaty dated 24 July 2001: CCH Editorial Staff, n 44 at [44,505-29]. The Revised Memorandum of Understanding regarding the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1996 (US–Switzerland Treaty) also contains a discussion, together with examples, of this element of the test: CCH Editorial Staff, n 44 at [42,005-28]. The discussion is substantively the same as that in the US Treasury Explanation, however the examples in that Explanation are more detailed than those provided in the Revised Memorandum of Understanding to the US–Switzerland Treaty.  
\(^\text{106}\) US Treasury Explanation, p 33.
subsidiary shares, and any interest on debt provided by the Australian company, should be entitled to
treaty benefits under Art 16(3). However, what would the position be if the Australian company
mined coal in Australia and the United States subsidiary mined copper in the United States? This
would not involve an upstream or downstream business, but would potentially involve a parallel
business. In terms of the US Treasury Explanation, the question would be whether this involves the
extraction of the “same sorts of products”. It should not be stretching this concept too far to
conclude that extracting different minerals involves a parallel business of mining. However, the US
Treasury Explanation states at p 33 that two activities will not be considered to be complementary
even if they are part of the same overall industry if they are not “related in the sense that the success
or failure of one activity will tend to result in the success or failure for the other.” In the example of
the diversified miner, the success or failure of one mining activity would not necessarily tend to result
in the success or failure of the other. Therefore, it appears that the United States would not regard the
diversified miner in the above example as satisfying the requirements of Art 16(3)(a).

The Explanatory Memorandum provides no guidance on how the ATO would apply Art 16(3).
Given that Australia has accepted the limitation on benefits Article against the background of the
discussion in the Technical Explanation of the US Model Convention and in other United States
treaties, it might be expected that the test would be applied in a similar way in Australia. In its public
ruling on the interpretation of tax treaties, the ATO states that the Technical Explanations prepared by
the US Treasury in relation to United States tax treaties are developed for internal United States
purposes and “are of little or no usefulness in objectively proving the intent of both parties to a
DTA.” However, the ruling recognises that such explanations might provide “useful signposts” to
the consensus reached by the parties to the relevant treaty. Given that Art 16 is a creature of United
States treaty practice, there would, in the author’s view, be a much stronger case for an interpretation
that has regard to how the provisions are interpreted in the United States than with other provisions
that are not United States-specific.

The attribution rule in Art 16(3)(c) is important in relation to holding companies. Holding
companies do not satisfy Art 16(3)(a) because they are in the business of managing investments for
their own account. Article 16(3)(c) allows the activities of persons connected with a person to be
attributed to that person. For this purpose, a person is stated to be connected with a company if it
owns at least 50% of the votes or value of the company’s shares. Therefore, in the case of an
Australian resident holding company, the activities of any Australian resident company in which the
holding company holds 50% or more of the shares would be treated as activities of the holding
company. If there are no such underlying active businesses then clearly the holding company will fail
the test. However, if, for example, an Australian subsidiary of an Australian holding company carried
on a manufacturing business, that business would be treated as being carried on by the holding
company. If a United States subsidiary of the Australian holding company distributed the Australian
company’s manufactured goods, it is likely that the income derived in the United States would be
viewed as being derived in connection with, or as incidental to, the Australian business. The other
situation in which the attribution rule might assist is where the holding company carries on a business
that is of a different kind to that of the subsidiary in the other State, but where there is a subsidiary in
the holding company’s State of residence which carries on a business of the same kind as that of the
foreign subsidiary.

