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HOUSE OF REPRESENTATIVES

INTERNATIONAL TAX AGREEMENTS AMENDMENT BILL (No. 1) 2008

EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon Wayne Swan MP)

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

<i>Abbreviation</i>	<i>Definition</i>
Agreements Act 1953	<i>International Tax Agreements Act 1953</i>
ATO	Australian Taxation Office
Commissioner	Commissioner of Taxation
GATS	<i>General Agreement on Trade in Services</i>
GST	goods and services tax
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
OECD	Organisation for Economic Co-operation and Development
OECD Model	<i>OECD Model Tax Convention on Income and on Capital</i>
OECD Model Commentary	The Commentaries on the Articles of the OECD Model Tax Convention
Protocol	<i>Protocol to the Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income</i>
the existing Agreement	<i>the Agreement between the Commonwealth of Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its associated Protocol, that were signed in Canberra on 20 March 1969</i>

<i>Abbreviation</i>	<i>Definition</i>
this Convention	<i>the Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its associated Protocol and Exchange of Notes, which were signed in Tokyo on 31 January 2008</i>
UK	United Kingdom of Great Britain and Northern Ireland
US	United States of America

General outline and financial impact

What will this Bill do?

This Bill amends the *International Tax Agreements Act 1953* (Agreements Act 1953) to give the force of law in Australia to the *Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* and its associated Protocol and Exchange of Notes, (together referred to as ‘this Convention’) that were signed in Tokyo on 31 January 2008.

This Convention is Australia’s second comprehensive tax treaty with Japan. It will modernise the tax relationship between the two countries and will serve to facilitate trade and investment between Australia and Japan. This Convention will replace the *Agreement between the Commonwealth of Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* and its associated Protocol that were signed in Canberra on 20 March 1969 (together referred to as ‘the existing Agreement’).

Who will be affected by this Bill?

Persons who are residents of Australia and/or Japan and who derive income, profits or gains from Australia or Japan will be affected by this Bill.

How is the legislation structured?

The Agreements Act 1953 gives the force of law in Australia to Australia’s tax treaties which appear as Schedules to that Act. The provisions of the *Income Tax Assessment Act 1936* (ITAA 1936), the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Fringe Benefits Tax Assessment Act 1986* are incorporated into and read as one with the Agreements Act 1953. The provisions of the Agreements Act 1953 (including the terms of the tax treaties) take precedence over provisions of the:

- ITAA 1936 (other than the general anti-avoidance rules under Part IVA);

- ITAA 1997; and
- *Fringe Benefits Tax Assessment Act 1986* (other than section 67 which is an anti-avoidance rule).

In what way does this Bill change the *International Tax Agreements Act 1953*?

The Agreements Act 1953 is amended to insert the text of this Convention as a Schedule to that Act. Australia's tax treaties appear as Schedules to the above Act, which gives them the force of law in Australia.

When will this Convention enter into force, and from what date will the Convention have effect?

This Convention will become law from the date of Royal Assent. Further, the Convention will enter into force 30 days after the date of the last notification by diplomatic notes that the domestic processes to give this Convention the force of law in the respective countries have been completed. In Australia, enactment of this Bill giving the force of law to this Convention is the prerequisite to such notification.

Once it enters into force this Convention will apply as follows

Application in Australia

For withholding taxes, on income derived:

- on or after 1 January in the calendar year next following the date on which this Convention enters into force.

For other Australian taxes, on income, profits or gains:

- any year of income beginning on or after 1 July in the calendar year next following the date on which this Convention enters into force.

Application in Japan

For taxes withheld at source, on amounts taxable:

- on or after 1 January in the calendar year next following the year in which this Convention enters into force.

With respect to all other taxes:

- any taxable year beginning on or after 1 January in the calendar year next following the year in which this Convention enters into force.

The financial impact of this Bill

Treasury has estimated the impact of the first round effects on forward estimates as \$345 million. The estimated distribution of the first round costs is shown in the table below:

<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>2011-12</i>
-\$40m	-\$100m	-\$100m	-\$105m

Indirect revenue benefits may arise from increased trade and investment between Australia and Japan and reduced tax credit obligations to Japan.

Compliance costs

No significant compliance costs will result from the entry into force of this Convention.

Summary of regulation impact statement

Regulation impact on business

Impact: High.

Main points:

- This Convention is expected to have an impact on Australian residents doing business with Japan and includes Australian investors, banks, suppliers of technology, consultants,

exporters, Australian employees working in Japan, and Australian residents receiving pensions from Japan. This Convention will also impact on the Australian Government and the Australian Taxation Office.

- While source country tax on interest will generally continue to be limited to 10 per cent, there will be no withholding tax charged on interest derived by a financial institution that is resident in the other country, or on interest derived by a government body or central bank of the other country, or by the Australian Export Finance and Insurance Corporation, Australia's Future Fund, the Japan Bank for International Cooperation or the Nippon Export and Insurance. No tax is payable on dividends in the source country where the dividend recipient is a company that holds directly at least 80 per cent of the voting power of the company paying the dividend, subject to certain conditions. A 5 per cent rate limit applies to other dividends where the dividend recipient is a company that holds directly at least 10 per cent of the voting power of the company paying the dividend. A 10 per cent limitation applies to other dividends. The general limit for royalties will be reduced from 10 per cent to 5 per cent. The limit for source country tax on distributions from Australian real estate investment trusts, and pre-Japanese dividend deduction companies with a majority of assets consisting of real property is set at 15 per cent.
- This Convention will assist the bilateral relationship by updating an important treaty in the network of commercial treaties between the countries and provides for greater cooperation between tax authorities to prevent fiscal evasion and tax avoidance.

Chapter 1

2008 Australia-Japan Convention

Outline of chapter

1.1 This Bill amends the *International Tax Agreements Act 1953* (Agreements Act 1953). This chapter explains the rules that apply in the 2008 *Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* and its associated Protocol and Exchange of Notes (together referred to as ‘this Convention’).

Context of amendments

1.2 This Convention was signed in Tokyo on 31 January 2008.

1.3 Once in force, this Convention will replace the *Agreement between the Commonwealth of Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, and its associated Protocol, that were signed in Canberra on 20 March 1969 (together referred to as ‘the existing Agreement’).

Summary of new law

Main features of this Convention

- 1.4 The main features of this Convention are as follows:
- Income from real property may be taxed in full by the country in which the property is situated. Income from real property for these purposes includes natural resource royalties [*Article 6*].
 - Business profits (including income derived from professional services or other activities of an independent nature) are generally to be taxed only in the country of residence of the recipient unless they are derived by a resident of one country through a branch or other prescribed permanent

establishment in the other country, in which case that other country may also tax the profits. These rules also apply to business trusts *[Article 7]*.

- Profits derived from the operation of ships and aircraft in international traffic are generally to be taxed only in the country of residence of the operator *[Article 8]*.
- Profits of associated enterprises may be taxed on the basis of dealings at arm's length *[Article 9]*.
- Dividends, interest and royalties may generally be taxed in both countries, but there are limits on the tax that the country in which the dividend, interest or royalty is sourced may charge on such income flowing to residents of the other country who are the beneficial owners of the income *[Articles 10 to 12]*.
- In the case of dividends:
 - no source country tax is payable on intercorporate dividends where the dividend recipient is a company that holds directly at least 80 per cent of the voting power of the company paying the dividend, subject to certain conditions *[Article 10, paragraph 3]*;
 - a 5 per cent rate limit applies to other intercorporate dividends where the dividend recipient is a company that holds directly at least 10 per cent of the voting power of the company paying the dividend *[Article 10, subparagraph 2(a)]*; and
 - a 10 per cent limitation applies to all other dividends *[Article 10, subparagraph 2(b)]*.
- In the case of dividends paid by a company that is a resident of Japan and that is entitled to a deduction for dividends paid to its beneficiaries:
 - a 15 per cent rate limit applies to dividends where more than 50 per cent of the assets of the company paying the dividend consist, directly or indirectly, of real property situated in Japan *[Article 10, subparagraph 4(a)]*; and
 - a 10 per cent limitation applies to all other dividends paid by such company *[Article 10, subparagraph 4(b)]*.

- Distributions of income, profits or gains by an Australian real estate investment trust may be taxed in both Contracting States, but limits the Australian tax charged on such income to 15 per cent of the gross amount of the distribution [*Article 10, paragraph 7*].
- Source country taxation on interest is limited to 10 per cent [*Article 11, paragraph 2*]. However, exemptions from source country taxation have been provided for interest paid to:
 - certain government bodies [*Article 11, subparagraph 3(a)*];
 - financial institutions [*Article 11, subparagraph 3(b)*]; and
 - the Australian Export Finance and Insurance Corporation; a public authority that manages the investments of the Future Fund; the Japan Bank for International Cooperation; the Nippon Export and Investment Insurance; and similar agreed institutions [*Article 11, subparagraph 3(c)*].
- The rate limit on source country taxation of royalties is 5 per cent [*Article 12, paragraph 2*].
- The definition of ‘royalty’ has been amended, to extend to forbearance in respect of any right, and, to exclude payments or credits in respect of the use of, or right to use, industrial, commercial or scientific equipment. Payments for spectrum licences are not royalties [*Article 12, paragraph 3 and item 16 of the Protocol*].
- Income, profits or gains from the alienation of real property may be taxed in full by the country in which the property is situated. Subject to that rule and other specific rules in relation to business assets and shares or other interests in land rich entities (which may be taxed in full by the country in which the property is situated), all other capital gains will be taxable only in the country of residence, unless this would result in double non-taxation (in the case of alienation of shares) [*Article 13*].
- Income from employment, that is, employees’ remuneration, will generally be taxable in the country where the services are performed. However, where the services are performed during certain short visits to one country by a resident of the other country, the income will be exempt in the country visited [*Article 14*].

- Directors' remuneration may be taxed in the country in which the company of which the person is a director is resident for tax purposes [*Article 15*].
- Income derived by entertainers and sportspersons may generally be taxed by the country in which the activities are performed [*Article 16*].
- Pensions and annuities (other than government service pensions) paid to an individual are taxed only in the country of residence of the recipient unless they are paid in a lump sum form. In the case of lump sums, the paying country may also tax the payment, with the country of residence of the recipient providing double tax relief [*Article 17*].
- Income from government service, including pensions paid periodically, will generally be taxed only in the country that pays the remuneration. However, the income shall be taxed only in the other country where the services are rendered in that other country by a resident of that other country who is a national of that other country or, in the case of salaries, wages and similar remuneration, did not become a resident of that other country for the purpose of rendering the services [*Article 18*].
- Payments made from abroad to visiting students and business apprentices for the purpose of their maintenance, training or education will be exempt from tax in the country visited (limited to a period not exceeding one year in the case of business apprentices) [*Article 19*].
- Income, profits or gains derived by a sleeping partner in 'sleeping partnership-Tokumei Kumiai' shall be taxable in the country where the income, profits or gains arise [*Article 20*].
- Other income (ie, income not dealt with by other Articles) derived by a resident of one country from sources in the other country may generally be taxed in both countries, with the country of residence of the recipient providing double tax relief [*Article 21*].
- Source rules in this Convention prescribe for domestic law and treaty purposes that the source of income, profits or gains derived by a resident of one country which under the provisions of the treaty may be taxed in the other country,

will be treated as having a source in that other country
[Article 22].

- Benefits of the treaty will be limited to ‘qualified persons’ in the case of business profits, certain dividend and interest payments and income from the alienation of property [Article 23].
- Limitations on the benefits that a country is obliged to provide apply where income or gains are taxed in the other country on a remittance basis or where income or gains of temporary residents are exempted from tax [Article 24].
- Double taxation relief for income which, under this Convention, may be taxed by both countries is required to be provided by the country of which the taxpayer is a resident under the terms of this Convention as follows:
 - in Australia, by allowing a credit for the Japanese tax against Australian tax payable on income derived by a resident of Australia from sources in Japan [Article 25, paragraph 2]; and
 - in Japan, by allowing a credit for the Australian tax against Japanese tax payable on income derived by a resident of Japan from sources in Australia. A credit for underlying tax will also be provided for certain non-portfolio intercorporate dividends [Article 25, paragraph 1].
- In the case of Australia, effect will be given to the double tax relief obligations arising under this Convention by application of the general foreign income tax offset provisions of Australia’s domestic law, or the relevant exemption provisions of that law where applicable.
- Rules in this Convention will protect nationals and businesses from tax discrimination in the other country and will give them private rights of appeal. However, Article 26 does not preclude Australia from applying its anti-avoidance rules (including thin capitalisation, dividend stripping, transfer pricing and controlled foreign companies measures), rebates or credits for dividends paid by resident companies, research and development concessions, consolidation rules or capital gains deferral rules [Article 26].

- This Convention provides for consultation and exchange of information between the two taxation authorities. This Convention authorises and requires Australia to exchange information where the information relates to federal taxes administered by the Commissioner of Taxation (Commissioner) [*Articles 27 and 28*].

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
Updates all Articles, having regard to Australian, Japanese and the Organisation for Economic Co-operation and Development (OECD) tax treaty developments since the existing Agreement was entered into.	Not applicable.
Updates the definition of ‘Australia’ to cover Australia’s ‘Exclusive Economic Zone’, the seabed and subsoil of the continental shelf.	Only territories specifically included.
<p>Extends the coverage of this Convention to Australian tax on capital gains and updates the list of taxes to which the new treaty arrangements apply. In the case of Australia, these taxes are:</p> <ul style="list-style-type: none"> • the income tax; • the petroleum resource rent tax; and • any identical or substantially similar taxes imposed under the federal law of Australia. <p>However, a broader range of taxes apply to certain Articles. In the case of Australia, the taxes are:</p> <ul style="list-style-type: none"> • taxes of every kind and description for Article 26 (<i>Non-Discrimination</i>); and • all taxes imposed under the federal tax laws administered by the Commissioner for Article 28 (<i>Exchange of Information</i>) 	<p>In the case of Australia, the taxes to which all Articles of the existing treaty apply are:</p> <ul style="list-style-type: none"> • the Commonwealth income tax (including the former additional tax upon the undistributed amount of the distributable income of a private company); and • any identical or substantially similar taxes imposed under the law of Australia.

<i>New law</i>	<i>Current law</i>
<p>Includes an Article setting out the basis on which the residential status of a person is to be determined for the purposes of this Convention. This Article includes tiebreaker rules for both individuals and corporations Article 4 (<i>Resident</i>).</p>	<p>No equivalent tie-breaker rules.</p>
<p>Updates the meaning of ‘permanent establishment’ in Article 5. In particular, under this Convention a building site or construction or installation project constitutes a permanent establishment only where it lasts for more than 12 months. An enterprise is deemed to have a ‘permanent establishment’ if:</p> <ul style="list-style-type: none"> • it carries on supervisory or consultancy activities connected with a building site or construction or installation project for a period exceeding 12 months; • it carries on activities (including the operation of substantial equipment) in the exploration for, or exploitation of, natural resources for a period or periods exceeding in the aggregate 90 days in any 12-month period; or • it operates substantial equipment (other than in natural resource activities) for a period or periods exceeding in the aggregate 183 days in any 12-month period. <p>Integrity provisions are included to prevent related parties from circumventing the permanent establishment time thresholds by splitting contracts.</p>	<p>A building site or construction, installation or assembly project which exists for more than six months is included in the list of examples of a permanent establishment. In addition, an enterprise is deemed to have a ‘permanent establishment’ if:</p> <ul style="list-style-type: none"> • it carries on supervisory activities for more than six months in connection with a building site, or construction, installation or assembly project. <p>No equivalent for activities in the exploration for, or exploitation of, natural resources.</p> <p>No equivalent for substantial equipment.</p>

<i>New law</i>	<i>Current law</i>
Includes an Article dealing with the taxation of real property. This Article allows source country taxation of income from real property, including from the exploration for, and exploitation of, natural resources; permanent establishment assets and interests in land rich entities. This is broadly consistent with the scope of Australia's domestic law treatment of capital gains.	No equivalent.
Aligns the treatment of income from independent personal services to that of business profits under Article 7. It also clarifies the application of the <i>Business Profits</i> Article to business trusts.	Income from independent personal services is treated under the previous international standard in Article 10 of the existing Agreement.
Limits the time for the tax authorities to initiate transfer-pricing adjustments to seven years, except in the case of fraud or wilful default where there remains no time limit.	No limit specified in the treaty. No limit in domestic law.
Dividend withholding tax is limited to: <ul style="list-style-type: none"> • zero for intercorporate dividends on non-portfolio holdings of more than 80 per cent, subject to certain conditions; • five per cent for intercorporate dividends on other non-portfolio holdings; and • ten per cent in all other cases. 	The rate of dividend withholding tax is limited to 15 per cent.
Limits withholding tax on distributions from Australian real estate investment trusts and dividends which are paid by a Japanese company which is entitled to a deduction for dividends paid to its beneficiaries in computing its taxable income in Japan to 15 per cent where the distribution is made up of predominantly rental income.	No equivalent.

<i>New law</i>	<i>Current law</i>
<p>Reduces the rate of interest withholding tax from a maximum of 10 per cent to zero where interest is paid to:</p> <ul style="list-style-type: none"> • government bodies and the Bank of Japan or the Reserve Bank of Australia; • financial institutions; or • the Japan Bank for International Cooperation, Nippon Export and Investment Insurance, Australia’s Export Finance and Insurance Corporation and any public authority that manages the investments of the Future Fund. 	No equivalent.
<p>Reduces the rate of royalty withholding tax to 5 per cent of the gross royalty payment and extends the meaning of royalty to include forbearance. Leasing of industrial, commercial or scientific equipment will no longer constitute a royalty.</p>	<p>The rate of royalty withholding tax is limited to 10 per cent of the gross payment.</p> <p>Definition of ‘royalties’ includes payments for use of industrial, commercial and scientific equipment.</p>
<p>Includes a comprehensive <i>Alienation of Property</i> Article which allocates taxing rights over capital gains and prevents double non-taxation of certain capital gains.</p>	No equivalent.
<p>Includes a <i>Directors’ Fees</i> Article.</p>	No equivalent.
<p>Includes a new Article dealing specifically with a Japanese ‘sleeping partnership-Tokumei Kumiai’.</p>	No equivalent.
<p>Includes a comprehensive <i>Limitation on Benefits</i> Article, which is broadly consistent with that agreed in the Australia-United States treaty.</p>	No equivalent.

<i>New law</i>	<i>Current law</i>
<p>Includes a new <i>Limitation of Relief</i> Article that:</p> <ul style="list-style-type: none"> • limits the treaty benefits that a country is obliged to provide where income, profits or gains of temporary resident individuals are exempted from tax; and • limits the relief a Contracting State must provide where an individual is taxed in the other Contracting State only on income, profits or gains that are remitted or received in that other state. 	No equivalent.
Includes a comprehensive Article preventing discrimination in relation to tax laws (Article 26 (<i>Non-Discrimination</i>)).	No equivalent.
Closely aligns Article 28 (<i>Exchange of Information</i>) to the 2005 OECD standard. The effect of the changes is to expand the range of taxes to which the Article applies and to clarify that bank secrecy laws do not limit the exchange of information.	The existing rules apply to a narrower range of taxes.

Detailed explanation of new law

Article 1 — Persons Covered

Scope

1.5 This Article establishes the scope of the application of this Convention by providing for it to apply to **persons** (defined to include individuals, companies and any other bodies of persons) who are residents of one or both of the countries. It generally precludes extra-territorial application of this Convention. [*Article 1*]

1.6 This Convention also applies to third country residents in relation to Article 26 (*Non-Discrimination*) in its application to nationals of one of the treaty countries, Article 27 (*Mutual Agreement Procedure*) so far as the person is a national of one of the treaty countries and in relation to the exchange of information under Article 28 (*Exchange of Information*).

1.7 The application of this Convention to persons who are dual residents (ie, residents of both countries) is dealt with in Article 4 (*Resident*).

Article 2 — Taxes Covered

Taxes covered

1.8 This Article specifies the existing taxes of each country to which this Convention applies. These are, in the case of Australia, the Australian income tax and the petroleum resource rent tax.

1.9 The term ‘income tax’ includes Australian income tax imposed on capital gains. The operation of this Convention therefore extends to Australian tax on capital gains, which was not covered in the existing Agreement.

1.10 Although Australia considers the petroleum resource rent tax to be encompassed by the term ‘income tax’, a specific reference to this has been included in this Convention to put beyond doubt that it is a tax covered. [*Article 2, sub-subparagraph 1(b)(ii), Protocol, item 1*]

1.11 As with the existing Agreement, this Convention generally does not cover Australia’s goods and services tax (GST), wool tax and levies, customs duties, state taxes and duties and estate tax and duties. However, all federal taxes administered by the Commissioner are covered for the purposes of Article 28 (*Exchange of Information*) and all taxes (including State and local taxes) are covered for the purposes of Article 26 (*Non-Discrimination*). [*Article 2, paragraph 1, Protocol, item 22, Article 26, paragraph 5*]

1.12 For Japan, this Convention applies to income tax and corporation tax. All Japanese taxes are covered for the purposes of Article 28 (*Exchange of Information*) and Article 26 (*Non-Discrimination*). [*Article 2, subparagraph 1(a)*]

Identical or substantially similar taxes

1.13 The application of this Convention will be automatically extended to any identical or substantially similar taxes which are subsequently imposed by either country in addition to, or in place of, the existing taxes. The competent authorities (ie, the Commissioner in the case of Australia and the Minister of Finance in the case of Japan, or their authorised representatives) are required to notify each other in the event of a significant change in the taxation law of the respective countries, within a reasonable period of time after those changes. [*Article 2, paragraph 2*]

Article 3 — General Definitions

Definition of Australia

1.14 As in Australia's other modern tax treaties; **Australia** is defined to include certain external territories and the continental shelf. This Convention also refers specifically to the 'exclusive economic zone'. Although the exclusive economic zone is considered to be covered by the definition used in Australia's other modern tax treaties, it is specifically included in this Convention for additional clarity. By reason of this definition, Australia preserves its taxing rights, for example, over mineral exploration and mining activities carried on by non-residents on the seabed and subsoil of the relevant continental shelf areas (under section 6AA of the *Income Tax Assessment Act 1936* (ITAA 1936), certain sea installations and offshore areas are to be treated as part of Australia). [Article 3, subparagraph 1(b)]

Definition of Japan

1.15 The definition of **Japan** covers the Territory of Japan and its territorial sea as well as the area beyond Japanese territory over which Japan has sovereign rights under international law where laws relating to Japanese tax are in force. This mirrors the definition of Australia and is consistent with Japan's recent treaties. [Article 3, subparagraph 1(a)]

Definition of tax

1.16 For the purposes of this Convention, the term 'tax' does not include any amount of penalty or interest imposed under the respective domestic tax law of the two countries. [Protocol, item 2]

1.17 In the case of a resident of Australia, any penalty or interest component of a liability determined under the domestic taxation law of Japan with respect to income that Japan is entitled to tax under this Convention would not be a creditable Japanese tax for the purposes of paragraph 2 of Article 25 (*Elimination of Double Taxation*). This is in keeping with the meaning of 'foreign income tax' in subsection 770-15(1) of the *Income Tax Assessment Act 1997* (ITAA 1997). Accordingly, such a penalty or interest liability would be excluded from calculations when determining the Australian resident taxpayer's foreign tax credit entitlement under paragraph 2 of Article 25 (pursuant to Division 770 of the ITAA 1997 — Foreign income tax offsets). [Article 3, subparagraph 1(d)]

Definition of person

1.18 The definition of **person** in this Convention accords with Australia's normal tax treaty practice and includes individuals, companies

and any other body of persons. This includes a partnership (as a body of persons). [Article 3, subparagraph 1(e)]

Definition of company

1.19 The definition of **company** in this Convention accords with Australia’s tax treaty practice, and means any body corporate or any entity which is treated as a company or body corporate for tax purposes.

1.20 The Australian tax law treats certain trusts (public unit trusts and public trading trusts) and corporate limited partnerships (limited liability partnerships) as companies for income tax purposes. These trusts and partnerships are included as companies for the purposes of this Convention. [Article 3, subparagraph 1(f)]

Definitions of business and enterprise

1.21 The terms **enterprise of a Contracting State** and **enterprise of the other Contracting State** are defined as an enterprise carried on by residents of the respective countries. [Article 3, subparagraph 1(h)]

1.22 The term **enterprise** is stated to apply to the carrying on of any business. The term **business** is defined to include the performance of professional services and other activities of an independent character. Both these definitions are identical to the definitions added to the OECD *Model Tax Convention on Income and on Capital* (OECD Model) concurrently with the deletion of Article 14 (*Independent Personal Services*). The inclusion of the two definitions is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (*Business Profits*) and not Article 21 (*Other Income*). [Article 3, subparagraphs 1(g), (h) and (l)]

Definition of international traffic

1.23 In this Convention, this term is of relevance for taxation of profits from shipping and air transport operations (Article 8 (*Shipping and Air Transport*)), income, profits or gains from the alienation of ships and aircraft (paragraph 5 of Article 13 (*Alienation of Property*)) and wages of crew (paragraph 3 of Article 14 (*Income from Employment*)).