Article 16(3)(b) provides a “carve out” to the application of Art 16(3)(a) where the trade or
business activity in the State of residence is not “substantial in relation to the trade or business
activity in the other State.” This is an anti-avoidance rule that is intended to prevent entities from

107 US Treasury Explanation, p 33.
108 ATO, Taxation Ruling TR 2001/13 at [125] (emphasis in original).
109 ATO, Taxation Ruling TR 2001/13 at [125]. However, Hill J has recently indicated in an article that there is no reason why
the views of one Contracting State to a tax treaty, even if prepared by officials who negotiated the treaty, should be given any
particular significance: see Justice Hill G, “The Interpretation of Double Taxation Agreements – the Australian Experience”
(2003) 57 Bulletin for International Fiscal Documentation 321 at 324. As indicated in the text, given the unique nature of the
limitation on benefits Article there is in the author’s view a stronger case for having regard to the US Treasury Explanation in
interpreting that Article than would be the case in relation to the other, more standard, provisions of the Protocol.
attempting to satisfy Art 16(3) through the establishment of a small business in the State of residence that is of the same nature as the business carried on in the source State. Whether a business is substantial in relation to another is to be determined on the basis of all of the facts and circumstances.

The US Treasury Explanation states at p 35 that these circumstances would generally include the comparative sizes of the trades or businesses in each State, the nature of the activities in each State, and the contributions made to the conduct of the trade or business in each State.

**Tracking shares**

Art 16(4) applies where a company has issued shares that entitle the holders to a portion of the income derived by the company from the other State that is larger than the portion of such income that such shareholders would otherwise receive. The US Treasury Explanation states at p 36 that this provision would apply to tracking stock that pays dividends based on a formula that approximates the company’s return on its assets employed in the United States. That Explanation provides an example involving an Australian company which has common shares and common class S shares on issue. Dividends on the class S shares are equal to the earnings and profits of a United States subsidiary of the Australian company. Dividends on the class S shares cannot be paid if the Australian company does not have earnings and profits, but otherwise the return on the shares is independent of the performance of the Australian business. In these circumstances, the Explanation concludes that because the dividends on the class S shares correspond to the earnings and profits of the United States subsidiary, Art 16(4) would apply to the Australian company. This example does not appear to require that the United States subsidiary actually distribute its profits to its Australian parent. Therefore, the provision could apply, for example, if the class S dividends were initially funded out of Australian earnings, and United States earnings were later repatriated to fund repayment of debt or the acquisition of an asset. This interpretation is not entirely consistent with the language of Art 16(4). For the provision to apply, the shares must entitle the holders to a portion of the income derived from the other State. If the dividends are merely calculated by reference to the earnings of subsidiaries in the other State, but dividend payments can be sourced from any profits of the issuer, the language of Art 16(4) would not be satisfied.

For Art 16(4) to apply, at least 50% of the voting power and value of the company deriving income from the other Contracting State must be owned by persons who are not qualified persons. Therefore, the provision would not apply where the tracker shares carried more than 50% of the value but less than 50% of the voting power. If Art 16(4) applies, treaty benefits are denied in relation to the “disproportionate part of the income”. In the example in the preceding paragraph, the disproportionate part of the income would be the dividends paid by the United States subsidiary company. If the Australian company earned other United States source income and that other income did not form part of the pool that is taken into account in determining the distributions to be made on the tracker shares, that other income would not be denied treaty benefits under Art 16(4). There is no concept of a “derivative benefit” in Art 16(4). For example, if the holder of the tracker shares is resident in a country that has a tax treaty with the United States containing equivalent dividend tax rates, no United States tax benefit would be obtained by the holder of those shares. In these circumstances, it might be possible to approach the United States competent authority for relief under Art 16(5).

**Determination by “competent authority”**

Article 16(5) provides that a resident of one of the States who is not a qualified person under Art 16(2) may be granted benefits of the Treaty if the “competent authority” of the other State determines that the “establishment, acquisition or maintenance” of the person, and the conduct of its operations, did not have as one of its principal purposes the obtaining of treaty benefits. The
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Explanatory Memorandum states at [2.112] that this recognises that there may be cases where significant participation by third country residents in an entity resident in one of the States may be justified “by sound business practice or long-standing business structures and does not necessarily indicate a treaty shopping motive”.