1.24 The definition of **international traffic** covers international transport by a ship or aircraft operated by an enterprise of one country, as well as domestic transport within that country. However, it does not include transport where the ship or aircraft is operated solely between places in the other country, that is, where the place of departure and the place of arrival of the ship or aircraft are both in that other country,

irrespective of whether any part of the transport occurs in international waters. For example, a ‘voyage to nowhere’ which begins and ends in Sydney on a ship operated by a Japanese enterprise would not come within the definition of ‘international traffic’, even if the ship travels through international waters in the course of the cruise. [Article 3, subparagraph 1(i)]

Definition of national

1.25 This Convention defines ***national*** by reference to an individual’s nationality or citizenship. A legal or juridical person (or an organisation that is treated as a legal or juridical person under the laws of one of the Contracting States) will be a national if it is created or organised under the laws of Australia or Japan. The reference to juridical person is included in this Article as Japanese law has no concept of ‘legal personality’; however it is not intended to add anything to the meaning of ‘legal person’ in Australia. [Article 3, subparagraph 1(j)]

1.26 The concept of nationality is used in subparagraph (b) of paragraph 2 of Article 4 (*Resident*), subparagraph (b) of paragraph 2 of Article 18 (*Government Service*) and Article 26 (*Non-Discrimination*).

Definition of competent authority

1.27 The ‘competent authority’ is the person or institution specifically authorised to perform certain actions under this Convention. For instance, the competent authority is required to give certain notifications (eg, in paragraph 2 of Article 2 (*Taxes Covered*), the competent authorities are required to notify each other of any significant changes to the relevant tax laws of their respective countries) and perform certain tasks (eg, exchange tax information in accordance with Article 28 (*Exchange of Information*)).

1.28 In the case of Australia, the ***competent authority*** is the Commissioner or an authorised representative of the Commissioner. In the case of Japan, the ***competent authority*** is the Minister of Finance or an authorised representative of the Minister of Finance. [Article 3, subparagraph 1(k)]

Terms not specifically defined

1.29 Where a term is not specifically defined within this Convention, that term (unless used in a context that requires otherwise) is to be taken to have the same interpretative meaning as it has under the domestic taxation law of the country applying this Convention at the time of its application. In that case, the meaning of the term under the taxation law

of the country will have precedence over the meaning it may have under other domestic laws.

1.30 The same term may have a differing meaning and a varied scope within different Acts relating to specific taxation measures. For example, GST definitions are sometimes broader than income tax definitions. The definition more specific to the type of tax should be applied in such cases. For example, where the matter subject to interpretation is an income tax matter, but definitions exist in either the ITAA 1936 or the ITAA 1997 and the *A New Tax System (Goods and Services Tax) Act 1999*, the income tax definition would be the relevant definition to be applied.

1.31 If a term is not defined in this Convention, but has an internationally understood meaning in tax treaties and a meaning under the domestic law, the context would normally require that the international meaning be applied. *[Article 3, paragraph 2]*

Article 4 — Resident

Residential status

1.32 This Article sets out the basis upon which the residential status of a person is to be determined for the purposes of this Convention. Residential status is one of the criteria for determining each country's taxing rights and is a necessary condition for the provision of relief under this Convention. In the case of Australia, the concept of who is a resident is determined according to Australia's taxation law. In the case of Japan, residence is determined by reference to liability to tax having regard to criteria such as domicile, residence, place of head or main office and other similar criteria. *[Article 4, paragraph 1]*

Residency of governments

1.33 Article 4 specifically provides that the government, a political subdivision, or local authority of the country, are residents for the purposes of this Convention. This means that the Australian Government, the state governments and local councils of Australia will be residents for the purpose of this Convention. This does not necessarily mean that income, profits or gains derived by these bodies from sources in Japan will be subject to tax in Japan as sovereign immunity principles may apply. *[Article 4, paragraph 1]*

1.34 The Commentaries on the Articles of the OECD Model Tax Convention (OECD Model Commentary) note that it has always been the understanding of member countries that the OECD Model applied to treat

governments as residents even in the absence of an express reference to that effect.

Special residency rules

1.35 A person is not a resident of a country (for the purposes of this Convention) if that person is liable to tax in that Contracting State in respect only of income from sources in that Contracting State.

1.36 Paragraph 1 deals with a person who may be considered to be a resident of a Contracting State according to its domestic laws but is only liable to taxation on income from sources in that Contracting State, such as foreign diplomatic and consular staff. In the Australian context, this also means, for example, that Norfolk Island residents, who are generally subject to Australian tax on Australian source income only, are not residents of Australia for the purposes of this Convention. Accordingly, Japan will not have to forgo tax in accordance with this Convention on income derived by residents of Norfolk Island from sources in Japan (which will not be subject to Australian tax). [*Article 4, paragraph 1*]

Dual residents

1.37 A set of tie-breaker rules is included for determining how residency is to be allocated to one or other of the countries for the purposes of this Convention if a taxpayer, whether an individual, a company or other taxable unit, qualifies as a dual resident, that is, as a resident of both countries in accordance with paragraph 1 of the Article.

1.38 The tie-breaker rules for individuals apply certain tests, in a descending hierarchy, for determining the residential status (for the purposes of this Convention) of an individual who is a resident of both countries. These rules, in order of application, are:

- if the individual has a permanent home available to that individual in only one of the countries, the person is deemed to be a resident solely of that country for the purposes of this Convention;
- if the individual has a permanent home available in both countries or in neither, then the person's residential status takes into account the person's personal or economic relations with Australia and Japan, and the person is deemed for the purposes of this Convention to be a resident only of the country with which the person has the closer personal and economic relations (centre of vital interests). In determining an individual's centre of vital interests regard shall be had to the individual's habitual abode [*Protocol, item 3*];

- residency will be determined on the basis of an individual's nationality where the foregoing test is not determinative; or
- if the individual is a national (as defined in subparagraph (j) of paragraph 1 of Article 3 of this Convention) of both countries or of neither, the competent authorities will endeavour to resolve the question of treaty residence by mutual agreement.

[Article 4, paragraph 2]

1.39 In relation to Australia, a dual resident remains a resident for the purposes of Australian domestic law. Accordingly, that person remains liable to tax in Australia as a resident, insofar as this Convention allows.

1.40 Where a non-individual (such as a company) is a resident of both countries in accordance with paragraph 1, the competent authorities shall endeavour to determine residency by mutual agreement, having regard to the entity's place of head or main office, its place of effective management and any other relevant factors. *[Article 4, paragraph 3]*

1.41 Such other relevant factors may include:

- where the senior day-to-day management is carried on;
- where the accounting records are held;
- where business is carried on; and
- which Contracting State's law governs the legal status.

[Protocol, item 4]

1.42 Unless and until the competent authorities reach mutual agreement on the residential status of a dual resident, the person shall not be considered a resident of either Contracting State for the purposes of the Convention, and will therefore not be entitled to the benefits of this Convention. However, the person will still remain protected from discriminatory taxation under Article 26 (*Non-Discrimination*) and will be able to seek redress under paragraph 1 of Article 27. *[Article 4, paragraph 4]*

Transparent entities

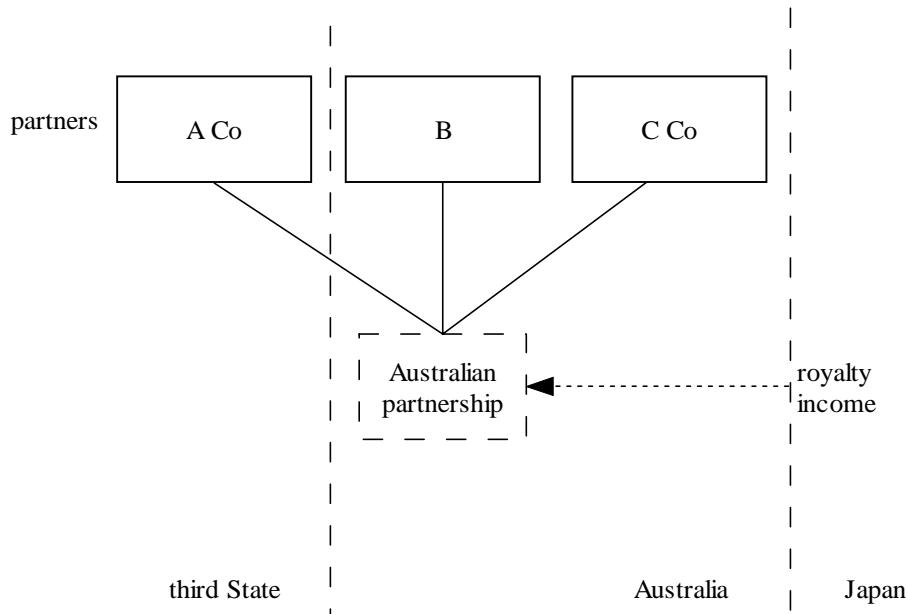
1.43 Paragraph 5 of this Convention deals with income, profits or gains derived through transparent entities. Subparagraphs (a) to (c) specify circumstances where treaty benefits will be granted. Subparagraphs (d) and (e) specify circumstances where treaty benefits are not available.

1.44 Subparagraph (a) deals with the situation where income (including profits or gains) is derived from sources in one Contracting State through an entity organised in the other Contracting State which is treated as fiscally transparent in that other State (ie, income derived through that entity is taxed in the hands of the beneficiaries, members or participants of the entity). In these circumstances, this Convention provides that the income will be entitled to such treaty benefits as would be granted if it were derived directly by the beneficiary, member or participant. Treaty benefits in respect of such income will be granted where:

- the beneficiaries, members or other participants are residents of the other Contracting State; and
- other conditions in this Convention (such as the specific anti-avoidance measures, limitation on benefits and limitation of relief) are satisfied.

1.45 It is irrelevant whether the first-mentioned Contracting State sees the income, profits or gains as the income, profits or gains of the beneficiaries, members or participants under the tax law of that Contracting State. *[Article 4, subparagraph 5(a)]*

Example 1.1



In the above diagram royalty income arising in Japan is paid to an Australian partnership. The Australian partnership includes Australian

partners (residents of Australia for the purposes of the treaty). Under Australian law the income is treated as the income of the partners.

As such, in this example, the royalty income paid to the partnership on which the Australian resident partners are assessable under Australian income tax law would be eligible for the benefits of this Convention. To the extent that the Australian partners owned only a share of the income, then only the share of the income attributable to the Australian partners' interest would be eligible for the benefits of this Convention.

Treaty relief will not apply to income derived by any partners that are not residents of Australia for purposes of this Convention, or income which is derived by temporary residents of Australia — Article 24 (*Limitation of Relief*).

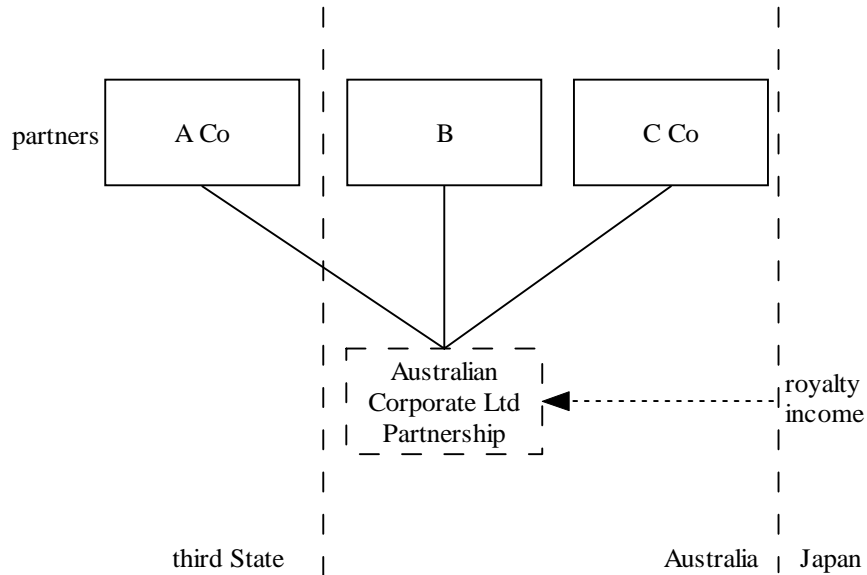
Eligibility for the treaty benefits will also be subject to the application of Article 23 (*Limitation on Benefits*) and the respective anti-avoidance measures contained in the specific income Article (in this example, paragraph 8 of Article 12 (*Royalties*)).

1.46 Subparagraph (b) deals with the situation where income is derived from sources in one Contracting State through an entity that is organised in the other Contracting State and is treated as a taxable entity under the tax law of that other Contracting State. In these circumstances, this Convention provides that the income will be entitled to such treaty benefits as would be granted to a resident of the latter Contracting State. Treaty benefits will be granted where:

- the entity is a resident of the other Contracting State; and
- other conditions in this Convention (such as the specific anti-avoidance measures, and limitation on benefits) are satisfied.

1.47 It is irrelevant whether the first-mentioned Contracting State sees the income, profits or gains as the income, profits or gains of the entity under the tax law of that Contracting State. [*Article 4, subparagraph 5(b)*]

Example 1.2



In the above diagram, royalty income arising in Japan is paid to an Australian Limited Liability Partnership. The Australian Corporate Limited Partnership includes Australian partners (residents of Australia for the purposes of the treaty). The Australian Corporate Limited Partnership is effectively treated as a company for Australian tax purposes.

As such, in this example, the royalty income would be eligible for the benefits of this Convention. This will be the case, notwithstanding that one or more of the participants in the corporate limited partnership is not a resident of Australia and irrespective of whether Japan, under its domestic law, would tax the income in the hands of the Australian corporate limited partnership or in the hands of the partners in the Australian corporate limited partnership.

Treaty relief will not apply to income derived by any partners that are not residents of Australia for purposes of this Convention, or income which is derived by temporary residents of Australia — Article 24 (*Limitation of Relief*).

Eligibility for the treaty benefits will be subject to the application of Article 23 (*Limitation on Benefits*) and the respective anti-avoidance measures contained in the specific income Article.

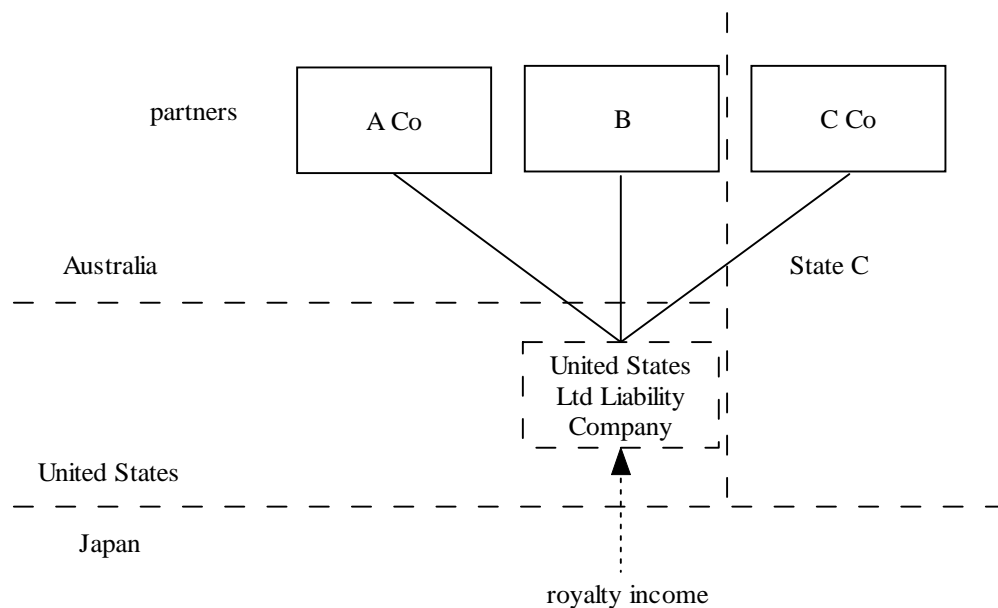
1.48 Subparagraph (c) deals with the situation where income is derived from sources in one Contracting State through a third State entity which is treated as fiscally transparent in the other Contracting State. In

these circumstances, this Convention provides that the income will be entitled to such treaty benefits as would be granted if it were derived directly by the beneficiary, member or participant. Treaty benefits in respect of such income will be granted where:

- the beneficiary, member or participant is a resident of the other Contracting State; and
- other conditions in this Convention (such as the specific anti-avoidance measures, limitation on benefits and limitation of relief) are satisfied.

1.49 It is irrelevant whether the first-mentioned Contracting State sees the income, profits or gains as the income, profits or gains of the beneficiary, member or participant under the tax law of that Contracting State. [Article 4, subparagraph 5(c)]

Example 1.3



In the above diagram, a Japanese entity pays interest income to a United States Limited Liability Company (US LLC). The US LLC includes Australian partners (residents of Australia for the purposes of the treaty).

As the US LLC is treated as a partnership for US tax law purposes, it is also treated as a partnership for Australian tax law purposes.

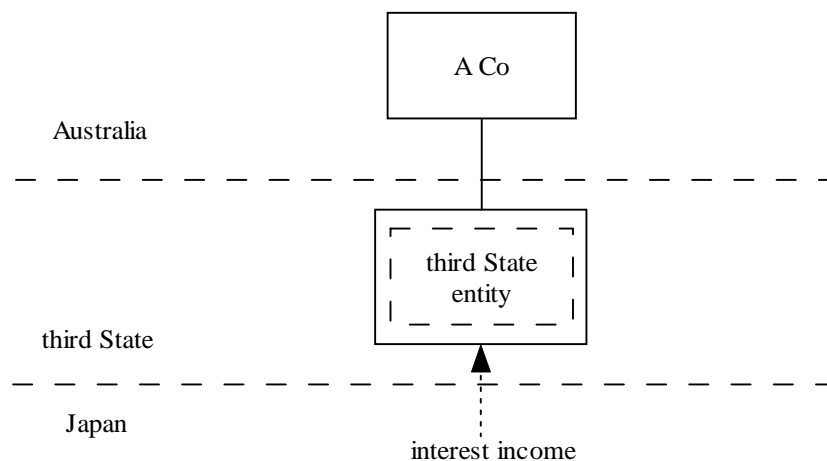
In this example, the royalty income derived by the US LLC on which the Australian resident partners are assessable under Australian income tax law would be eligible for the benefits of the Convention.

Treaty relief will not apply to income derived by any partners that are not residents of Australia for purposes of this Convention, or income which is derived by temporary residents of Australia — Article 24 (*Limitation of Relief*).

Eligibility for the treaty benefits will be subject to the application of Article 23 (*Limitation on Benefits*), Article 24 (*Limitation of Relief*) and the respective anti-avoidance measures contained in the specific income Article.

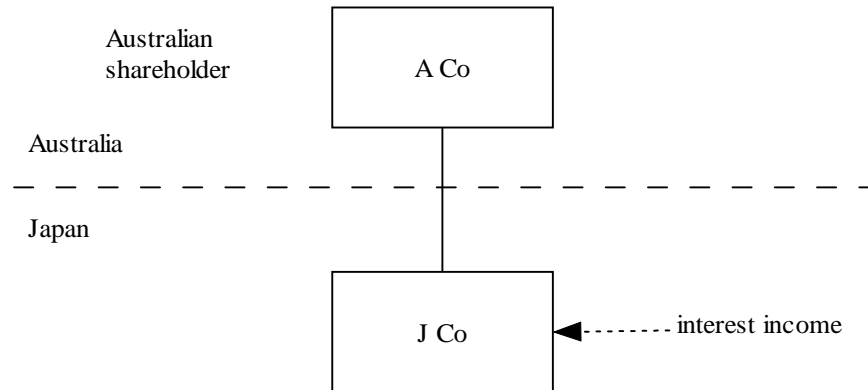
1.50 No treaty benefits will be granted in respect of income derived from a Contracting State through a third State entity where that income is treated as derived by the entity under the tax law of the other Contracting State. [*Article 4, subparagraph 5(d)*]

Example 1.4



In the above diagram, a Japanese entity pays interest to a third State entity that is treated as a company for Australian tax purposes. In this case, the interest income will not be eligible for the benefits of this Convention. This occurs even if the third State entity was treated differently under the tax laws of Japan.

1.51 Similarly, income derived from a Contracting State through an entity organised in that State will not be eligible for treaty benefits if the income is treated as derived by that entity under the tax laws of the other Contracting State. [*Article 4, subparagraph 5(e)*]

Example 1.5

In the above diagram, a Japanese entity pays interest income to another Japanese entity, J Co. A Co, an Australian resident shareholder holds shares in J Co. Australia treats J Co as the entity that derives the interest income.

In this example, the interest income would be ineligible for the benefits of this Convention. It is irrelevant how Japan would treat the entity.

Article 5 — Permanent Establishment***Role and definition***

1.52 The application of various provisions of this Convention (principally Article 7 (*Business Profits*)) is dependent upon whether a person who is a resident of one country carries on business through a permanent establishment in the other country, and if so, whether income derived by that person is attributable to, or assets of that person are effectively connected with, that permanent establishment.

1.53 The definition of the term ‘permanent establishment’ in this Article corresponds generally with definitions of the term in Australia’s more recent tax treaties. The term also fully encompasses the concept of ‘fixed base’, which is used in the existing Agreement in a separate Article dealing with professional services and other similar independent activities. As such services will now be dealt with under Article 7 (*Business Profits*), it is intended that places that constitute a fixed base for purposes of the existing Agreement would come within the meaning of permanent establishment for the purposes of this Convention.

Meaning of permanent establishment

1.54 The primary meaning of ***permanent establishment*** is expressed as being a fixed place of business through which the business of an enterprise is wholly or partly carried on. To be a permanent establishment within the primary meaning of that term, the following requirements must be met:

- there must be a place of business;
- the place of business must be fixed (both in terms of physical location and in terms of time); and
- the business of the enterprise must be carried on through this fixed place.

[Article 5, paragraph 1]

1.55 Other paragraphs of this Article elaborate on the meaning of the term by giving examples (by no means intended to be exhaustive) of what may constitute a permanent establishment — for example:

- an office;
- a factory;
- an agricultural, pastoral or forestry property; or
- a place of extraction of natural resources.

1.56 As paragraph 2 of this Article is subordinate to paragraph 1, the examples listed will only constitute a permanent establishment if the primary definition in paragraph 1 is satisfied. ***[Article 5, paragraph 2]***

Agricultural, pastoral or forestry activities

1.57 Most of Australia's tax treaties include as a permanent establishment an agricultural, pastoral or forestry property. This reflects Australia's policy of retaining taxing rights over exploitation of Australian land for the purposes of primary production. This approach ensures that the arm's length profits test provided for in Article 7 (*Business Profits*) applies to the determination of profits derived from these activities. This position is also reflected in this Convention in relation to such properties situated in Australia. ***[Article 5, subparagraph 2(g)]***

Building site or construction or installation project

1.58 A building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months. The provision has been relocated to a separate paragraph which aligns with the OECD Model formatting and ensures that sites or projects which last less than 12 months will not constitute a permanent establishment.

1.59 The term ‘building site or construction or installation project’ includes not only places used for the construction of buildings but also for the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. Planning and supervision are considered part of the building site if carried out by the construction contractor. However, planning and supervision carried out by another unassociated enterprise will not be taken into account in determining whether the construction contractor has a permanent establishment in Australia. *[Article 5, paragraph 3]*

Deemed permanent establishment

Supervisory and consultancy activities

1.60 Supervisory and consultancy activities undertaken for more than 12 months in connection with a building site or a construction or installation project are deemed to be performed through a permanent establishment. This reflects Australia’s reservation to Article 5 (*Permanent Establishment*) of the OECD Model. *[Article 5, subparagraph 4(a)]*

Natural resource activities

1.61 Where an enterprise carries on activities (including the operation of substantial equipment) in the exploration for, or exploitation of, natural resources within a country for a period or periods aggregating more than 90 days in any 12-month period, it will be deemed to have a permanent establishment in that country through which those activities are performed. *[Article 5, subparagraph 4(b)]*

Substantial equipment

1.62 If an enterprise operates substantial equipment in a country for longer than 183 days in any 12-month period, the activity will be deemed to be performed through a permanent establishment. For the purposes of calculating this period, days during which the substantial equipment is used in the exploitation of, or exploration for, natural resources are not included. *[Article 5 subparagraph 4(c)]*

1.63 Subparagraphs 4(b) and (c) together reflect Australia's reservation to the OECD Model concerning the use of substantial equipment. Australia's experience is that the permanent establishment provision in the OECD Model may be inadequate to deal with high value mobile activities involving the use of such equipment.