It might be necessary to rely on Art 16(5) where there is a change in circumstances in relation to a particular entity that results in that entity ceasing to be a qualified person. For example, if an Australian resident company sells all of its shares in a wholly owned Australian subsidiary to a third country resident, that subsidiary could cease to be a qualified person under Art 16(2)(c) or (g). In these circumstances, if the subsidiary derives United States source income it would be necessary to approach the United States competent authority under Art 16(5) for relief unless the active business test in Art 16(3) applied. The Exchange of Notes in relation to the UK–US Treaty gives examples of changes in circumstances that need not result in a denial of treaty benefits. These are

- a change in the State of residence of a major participator in the company;
- the sale of part of the ownership interests in a company to a resident of another Member State of the European Community, of a state in the European Economic Area or of a party to the North American Free Trade Agreement; or
- an expansion of a company’s business activities in one of these States.112

The Exchange of Notes states that if these changes are not attributable to tax avoidance motives, this will be a factor weighing in favour of the granting of benefits under the equivalent provision to Art 16(5). The references to the European Community, European Economic Area or North American Free Trade Agreement are not relevant in the context of the US Treaty. However, they do illustrate the types of changes in circumstances where treaty benefits may cease to be available in the absence of a competent authority determination. In the case of a change in residence of a major participator in the company, or of a sale of ownership interests to a resident of a third country, a determination that treaty benefits remain available should be made if the company continues to carry on an active business in its State of residence. On the other hand, if the company is merely a holding company it could be more difficult to obtain a determination. In that case if the shareholder changes residence to, or the shares are sold to a resident of, a country that has a tax treaty with the other State, and the relevant benefits under that other treaty are the same as under the US Treaty, a determination should be available on the basis that the maintenance of the holding company structure is not driven by treaty benefits. Also, if significant tax costs would be incurred if a restructuring were undertaken, it would be arguable that the continuation of the structure does not have a purpose of obtaining treaty benefits.

The Memorandum of Understanding in relation to the US–Netherlands Treaty lists a number of factors that may be taken into account by the competent authorities in making a determination under the equivalent provision to Art 16(5). While equivalent guidance has not been provided in the Protocol or in the US Treasury Explanation, the list provides a reasonable indication of the types of factors that are likely to be relevant in relation to Art 16(5). First, the date of incorporation of the company in relation to the date on which the Treaty enters into force may be relevant. If the company was established before the date on which the Treaty entered into force this would suggest that it was not established for the purpose of obtaining treaty benefits. Second, the continuity of the historical business and ownership may be relevant. If there was a change in ownership followed by a change in business, this might suggest that the company is acquired or maintained for the purpose of obtaining treaty benefits. Third, consideration may be given to the business reasons for the company residing in its State of residence. If the company has significant business operations in that State this should be a sufficient business reason for its residence there. Fourth, the extent to which the company is claiming special tax benefits in its State of residence may

112 CCH Editorial Staff, n 44 at [44,505] – [44,530].

113 Memorandum of Understanding at [XIX]: CCH Editorial Staff, n 44 at [36,440]. Art 10(3)(c) of the 2003 Australia–UK Treaty contains a provision similar to Art 16(5) of the US Treaty that applies in relation to the exemption provided under that Treaty for dividends paid to corporate shareholders who hold 80% or more of the voting power of the company paying the dividends. At the date of writing this article, no guidance had been provided in Australia or in the United Kingdom as to how that provision would be applied.
be relevant. Fifth, consideration may be given to the extent that the company’s business activity in the source State is dependent on capital, assets or personnel in the company’s State of residence. Presumably, if the level of dependency is low this might suggest a low level of connection between the residence and source State businesses, and might point towards a purpose of obtaining treaty benefits. Finally, regard may be had to the extent to which the company would be entitled to equivalent treaty benefits if it were incorporated in the State of residence of the majority of its shareholders. For example, if an Australian resident company with United States source income is wholly owned by a United Kingdom incorporated company, the availability of equivalent benefits under the UK–US Treaty should be a significant consideration in determining whether the United States will allow the Australian company to enjoy benefits under the US Treaty. For United States residents with Australian source income, it would be possible to seek a determination under Art 16(5) in the form of a private ruling from the ATO. For Australian residents with United States source income, it would be possible to seek a ruling from the IRS.