1.64 The terms 'operation' and 'operates' have been included to clarify that only active use of substantial equipment assets will be captured by subparagraphs 4(b) and (c). This means that an enterprise that merely leases substantial equipment to another person for that other person's own use in a country, would not be deemed to have a permanent establishment in that country under these provisions. *[Protocol, subitem 5(a)]*

1.65 For example, if a Japanese enterprise itself operates a mobile crane at an Australian port for more than 183 days in a 12-month period, the Japanese enterprise would be deemed to have a permanent establishment in Australia under subparagraph 4(c). If, however, that Japanese enterprise merely leases the mobile crane to another person and that other person operates the crane at an Australian port for its own purposes, the Japanese enterprise would not be deemed to have a permanent establishment in Australia under subparagraph 4(c). However, if that other person operates the substantial equipment for or on behalf of the enterprise, the enterprise would be considered to operate the equipment in the country.

1.66 The meaning of the term 'substantial' depends on the relevant facts and circumstances of each individual case. Factors such as the size, quantity or value of the equipment, or the role of the equipment in income producing activities, are relevant in determining whether the equipment is substantial. *[Protocol, subitem 5(b)]*

1.67 A non-exhaustive list of examples of substantial equipment is specified in the Protocol to this Convention. These include:

- industrial earthmoving equipment or construction equipment used in road building, dam building or powerhouse construction;
- manufacturing or processing equipment used in a factory; and
- oil or drilling rigs, platforms and other structures used in the petroleum or mining industry.

[Protocol, subitem 5(c)]

Anti-avoidance provision

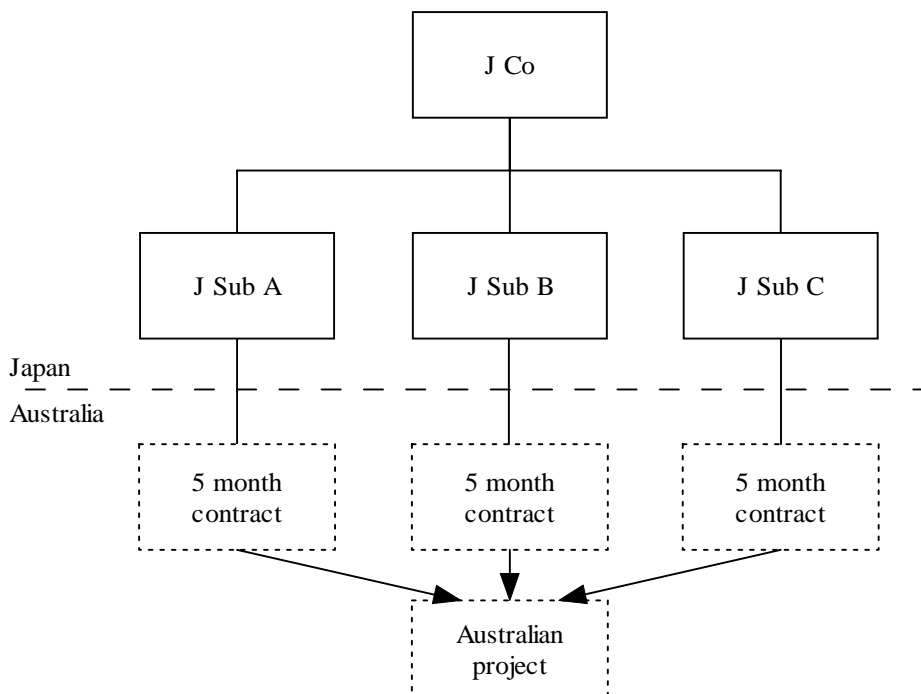
1.68 Given that Article 5 contains certain timeframes, an anti-avoidance rule is included to ensure that where associated enterprises carry on connected activities, the periods will be aggregated in determining whether an enterprise has a permanent establishment in the country in which the activities are being carried on. Activities will be regarded as connected where, for example, different stages of a single project are carried out by different subsidiaries within a group of companies or where the nature of the work carried on by the associated enterprises in respect of such project is the same.

1.69 This provision is an anti-avoidance measure aimed at counteracting contract splitting for the purposes of avoiding the application of the permanent establishment rules.

1.70 The OECD Model Commentary recognises that time thresholds in Article 5 may give rise to abuses and notes that countries concerned with this issue may adopt solutions in bilateral negotiations to prevent such abuse.

1.71 This Convention provides that an enterprise shall be deemed to be associated with another enterprise if one enterprise participates directly or indirectly in the management, control or capital of the other enterprise or the same persons participate directly or indirectly in the management, control or capital of the enterprises. It also provides that a period of concurrent activities by such associated enterprises is only counted as one period for aggregation purposes. [*Article 5, paragraph 5*]

Example 1.6



In the above diagram, each of the subsidiaries may conduct similar connected activities, for example, supervisory activities at a single building site. In determining whether the 12-month time threshold has been met, the time spent by each of the enterprises would be aggregated. However, any period during which more than one of the subsidiaries were carrying on activities concurrently would be counted only once. Where the time threshold is met, each of the subsidiaries would be deemed to have a permanent establishment through which its activities with respect to the project are conducted. Only the profits derived by each subsidiary from its own activities would be attributed to each company's permanent establishment.

Preparatory and auxiliary activities

1.72 Certain activities do not generally give rise to a permanent establishment (eg, the use of facilities solely for storage, display or delivery).

1.73 These activities are ordinarily of a preparatory or auxiliary character and are unlikely to give rise to substantial profits. The necessary economic link between the activities of the enterprise and the country in which the activities are carried on does not exist in these circumstances.

1.74 Unlike the OECD Model, which provides that the listed activities are deemed not to constitute a permanent establishment, this Convention provides that an enterprise will not be deemed to have a permanent establishment merely by reason of such activities. This is to prevent the situation where enterprises structure their business so that most of their activities fall within the exceptions but when, viewed as a whole, the activities ought to be regarded as a permanent establishment.

1.75 Another feature consistent with Australia’s tax treaty practice is that subparagraph 4(f) of Article 5 (*Permanent Establishment*) of the OECD Model — dealing with combinations of activities of the kind referred to in subparagraphs 6(a) to (e) of this treaty — is not included. Australia does not consider that an enterprise undertaking multiple functions of the kind indicated in subparagraphs 6(a) to (e) would generally be regarded as only engaged in preparatory or auxiliary activities. [*Article 5, paragraph 6*]

Dependent agents

1.76 A person who acts on behalf of an enterprise of another country is deemed to constitute a permanent establishment of that enterprise if that person has and habitually exercises an authority to substantially negotiate or conclude contracts on behalf of the enterprise.

1.77 Consideration will be given to all the relevant facts and circumstances in determining whether a person has authority or not to substantially negotiate or conclude contracts.

1.78 The term ‘substantially negotiate’ has been included to remove any doubt as to the existence of a permanent establishment where contracts that have been negotiated in one country by an agent are formally concluded in the other country by signature by another person in that other country. [*Protocol, item 6*]

1.79 Activities of a dependent agent will not give rise to a permanent establishment where that agent’s activities are limited to the preparatory and auxiliary activities mentioned in paragraph 6. [*Article 5, subparagraph 7(a)*]

Manufacturing or processing on behalf of others

1.80 Consistent with Australia’s reservations to the OECD Model, where a person acts on behalf of another in manufacturing or processing the other’s goods, this will give rise to a deemed permanent establishment. An example is the situation where a mineral plant refines minerals at cost, so that the plant operations produce no Australian profits. Title to the

refined product remains with the mining consortium and profits on sale are realised mainly outside of Australia.

1.81 The refining activities performed for the enterprise through such a plant are deemed to be carried on through a permanent establishment of the enterprise because the manufacturing or processing activity (which gives the processed minerals much of their value) is conducted in Australia on behalf of the enterprise. Accordingly, Australia should have taxing rights over the business profits attributable to the processing activity carried on in Australia. Subparagraph 7(b) prevents an enterprise which carries on substantial manufacturing or processing activities in a country through an intermediary from escaping tax in that country.

1.82 The inclusion of this subparagraph is insisted upon by Australia in its tax treaties and is consistent with Australia's policy of retaining taxing rights over profits from manufacturing or processing on behalf of others including, importantly, in the exploitation of Australia's mineral resources. *[Article 5, subparagraph 7(b)]*

1.83 Manufacturing or processing activities will not give rise to a permanent establishment where the activities are limited to the preparatory and auxiliary activities mentioned in paragraph 6.

Independent agents

1.84 Business carried on through an independent agent will not, of itself, give rise to a permanent establishment, provided that the independent agent is acting in the ordinary course of that agent's business as such an agent. *[Article 5, paragraph 8]*

Subsidiary companies

1.85 Generally, a subsidiary company will not be a permanent establishment of its parent company. A subsidiary, being a separate legal entity, would not usually be carrying on the business of the parent company but rather its own business activities. However, a subsidiary company gives rise to a permanent establishment if the subsidiary permits the parent company to operate from its premises such that the tests in paragraph 1 of Article 5 are met, or the subsidiary acts as an agent such that a dependent agent permanent establishment is constituted. *[Article 5, paragraph 9]*

Other Articles

1.86 The principles set down in this Article are also to be applied in determining whether a permanent establishment exists in a third country

or whether an enterprise of a third country has a permanent establishment in Australia (or Japan) when applying the source rule contained in:

- paragraph 7 of Article 11 (*Interest*); and
- paragraph 5 of Article 12 (*Royalties*).

[Article 5, paragraph 10]

Article 6 — Income from Real Property

Where income from real property is taxable

1.87 Consistent with the OECD Model, this Article provides that the income of a resident of one country, from real property situated in the other country, may be taxed by that other country. Thus, income from real property in Australia will be subject to Australian tax laws. *[Article 6, paragraph 1]*

Definition

1.88 ‘Real property’ is primarily defined as having the meaning which it has under the domestic law of the country where the property is situated. The definition also provides some particular examples of what real property would include, such as the usufruct of real property (being a right to use property without degrading it and to retain any profits derived from it). *[Article 6, paragraph 2]*

1.89 The Protocol clarifies that the principal rights intended to be covered by subparagraph (f) of paragraph 2 (which refers to rights relating to the exploitation of, and exploration for, natural resources) are rights to receive payments for the granting of the right to explore for, or exploit natural resources, and rights to receive payments in relation to the exploitation of, or exploration for, natural resources. This would apply regardless of whether the person receiving the payments had an interest in the resources. For example, where a geologist is engaged to identify potential mineral deposits, and is paid by a mining company by reference to the value of the minerals extracted, the right to receive such payment would come within the definition of real property even if the mining company, not the geologist, holds the right to extract those minerals. *[Protocol, item 8]*

1.90 Ships and aircraft are excluded from the definition of ‘real property’. Therefore this Article does not cover income from their use. *[Article 6, paragraph 2]*

1.91 This Article will not prevent a Contracting State applying domestic law where a resident derives income from real property situated in that State, regardless of whether that property is effectively connected with a permanent establishment in the other Contracting State. [*Protocol, item 7*]

Deemed situs

1.92 Under Australian law the place where an interest in land, such as a lease, is situated (*situs*) is not necessarily where the underlying property is situated. Paragraph 3 puts the situation of the interest or right beyond doubt by deeming the *situs* to be where the underlying real property over which the lease or right is granted, is situated or where any exploration may take place. [*Article 6, paragraph 3*]

Real property of an enterprise

1.93 Paragraphs 1, 3 and 4 of Article 6 are extended to income derived from the use or exploitation of real property of an enterprise.

1.94 Accordingly, this Article (when read with Article 7 (*Business Profits*)) ensures that the country in which the real property is situated may impose tax on the income derived from that property by an enterprise of the other country, irrespective of whether or not that income is attributable to a permanent establishment of such an enterprise situated in the first-mentioned country. [*Article 6, paragraph 5*]

Form of exploitation of real property

1.95 Paragraph 4 makes it clear that the general rule in paragraph 1 applies irrespective of the form of exploitation of the real property. The Article applies to income derived from the direct use, letting or use in any other form of real property. [*Article 6, paragraph 4*]

Article 7 — Business Profits

1.96 This Article is concerned with the taxation by one country of business profits derived by an enterprise that is a resident of the other country.

1.97 The taxing of these profits depends on whether they are attributable to the carrying on of a business through a permanent establishment in that country. If a resident of one country carries on business through a permanent establishment (as defined in Article 5 (*Permanent Establishment*)) in the other country, the country in which the permanent establishment is situated may tax the profits of the enterprise that are attributable to that permanent establishment. [*Article 7, paragraph 1*]

1.98 If an enterprise which is a resident of one country derives business profits in the other country other than profits attributable to a permanent establishment in that other country, the general principle of this Article is that the enterprise will not be liable to tax in the other country on its business profits (except where paragraph 7 of this Article applies — see the explanation in paragraphs 1.108 and 1.109).

1.99 This Article will not prevent a Contracting State applying domestic law where a resident derives income from real property situated in that State, regardless of whether that property is effectively connected with a permanent establishment in the other Contracting State. [*Protocol, item 7*]

Determination of business profits

1.100 Profits of a permanent establishment are to be determined for the purposes of this Article on the basis of arm's length dealings. The provisions in this Convention correspond to international practice and the comparable provisions in Australia's other tax treaties. [*Article 7, paragraphs 2 and 3*]

1.101 No deductions are allowed in respect of expenses which would not be deductible if the permanent establishment were an independent enterprise which incurred the expense. [*Article 7, paragraph 3*]

1.102 No profits are to be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise. Accordingly, profits of a permanent establishment will not be increased by adding to them any profits attributable to the purchasing activities undertaken for the head office. It follows, of course, that any expenses incurred by the permanent establishment in respect of those purchasing activities will not be deductible in determining the taxable profits of the permanent establishment. [*Article 7, paragraph 5*]

1.103 Paragraph 6 follows the OECD Model and was inserted at the request of Japan to lay down clearly in the treaty that a method of allocation once used should not be changed merely because in a particular year a more favourable result is produced under a different method. It also provides assurances of continuous and consistent tax treatment for business dealings through branches between the two countries, unless there is good and sufficient reason to change. [*Article 7, paragraph 6*]

1.104 A good and sufficient reason to change the method used to determine the profits to be attributed to the permanent establishment will be taken to exist where an alternative method gives the most appropriate determination of the profits in accordance with the principles contained in the Article. [*Protocol, item 10*]

1.105 The Protocol to this Convention clarifies that income, profits or gains may continue to be taxed in the country where the permanent establishment was situated after an enterprise ceases to carry on business through that permanent establishment, provided the income is attributable to that permanent establishment. [*Protocol, item 9*]

Application of domestic law

1.106 The domestic law of the country in which the permanent establishment is situated (eg, Australia's Division 13 of Part III of the ITAA 1936) may be applied to determine the tax liability of a person, consistently with the principles stated in this Article. This is of particular relevance where, due to inadequate information, the correct amount of profits attributable on the arm's length principle basis to a permanent establishment cannot be determined, or can only be ascertained with extreme difficulty. This is especially important where there is no data available or the available data is not of sufficient quality to rely on the traditional transaction methods for the attribution of the arm's length profits.

1.107 Paragraph 4 explicitly recognises the right of each country to apply its domestic law in these circumstances. This is consistent with Australia's reservation to Article 7 (*Business Profits*) of the OECD Model. [*Article 7, paragraph 4*]

Profits dealt with under other Articles

1.108 Where income or gains are specifically dealt with under other Articles of this Convention, the effect of those particular Articles is not overridden by this Article.

1.109 This provision lays down the general rule of interpretation that categories of income or gains which are the subject of other Articles of this Convention (eg, Article 8 (*Shipping and Air Transport*), Article 10 (*Dividends*), Article 11 (*Interest*), Article 12 (*Royalties*) and Article 13 (*Alienation of Property*)) are to be treated in accordance with the terms of those Articles. However, under certain articles, for example paragraph 8 of Article 10 (*Dividends*), where the asset in respect of which the income is paid is effectively connected with a permanent establishment that income will be dealt with under Article 7 (*Business Profits*). [*Article 7, paragraph 7*]

Insurance with non-residents

1.110 Each country has the right to continue to apply any provisions in its domestic law relating to the taxation of income from insurance. An effect of this paragraph is to preserve, in the case of Australia, the

application of Division 15 of Part III of the ITAA 1936 (Insurance with Non-residents). This is consistent with Australia’s reservation to Article 7 (*Business Profits*) of the OECD Model. [Article 7, paragraph 8]

Trust beneficiaries

1.111 The principles of this Article will apply to profits which are derived by a resident of one of the Contracting States (directly or through one or more interposed trusts) as a beneficiary of a trust, except where the trust is treated as a company for tax purposes. [Article 7, paragraph 9]

1.112 In the case of Japan, it is noted in the Protocol that ***a trust which is treated as a company for tax purposes*** means a trust, the trustee of which is subject to tax in respect of profits derived from business carried on by the use of the trust estate. [Protocol, item 11]

1.113 In accordance with this Article, Australia has the right to tax a share of business profits, originally derived by a trustee of a trust estate (other than a trust estate that is treated as a company for tax purposes) from the carrying on of a business through a permanent establishment in Australia, to which a resident of Japan is beneficially entitled under the trust. Paragraph 9 of this Article ensures that such business profits will be subject to tax in Australia where, in accordance with the principles set out in Article 5 (*Permanent Establishment*), the trustee of the relevant trust has a permanent establishment in Australia in relation to that business. The principles of this paragraph will also apply where relevant to other Articles of this Convention, such as Article 13 (*Alienation of Property*) in its application to income, profits or gains arising from the alienation of the assets of a permanent establishment or the permanent establishment itself.

Article 8 — Shipping and Air Transport

Profits from international traffic

1.114 The main effect of this Article is that the right to tax profits from the operation of ships or aircraft in international traffic, including a share of profits attributable to participation in a pool service or other profit sharing arrangement, is generally reserved to the country in which the operator is a resident for tax purposes. [Article 8, paragraphs 1 and 5]

1.115 The profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to facilitate or

support their international operations. Consistent with the OECD Model Commentary on Article 8 (*Shipping, Inland Waterways Transport and Air Transport*), paragraph 1 also covers profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships or aircraft in international traffic but which are ancillary to such operation.

1.116 This Article exempts Australian enterprises from Japan's local inhabitant and enterprise taxes in respect of the operation of ships and aircraft in international traffic, provided that no political subdivision or local authority in Australia would subject a Japanese enterprise to a similar tax. [*Article 8, paragraph 2*]

Internal traffic

1.117 Profits derived directly or indirectly by a Japanese enterprise from the operation of ships or aircraft, to the extent that they relate to operations confined solely to places in Australia, may be taxed in Australia. This reflects Australia's treaty policy of reserving to the source country the right to tax profits from internal traffic and profits from other coastal and continental shelf activities, including non-transport shipping and aircraft activities, within its own waters and airspace. [*Article 8, paragraph 3*]

1.118 Australia's taxing rights are specifically preserved over profits from the carriage by ships or aircraft of passengers or cargo (including mail) where the passenger or cargo is shipped and discharged in Australia. [*Article 8, paragraph 4*]

1.119 There is no specified limit on the amount of tax that can be charged on profits from the operation of ships and aircraft in internal traffic. However, under Division 12 of Part III of the ITAA 1936, 5 per cent of the amount paid in respect of the transport of passengers, livestock, mail or goods would be deemed to be taxable income of the Japanese ship operator.

Example 1.7

A ship operated by a Japanese enterprise, in the course of an international voyage from Sendai to Melbourne, makes a stop in Cairns to pick up cargo. Profits derived from the transport of the goods loaded in Cairns and discharged in Melbourne would be profits from operations confined solely to places in Australia. Australia would therefore have the right to tax the profits relating to such transport. Five per cent of the amount paid in respect of the transport of those goods would be deemed to be taxable income of the operator for Australian tax purposes pursuant to Division 12 of Part III of the ITAA 1936.

Example 1.8

A Japanese enterprise operates sightseeing flights over the Southern Ocean. Passengers board the aircraft in Hobart and disembark at the same airport later on the same day. These operations would be regarded as operations confined solely to places in Australia, notwithstanding that the aircraft passes through international airspace. Australia would therefore have the right to tax the profits relating to the carriage of these passengers.

1.120 Operations involving the use of ships or aircraft, such as haulage, survey or dredging activities, or other activities that are undertaken in Australia (including coastal waters, the continental shelf, the exclusive economic zone and external territories) are also regarded as operations confined solely to places in Australia.

Article 9 — Associated Enterprises

Reallocation of profits

1.121 This Article deals with associated enterprises (such as parent and subsidiary companies and companies under common control). It authorises the reallocation of profits between related enterprises in Australia and Japan on an arm's length basis where the commercial or financial arrangements between the enterprises differ from those that might be expected to operate between unrelated enterprises dealing wholly independently with one another.

1.122 This Article does not generally authorise the rewriting of accounts of associated enterprises where it can be satisfactorily demonstrated that the transactions between such enterprises have taken place on normal, open market commercial terms. Consistent with Australia's recent treaty practice, the inclusion of the expression 'dealing wholly independently with one another' in paragraph 1 recognises dealings on a truly independent basis as the appropriate benchmark for determining whether the transactions have taken place on normal, open market commercial terms. *[Article 9, paragraph 1]*

1.123 The broad scheme of Australia's domestic law provisions relating to international profit shifting arrangements under which profits are shifted out of Australia, whether by transfer pricing or other means, is to impose arm's length standards in relation to international dealings. Where the Commissioner cannot ascertain the arm's length consideration, it is deemed to be such an amount as the Commissioner determines.

1.124 Each country has the right to apply its domestic law relating to the determination of the tax liability of a person (eg, Australia's

Division 13 of Part III of the ITAA 1936) to enterprises in cases where the available information is inadequate, provided that, on the basis of the available information, such provisions are applied, so far as it is practicable to do so, consistently with the principles of paragraph 1 of the Article. This is of particular relevance where there is no data available or the available data is not of sufficient quality to rely on the traditional transaction methods for the attribution of arm's length profits. This reflects Australia's reservation to Article 9 (*Associated Enterprises*) of the OECD Model. *[Article 9, paragraph 2]*

Correlative adjustments

1.125 Where a reallocation of profits is made (either under this Article or, by virtue of paragraph 2, under domestic law) so that the profits of an enterprise of one country are adjusted upwards, a form of double taxation would arise if the profits so reallocated continued to be subject to tax in the hands of an associated enterprise in the other country. To avoid this result, where the competent authorities of the two countries agree that the first adjustment reflects arm's length profits, the other country is obliged to make an appropriate compensatory adjustment to the amount of tax charged on the profits involved to relieve any such double taxation.

1.126 It would generally be necessary for the affected enterprise to apply to the competent authority of the country not initiating the reallocation of profits for an appropriate compensatory adjustment to reflect the reallocation of profits made by the other treaty partner country. *[Article 9, paragraph 3]*

OECD guidelines

1.127 The Exchange of Notes reflects the understanding reached by negotiators that Australia and Japan will conduct transfer pricing evaluations in accordance with the OECD transfer pricing guidelines. This accords with Australia's practice of applying the OECD transfer pricing guidelines.

Time limitation

1.128 Any enquiry into the profits of the enterprise must be initiated within seven years in order to make an adjustment under paragraph 1 or 2. However, the time limit does not apply in the case of fraud or wilful default, or where the ability to initiate an enquiry is hindered by the action or inaction of the enterprise. *[Article 9, paragraph 4]*

1.129 The Article does not impose a time limit on conclusion of the inquiry into the profits of the enterprise.

Article 10 — Dividends

1.130 This Article allocates taxing rights in respect of dividends flowing between Australia and Japan. The Article provides that:

- certain cross-border intercorporate dividends will be either exempt from source taxation or subject to a maximum 5 per cent rate of tax in that country;
- a maximum 10 per cent rate of source country tax may be applied on all other dividends;
- dividends paid in respect of a holding which is effectively connected with a permanent establishment are to be dealt with under Article 7 (*Business Profits*); and
- the extra-territorial application by either country of taxing rights over dividend income is not permitted.

1.131 The Article also provides for limited source taxation on distributions from Australian real estate investment trusts and from Japanese pre-dividend deduction companies.

1.132 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

1.133 The phrase ‘for the purposes of its tax’, which appears in paragraph 1 of Article 10, refers to the case where a person is a resident of a Contracting State by virtue of paragraph 1 of Article 4 of the Convention, even if the person is deemed to be a resident of the other Contracting State by virtue of paragraph 2 or 3 of that Article. [*Protocol, item 12*]

Permissible rate of source country taxation

Exemption for certain cross-border intercorporate dividends

1.134 No tax will be payable in the source country on dividends paid to a company that is the beneficial owner of those dividends and is resident in the other country where the recipient company:

- holds directly 80 per cent or more of the voting power of the company paying the dividend;
- satisfies a 12-month holding requirement at the time the dividend is determined in relation to the shares in respect of which the dividend is payable; and

- meets certain qualifying tests.