Domestic anti-avoidance rules

Article 16(7) provides that nothing in Art 16 shall be construed as restricting the right of the Contracting States to apply any anti-avoidance provisions of its taxation law. No equivalent provision is contained in the limitation on benefits Article in the UK–US Treaty, and its inclusion in the US Treaty therefore appears to be an Australian initiative. From an Australian perspective, the operation of the general anti-avoidance provisions of Pt IVA of the ITAA 1936 are in any event preserved in a treaty context by s 4(2) of the ITAA 1953 and s 177B(1) of the ITAA 1936. Therefore, it appears that Art 16(7) of the US Treaty has been included to remove any prospect of Art 16 being used as a shield by taxpayers. In practice, it is likely that if the ATO considers that the US Treaty has been used for treaty shopping purposes it will potentially challenge the relevant structure both on the technical basis that the requirements of Art 16 are not satisfied and on Pt IVA grounds.

Comparison with old limitation on benefits Article

While the new Art 16 is considerably more complex than its predecessor, it will in many circumstances be easier to qualify for treaty benefits. For example, subsidiaries of listed companies will qualify for benefits if they are 50% or more owned by a qualifying listed company whereas under the old Art 16(1)(a)(iv) the ownership threshold was more than 75%. The active trade or business test in new Art 16(3) will also allow entities owned by third country residents to qualify for treaty benefits without requiring a competent authority determination. The recognised headquarters rule in new Art 16(2)(h) is unlikely to be of great practical significance in the medium term, but may become more important if more corporate groups locate their regional headquarters in Australia. Finally, in relation to unlisted companies which are not subsidiaries of listed companies, the required level of ownership by Australian or United States residents is reduced from more than 75% to 50%. However, a base erosion test now also applies in this context and in some circumstances

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114 Section 14ZAE of the Taxation Administration Act 1953 (Cth) allows the Commissioner to make private rulings on the way in which the Commissioner would exercise a discretion under a tax law. Under s 14ZAE, a discretion for this purpose includes the making of a determination.

115 The US Treasury Explanation states at p 37 that taxpayers will be able to present their case to the relevant competent authority for an advanced determination.

116 Commentators have argued that there are limitations on the way in which Pt IVA can apply in relation to transactions involving “treaty shopping”. Gzell argues that in circumstances such as those arising in FCT v Lamesa Holdings BV (1997) 77 FCR 597 where a treaty prevents Australia from taxing an amount which otherwise would be taxable, no tax benefit arises for the purposes of s 177C of the ITAA 1936 because technically the amount is still included in assessable income but Australia is simply bound by the treaty not to tax it: see Gzell I, “Treaty Shopping” (1998) 27 A T Rev 65. An alternative analysis is that the prohibition on taxing treaty-protected income or gains is effected by excluding the amount from assessable income. On this view, a tax benefit could arise for the purposes of Pt IVA of the ITAA 1936 if a treaty prevents an amount from being taxed in Australia. Another limitation on the operation of Pt IVA suggested by Momsen in relation to withholding tax is that s 177CA of the ITAA 1936 does not apply where a treaty reduces the rate of withholding tax but rather applies only when an amount of income is not subject to withholding tax: see Momsen J H, “Treaty shopping and the dividend interest and royalty Articles in Australia’s double tax agreements” (1998) 27 A T Rev 155.
this could make qualified person status more difficult to attain than under the existing ownership-focused test.

**Administration**

Given the degree of source country taxation conceded by Australia in the US Treaty, particularly in relation to the treatment of dividends, interest and royalties, it can be expected that the ATO will focus closely on the question of whether United States residents who derive Australian source income are entitled to the benefits of the Treaty. Presumably, the ATO will require some due diligence on the part of Australian residents making payments to United States residents who claim the benefit of the US Treaty. From the perspective of an Australian subsidiary paying dividends to a United States parent company, it would be expected that the parent company will provide sufficient information, where required, to support any claim for lower dividend tax rates. In relation to interest and royalties, it might be expected that Australian borrowers and licensees would require contractual representations to the effect that the counter-party is entitled, and will continue to be entitled, to treaty benefits. Termination provisions may also be included to deal with the situation where the counter-party is found not to be entitled to treaty benefits, or where its circumstances change such that treaty benefits cease to be available.