[Article 10, paragraph 3]

1.135 In the case of Australia, ***the date on which entitlement to the dividends is determined*** is the date on which the dividends are declared. As such, the phrase should be regarded as consistent with Australia's other tax treaties which use the word *declared*. For the purposes of Japan, the phrase will be interpreted as meaning the end of the accounting period for which the distribution of profits takes place. *[Exchange of Notes, paragraph 3]*

1.136 To qualify for the exemption, the company that is the beneficial owner of the dividends must either:

- be a publicly listed company that is a 'qualified person' (as defined under subparagraph 2(c) of Article 23 (*Limitation on Benefits*));
- have at least 50 per cent of the aggregate vote and value of its shares owned directly or indirectly by five or fewer such companies; or
- be granted benefits with respect to those dividends under paragraph 5 of Article 23 (*Limitation on Benefits*).

[Article 10, paragraph 3]

1.137 For the purpose of the above tests, refer to the discussion on Article 23 (*Limitation on Benefits*) in paragraphs 1.275 to 1.300.

Five per cent rate limit on source country tax of certain cross-border intercorporate dividends

1.138 The Article allows both countries to tax other dividends flowing between them but limits the rate of tax that the country of source may impose on dividends paid by companies that are residents of that country under its domestic law to companies resident in the other country who are the beneficial owners of the dividends. *[Article 10, paragraphs 1 and 2]*

1.139 A rate limit of 5 per cent will apply for dividends paid in respect of company shareholdings that do not qualify for the intercorporate dividend exemption under paragraph 3 of this Article, but constitute a direct voting interest of at least 10 per cent. *[Article 10, subparagraph 2(a)]*

Ten per cent rate limit for all other dividends

1.140 Except as provided in paragraph 4 (see paragraphs 1.142 to 1.144), this Article provides that the source country will limit its tax to 10 per cent of the gross amount of the dividend in all other cases. In the case of Australia, this will mean that the domestic rate of withholding tax imposed on unfranked dividends will be reduced from 30 per cent to 10 per cent. *[Article 10, subparagraph 2(b)]*

1.141 Although the provisions in Article 10 would allow Australia to impose withholding tax on both franked and unfranked dividends in the specified circumstances, the dividend withholding tax exemption provided by Australia under its domestic law for franked dividends paid to non-residents will continue to apply.

Japanese pre-dividend deduction entity

1.142 Under Japanese law, certain entities (such as Private Placement Investment Trusts which invest mainly in securities in the market and distribute profits arising from such investment to investors) are entitled to a deduction for dividends paid to their beneficiaries.

1.143 This Article allocates source taxing rights in respect of dividends paid by such Japanese entities to their Australian resident beneficiaries. Paragraph 4 provides that the Japanese source taxation shall be limited to:

- a maximum of 15 per cent on the gross amount of the dividend if more than 50 per cent of the assets of the company consist, directly or indirectly, of real property situated in Japan; or
- a maximum of 10 per cent on the gross amount in all other cases.

[Article 10, paragraph 4]

1.144 The term ‘beneficiary’ is used in this context because under Japanese domestic law, pre-dividend deduction companies issue ‘beneficiary securities’ rather than stock. As such, in this context, the word *beneficiaries* means, persons in general who own any kind of beneficial securities of a pre-dividend deduction company. *[Article 10, paragraph 4]*

1.145 Paragraph 5 provides that the provisions of paragraphs 2 to 4 are not intended to affect the tax on a company’s profits from which dividends are paid. This paragraph reflects the OECD Model provision and was included at the request of Japan for the avoidance of doubt. *[Article 10, paragraph 5]*

Real estate investment trust distributions

1.146 Paragraph 7 allows distributions from an Australian real estate investment trust to a resident of Japan to be taxed in both countries but limits the Australian tax charged on such income to 15 per cent of the gross amount of the distribution. [Article 10, subparagraphs 7(a) and (b)]

1.147 This provision is broadly consistent with an alternative provision developed by the OECD to address the taxation of cross-border distributions by real estate investment trusts. Like the OECD provisions, paragraph 7 does not apply to distributions in respect of non-portfolio interests in real estate investment trusts, since such interests may be a substitute for direct investment in the underlying real property held through the real estate investment trust.

1.148 Accordingly, the limit on the Australian tax charged on the distribution, is only available to portfolio investors. Non-portfolio investors who hold at least a 10 per cent beneficial ownership interest at any time in the 12 months preceding the date that the distributions are made will continue to be subject to tax in accordance with Australia's domestic law. [Article 10, subparagraph 7(b)]

1.149 The term ***real estate investment trust*** is defined as a managed investment trust created or organised under the laws of Australia the business of which consists of direct or indirect investment in real property for the main purpose of deriving rent. [Article 10, subparagraph 7(c)]

Dividends effectively treated as business profits

1.150 Limitations on the tax of the country in which the dividend is sourced do not apply to dividends derived by a resident of the other country who has a permanent establishment in the source country from which the dividends are derived, if the holding giving rise to the dividends is effectively connected with that permanent establishment. A similar rule operates with respect to real estate investment trust distributions where the investor's holding is effectively connected with a permanent establishment of the investor in Australia.

1.151 In relation to real estate investment trusts, the rate limitation on Australian tax will not apply where the holding in respect of which a distribution is paid is effectively connected with a permanent establishment of the unit holder in Australia. In determining whether the holding is effectively connected with the unit holder's permanent establishment the deeming provisions of paragraph 9 of Article 7 will not apply. This reflects the fact that the holding in respect of which the distribution is paid is not a holding of the trustee.

1.152 Where the holding is so effectively connected, the dividends are to be treated as business profits and therefore subject to the full rate of tax applicable in the country in which the dividend is sourced in accordance with the provisions of Article 7 (*Business Profits*).

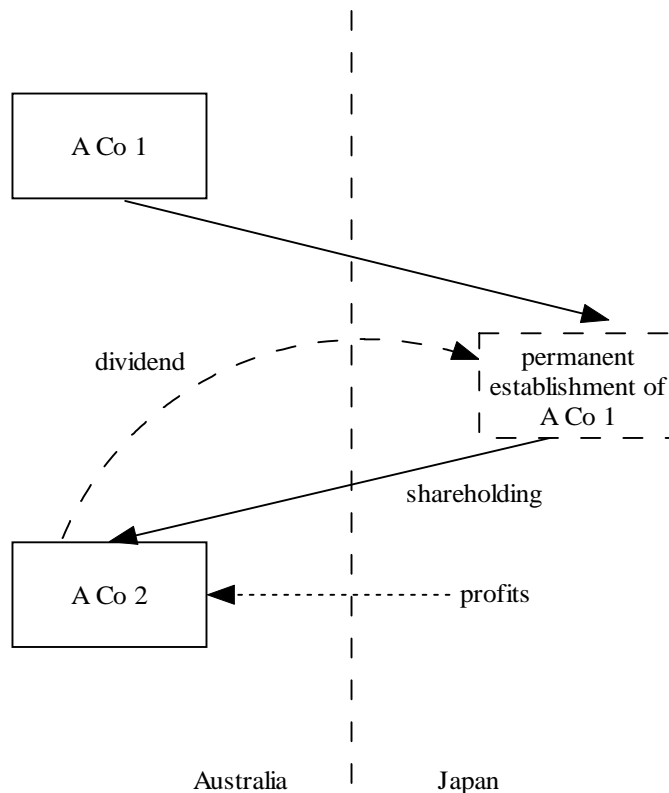
1.153 Franked and unfranked dividends paid by an Australian company will be included in the assessable income of a non-resident company or individual where the dividends are attributable to a permanent establishment of that non-resident situated in Australia. Expenses incurred in deriving the dividend income are allowable as a deduction from that income when calculating the taxable income of the non-resident. Further, a non-resident company or individual may be entitled to tax offsets in respect of any franked dividends under Australia's domestic law. [*Article 10, paragraph 8*]

Extra-territorial application precluded

1.154 The extra-territorial application by either country of taxing rights over dividend income is precluded. Broadly, one country (the first country) will not tax dividends paid by a company resident solely in the other country, unless:

- the person deriving the dividends is a resident of the first country; or
- the shareholding giving rise to the dividends is effectively connected with a permanent establishment in the first country.

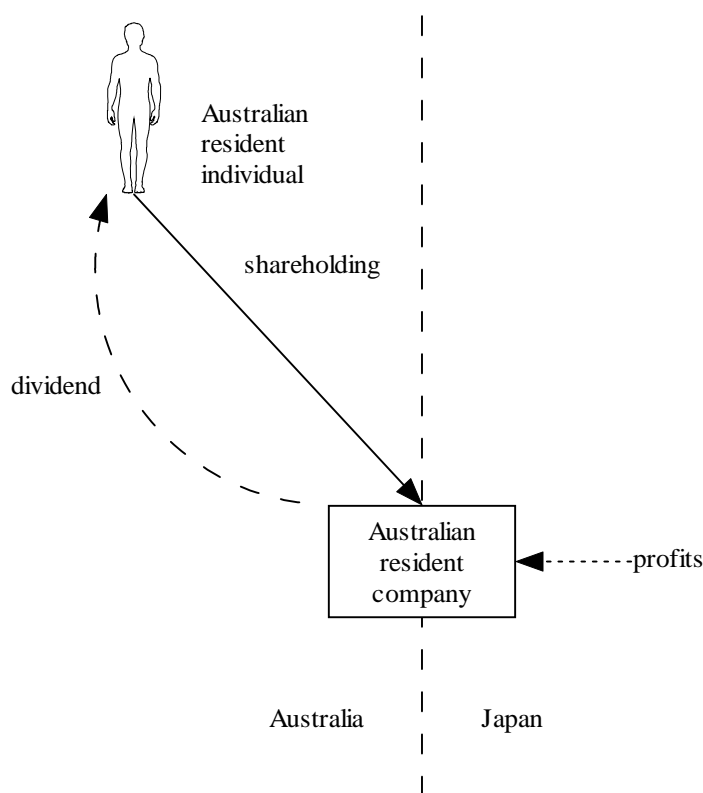
Example 1.9



In the diagram above, paragraph 9 would, but for the exception, preclude Japan from taxing the dividend paid by A Co 2 to A Co 1 out of profits derived from Japanese sources. However, as the dividends relate to the Australian shareholder's permanent establishment in Japan with which the holding is effectively connected, Japan may tax the dividends.

1.155 In addition, paragraph 9 also provides an exception in the case of dividends paid by a dual resident company which has been deemed under mutual agreement between the competent authorities of Australia and Japan to be a resident of only one of the countries. In these circumstances the other country may tax dividends where they are paid out of profits or income arising in that other country. Where the dividends are beneficially owned by a resident of the first-mentioned Contracting State, the rate limits provided under paragraph 2 or 3 of Article 10 will apply. [Article 10, paragraph 9]

Example 1.10



In the diagram above, the Australian resident company is a dual resident, which has been determined under the Mutual Agreement Procedure to be a resident of Australia for purposes of the treaty. The company makes a payment of dividends to an Australian resident individual out of profits derived from Japan. In these circumstances Japan may tax the dividends in accordance with subparagraph 2(b) of Article 10.

Definition of dividends

1.156 The term ***dividends*** in this Article means income from:

- shares or other rights which participate in profits and are not debt-claims; and
- income or other distributions which are subject to the same taxation treatment as income from shares in the country of which the distributing company is resident.

[Article 10, paragraph 6]

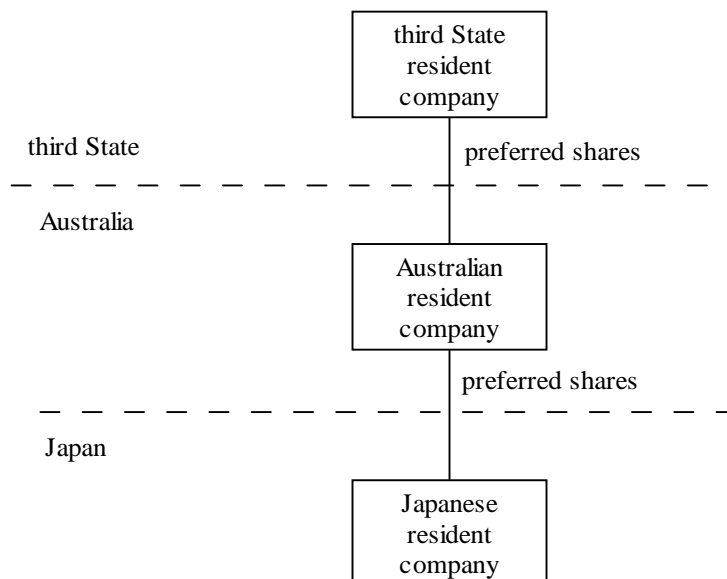
Back-to-back arrangements

1.157 Paragraph 10 is an anti-treaty-shopping provision which has been inserted at the request of Japan to ensure that residents of third States are not entitled to the benefits of this Convention through the use of preferred shares or other similar interests in a back-to-back arrangement.