The United States imposes a number of administrative requirements on taxpayers claiming treaty protection. Where a non-United States resident derives United States source income in respect of which it wishes to claim benefits under a tax treaty, it may be required under s 301.6114-1 of the Treasury Regulations to disclose its reliance on the Treaty. Disclosure may be required where a taxpayer takes a return position that any treaty of the United States overrules or modifies any provision of the IRC and that has the effect of reducing the amount of tax incurred. Payments to related parties of more than US$500,000 are specifically required to be disclosed, unless one of a number of exemptions applies, where a reduction in or exemption from withholding tax is claimed under a treaty that has a limitation on benefits Article. Exemptions from disclosure are provided in a number of circumstances, including where the relevant income is fixed or determinable annual or periodic income—such as interest, dividends or royalties—that is beneficially owned by an individual or State. Where disclosure is required, the relevant disclosure form requires the taxpayer to specify the particular treaty provisions relied upon, the IRC provisions that are overruled or modified, the provisions of the limitation on benefits Article of the Treaty that the taxpayer relies upon, and an explanation of the Treaty based return position taken. The Treasury Regulations also require taxpayers making payments to non-residents that are subject to a reduced rate of withholding under a treaty to in some circumstances obtain a form from the beneficial owner of the income containing the information required to support the reduced rate. The relevant form requires the beneficial owner to specify the particular treaty provision under which the special rate of withholding applies and, for persons other than individuals, to declare that it meets the requirements for treaty benefits under the relevant limitation on benefits Article.

The ATO has not indicated whether it is intending to develop any administrative requirements similar to those in the United States. However, given that Australia has recently agreed in the 2003 Australia–UK Treaty to dividend, interest and royalty rates equivalent to those in the US Treaty, it would not be surprising if the ATO was contemplating the adoption of a certification procedure, or some other procedure, dealing with the availability of treaty benefits.

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117 Section 301.6114-1(a)(1)(i), Treasury Regulations. If a return is not otherwise required to be filed, s 301.6114-1(a)(1)(ii) of the Treasury Regulations nevertheless requires a return to be filed for the purpose of disclosing the treaty-based position.
118 Section 301.6114-1(c)(1)(i), Treasury Regulations.
120 Section 1.1441-6(b)(1), Treasury Regulations.
OTHER INCOME

The Protocol replaced the other income Article (Art 21), with a new Article (Art 11, the Protocol) that has substantially the same effect as its predecessor. The Explanatory Memorandum states at [2.116] that the “new Article reflects recent treaty language and has the same effect as the Article [that it] replaced”. Under Art 21, items of income not dealt with in the preceding provisions of the Treaty may be taxed in a State if they are sourced there. The US Treasury Explanation at p 39 makes the point that the residual source country taxing rights in Art 21 are taken from the United Nations Model Double Taxation Convention Between Developed and Developing Countries 2001 (United Nations Model Convention), and are inconsistent with the United States and OECD Models which provide a source country exemption for other income. Article 21 also permits Australia and the United States to tax income effectively connected with a permanent establishment located within their jurisdiction. Such income should be dealt with in any event under Art 7. However, the US Treasury Explanation indicates at p 38 that this provision would permit the relevant State to tax income earned through the permanent establishment from foreign sources. This makes it clear that Art 7 cannot be applied narrowly to permit tax to be imposed only on domestic source business profits.

CONCLUSION

The operation of some of the innovative aspects of the Protocol is uncertain and will only be clarified over time. In particular, the precise scope of the “financial institution” definition in the new Art 11 is unclear and may require some elaboration from the ATO. Also, the removal of equipment rentals from the “royalty” definition focuses more attention on the equipment leasing limb of the “permanent establishment” definition in Art 5. In the case of listed companies, whether the dividend exemption will be available should ordinarily be clear. However, unlisted companies wishing to obtain that benefit will need to obtain clearance from the relevant competent authority under Art 16(5) if it can be demonstrated that they have not been established or maintained for “treaty shopping” purposes. As circumstances change, it will be necessary to refresh those clearances. Given the special features of the US Treaty, and the pressure points that these create, it is likely that the ATO will focus some attention on the operation of the limitation on benefits Article, particularly in relation to royalty and exempt interest flows. As the limitation on benefits Article is largely a creature of United States treaty practice, it is to be hoped that Australian courts ultimately would derive some assistance in interpreting its terms from United States materials in relation to the Protocol and in relation to other United States treaties with similar provisions.

From a tax policy perspective, the Australian Government has indicated that the greater focus on residence based taxation inherent in the Protocol will, in appropriate cases, be a feature of future treaty negotiations. In this context it should be remembered that the US Treaty still contains significant elements of source based taxation. For example, as pointed out at p 39 of the US Treasury Explanation, the position reflected in the other income Article (Art 21) is essentially taken from the United Nations Model Convention which has a strong emphasis on source-based taxation. The importance placed on preserving Australia’s right to tax capital gains also reflects an emphasis on source based taxation. The “permanent establishment” definition in Art 5 also has a source focus. For example, the provisions dealing with installations, drilling rigs and ships used in connection with the exploration or exploitation of natural resources (Art 5(2)(a)), the maintenance of substantial equipment for rental or other purposes (Art 5(4)(b)), and the conduct of supervisory activities (Art 5(4)(c)) are not mirrored in the more residence based OECD Model Convention. This suggests that the approach to future treaty negotiations will, in some cases, involve Australia making concessions to residence based taxation while seeking to preserve significant elements of source based taxation. Source based taxation in relation to resources industries and in relation to capital gains will continue to be important from an Australian viewpoint. If there is no particular benefit to Australia from pursuing residence based taxation – for example, because of the limited economic relations with the treaty partner – it is likely that Australia will take the more traditional approach of insisting on the retention of broad source country taxation. The approach adopted in the Protocol has

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122 Costello, Press Release No 32, Review of International Taxation Arrangements (13 May 2003), Attachment E.
recently been replicated in the 2003 Australia–UK Treaty with exemptions provided for dividends and interest, and a reduced royalty rate, mirroring those in the Protocol. However, in other treaties entered into after the Protocol these lower rates have not been provided.\textsuperscript{123} Therefore, it can be expected that a broad range of outcomes will continue to be reflected in future Australian treaties. One consequence of this selective approach is that it will be cheaper for Australian residents to borrow or licence from residents of favoured countries than from other non-residents, all other things being equal. Therefore, United States and United Kingdom banks will be advantaged over Singapore and Canadian banks, and United States and United Kingdom licensors will be advantaged over French and South African licensors. This type of non-neutrality is a natural consequence of any bilateral treaty so that, for example, Hong Kong resident licensors have always been disadvantaged compared with licensors resident in treaty countries. However, the difference under the new approach is that the favoured treatment is likely to extend only to a small number of countries, so that the costs incurred in dealing with residents of different countries is likely to be thrown into sharp relief more frequently. Ultimately, as with any tax preference, this will be a source of friction between taxpayers and the revenue as disadvantaged taxpayers seek to access treaty benefits to which they are not directly entitled, and the revenue seeks to curb this activity through the use of treaty and domestic anti-avoidance rules.

\textsuperscript{123} In the Protocol to the Canadian Treaty signed in January 2002 a 5\% dividend rate is available but only in relation to franked dividends. Also, interest and royalties are taxed at 10\%. In the Mexican Treaty a zero dividend rate applies only on franked dividends, interest can be taxed at 10\% or 15\% and royalties are taxed at 10\%. 

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