[Article 10, paragraph 10]

1.158 The paragraph is intended to capture cases where a third State resident holds preferred shares or similar interests in an interposed resident of a Contracting State who in turn holds the same preferred shares or similar interests in a resident of the other Contracting State, with a view to obtaining benefits that would not otherwise be available via a direct investment by the third State resident into the other Contracting State.

1.159 Similar rules are provided in paragraph 9 of Article 11 (*Interest*), and paragraph 7 of Article 12 (*Royalties*).

Example 1.11

In the above diagram, an Australian resident company owns preferred shares in a Japanese resident company. A third State resident company owns preferred shares in the Australian resident company that are issued on the same or similar terms and conditions to those shares issued by the Japanese resident company. The third State does not have a tax treaty, or has a less favourable tax treaty with Japan than this Convention, such that the rate of tax imposed on dividends paid by the Japanese resident company would be higher than the rate payable under this Convention, on dividends paid to the Australian resident company.

The preferred shares would not have been acquired but for the holding of equivalent shares by the third State resident company in the Australian resident company.

In these circumstances, the Australian resident company will not be seen to be the beneficial owner of the dividend payments on the preferred shares from the Japanese resident company to the Australian resident company.

Limitation of benefits

1.160 The source country rate limits and exemptions available under this Article will not apply to an assignment of dividends or distributions, or a creation or assignment of shares or other rights in respect of which dividends are paid, has been made with the main objective, or one of the main objectives, of accessing the relief otherwise available under this Article. *[Article 10, paragraph 7]*

Article 11 — Interest

1.161 This Article allocates taxing rights in respect of interest flows between Australia and Japan. Article 11 provides that:

- an exemption from source country tax applies to certain cross-border interest flows to:
 - government bodies or the Bank of Japan or the Reserve Bank of Australia;
 - financial institutions;
 - the Japan Bank for International Cooperation;
 - the Nippon Export and Investment Insurance;
 - the Australian Export Finance and Insurance Corporation;
 - a public authority in Australia that manages the investments of the Future Fund; or
 - any similar organisation agreed to between the Governments of the Contracting States;
- a maximum 10 per cent rate of source country tax may be applied on all other interest income;
- interest paid on an indebtedness which is effectively connected with a permanent establishment shall be subject to Article 7 (*Business Profits*);
- interest payments are deemed to have an Australian source (and may therefore be taxed in Australia) where:
 - the interest is paid by an Australian resident to a Japanese resident; or
 - the interest is paid by a non-resident to a Japanese resident and it is an expense of the payer in carrying on business in Australia through a permanent establishment; and
- relief will be restricted to the gross amount of interest which would be expected to be paid on an arm's length dealing between independent parties.

1.162 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

1.163 The phrase ‘for the purposes of its tax’, which appears in paragraph 7 of Article 11, refers to the case where a person is a resident of a Contracting State by virtue of paragraph 1 of Article 4 of this Convention, even if the person is deemed to be a resident only of the other Contracting State by virtue of paragraph 2 or 3 of that Article. [*Protocol, item 12*]

Permissible rate of source country taxation

Ten per cent rate limit

1.164 This Article provides for interest income to be taxed by both countries but requires the country in which the interest arises to generally limit its tax to 10 per cent of the gross amount of the interest where a resident of the other country is the beneficial owner of the interest. [*Article 11, paragraphs 1 and 2*]

Exemptions for interest paid to government bodies and central banks

1.165 The exemption for interest paid to the government of a Contracting State reflects the principle of sovereign immunity and will apply to interest derived by Australia or Japan, or any political subdivision or local authority in either Australia or Japan, in addition to any other body exercising governmental functions. It also applies to the central banks of Australia and Japan. [*Article 11, subparagraph 3(a)*]

1.166 According to item 13 of the Protocol, the term ‘any other body exercising governmental function’ is to be determined in accordance with the law of the Contracting State where the interest arises. [*Protocol, item 13*]

1.167 This would mean, for example, that a statutory authority that exercises governmental functions would qualify for the exemption.

Exemptions for interest paid to financial institutions

1.168 The exemption for interest paid to financial institutions recognises that the agreed 10 per cent rate on gross interest can be excessive given their cost of funds. The exemption will also broadly align the treatment of interest paid to Japanese financial institutions with the Australian domestic law exemption for interest paid on widely distributed arm’s length corporate debenture issues (section 128F of the ITAA 1936). [*Article 11, subparagraph 3(b)*]

1.169 The term ***financial institution*** means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial

markets or by taking deposits at interest and using those funds in carrying on the business of providing finance. This does not include a corporate treasury or a member of a group that performs the financing services of the group. *[Article 11, subparagraph 3(b)]*

1.170 A financial institution will be regarded as ‘substantially deriving its profits’ where that activity is its main activity when compared to any other activity that it undertakes. *[Protocol, item 14, paragraph (b)]*

1.171 For the interest payment to be eligible for the financial institutions exemption, the issuer of the debt must be unrelated to the holder of the debt. Item 14 of the Protocol provides that the two parties will be unrelated where neither party is able exert sufficient influence over the other. *[Protocol, item 14, paragraph (a)]*

1.172 The exemption will not be available for interest paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and structured to have a similar effect. The denial of the exemption for these back-to-back loan type arrangements is directed at preventing related party and other debt from being structured through financial institutions to gain access to a withholding tax exemption. The exemption will only be denied for interest paid on the component of a loan that is considered to be back-to-back. *[Article 11, paragraph 4]*

1.173 An example of a back-to-back arrangement is described in the Protocol. Such an arrangement would include a transaction or series of transactions structured in such a way that:

- a Japanese financial institution receives or is credited with an item of interest arising in Australia; and
- a financial institution pays an equivalent interest to another person who is a resident of Japan, which, if that other person received the interest directly from Australia, would not be entitled to similar benefits with respect to that interest.

[Protocol, item 15]

1.174 However, a back-to-back arrangement would generally not include a loan guarantee provided by a related party to a Japanese financial institution.

Exemptions for interest paid to specific government bodies

1.175 Subparagraph 3(c) provides that the exemption from interest withholding tax will be extended to:

- the Japan Bank for International Cooperation;
- the Nippon Export and Investment Insurance;
- the Australian Export Finance and Insurance Corporation;
- a public authority in Australia that manages the investments of the Future Fund; and
- any similar institution as may be agreed upon from time to time between the governments of the Contracting States through an exchange of diplomatic notes.

[Article 11, subparagraph 3(c)]

1.176 Subparagraph 3(c) has been inserted at the request of Japan to clarify that interest payments to these bodies are free from interest withholding tax.

Definition of interest

1.177 The term *interest* is defined for the purposes of this Article to mean:

- income from debt-claims of every kind;
- interest from government securities;
- interest from bonds and debentures;
- premiums and prizes attaching to such securities, bonds or debentures; and
- income which is subjected to the same taxation treatment as income from money lent by the law of the Contracting State in which the income arises.

[Article 11, paragraph 5]

1.178 The use of the term ‘debt-claims’ in this Article of the treaty rather than the more commonly used ‘indebtedness’ in Australia’s other treaties reflects the preferred tax treaty practice of Japan and is of no

practical consequence for the purposes of Australian law. The two terms are intended to encompass the same kinds of debt.

Interest effectively treated as business profits

1.179 Interest derived by a resident of one country which is paid in respect of the debt-claims or other rights which are effectively connected with a permanent establishment of that person in the other country, will form part of the business profits of that permanent establishment and be subject to the provisions of Article 7 (*Business Profits*). Accordingly, the rate limitation of 10 per cent and the exemption for financial institutions do not apply to such interest in the country in which the interest is sourced. [*Article 11, paragraph 6*]

Deemed source rules

1.180 The source rules which determine where interest arises for the purposes of this Article are set out in paragraph 7. They operate to allow Australia to tax interest paid by a resident of Australia to a resident of Japan who is the beneficial owner of that interest. Australia may also tax interest paid by a non-resident, being interest which is beneficially owned by a Japanese resident, if it is an expense incurred by the payer of the interest in carrying on a business in Australia through a permanent establishment.

1.181 However, consistent with Australia's interest withholding tax provisions, an Australian source is not deemed in respect of interest that is an expense incurred by an Australian resident (for the purposes of Australian tax) in carrying on a business through a permanent establishment outside both Australia and Japan (ie, the permanent establishment is in a third country). In that case, the interest is not deemed to arise in either Contracting State. [*Article 11, paragraph 7*]

1.182 In determining whether a permanent establishment exists in a third country, the principles set out in Article 5 (*Permanent Establishment*) apply.

Related persons

1.183 This Article includes a general safeguard against payments of excessive interest where a special relationship exists between the persons associated with a loan transaction — by restricting the amount on which the 10 per cent source country tax rate limitation applies to an amount of interest which might have been expected to have been agreed upon if the parties to the loan agreement were dealing with one another at arm's length. Any excess part of the interest remains taxable according to the

domestic law of each country but subject to the other Articles of this Convention. *[Article 11, paragraph 8]*

1.184 Examples of cases where a special relationship might exist include payments to a person (either individual or legal):

- who controls the payer (whether directly or indirectly);
- who is controlled by the payer; or
- who is subordinate to a group having common interests with the payer.

1.185 A special relationship also covers relationships of blood or marriage and, in general, any community of interests.

Back-to-back arrangements

1.186 Paragraph 9 is an anti-treaty-shopping provision which has been inserted at the request of Japan to ensure that residents of third States are not entitled to the benefits of this Convention through the use of debt claims or other rights in a back-to-back arrangement. *[Article 11, paragraph 9]*

1.187 Paragraph 9 is intended to capture cases where a third State resident holds an equivalent debt-claim or other right in an interposed resident of a Contracting State who in turn holds the same debt-claim or other right in a resident of the other Contracting State, with a view to obtaining benefits that would not otherwise be available via a direct investment by the third State resident into the other Contracting State.

1.188 Similar rules are provided in paragraph 10 of Article 10 (*Dividends*), and paragraph 7 of Article 12 (*Royalties*).

Limitation of benefits

1.189 The source country rate limit and exemptions available under this Article will not apply where an assignment of the interest, the creation or assignment of a debt-claim or other rights in respect of which interest is paid, or the establishment, acquisition or maintenance of a company which is the beneficial owner of the interest or the conduct of its operations has been made or performed with the main objective, or one of the main objectives, of accessing the relief otherwise available under this Article. *[Article 11, paragraph 10]*

Article 12 — Royalties

1.190 This Article allocates taxing rights in respect of royalties paid or credited between Australia and Japan. The Article provides that:

- a maximum 5 per cent rate of source country tax may be levied on the gross amount of the royalties;
- royalties paid in respect of a right or property which is effectively connected with a permanent establishment are subject to Article 7 (*Business Profits*);
- equipment royalties are not included within the definition of ‘royalties’ and are subject to either Article 7 (*Business Profits*) or Article 8 (*Ships and Aircraft*);
- payments for spectrum licences are not included within the definition of royalties and are dealt with under Article 7 (*Business Profits*);
- royalties are deemed to have an Australian source (and may therefore be taxed in Australia) where:
 - the royalties are paid by an Australian resident to a Japanese resident; or
 - the royalties are paid by a non-resident to a Japanese resident and are an expense of the payer in carrying on business through a permanent establishment in Australia; and
- relief will be restricted to the gross amount of royalties which would be expected to be paid on an arm’s length dealing between independent parties.

1.191 However, no such relief is available in cases that have been designed with a main purpose of taking advantage of this Article.

1.192 The phrase ‘for the purposes of its tax’, which appears in paragraph 1 of Article 12, refers to the case where a person is a resident of a Contracting State by virtue of paragraph 1 of Article 4 of this Convention, even if the person is deemed to be a resident of the other Contracting State by virtue of paragraph 2 or 3 of that Article. [*Protocol, item 12*]

Permissible rate of source country taxation

1.193 This Article in general allows both countries to tax royalty flows but limits the tax of the country of source to 5 per cent of the gross amount of royalties beneficially owned by residents of the other country. [Article 12, paragraphs 1 and 2]

1.194 In the absence of a tax treaty, Australia taxes royalties paid to non-residents at 30 per cent of the gross royalty.

1.195 The 5 per cent rate limitation does not apply to natural resource royalties, which, in accordance with Article 6 (*Income from Real Property*), remain taxable in the country of source without limitation of the tax that may be imposed.

Definition of royalties

1.196 The definition of ‘royalties’ in this Article reflects most elements of the definition in Australia’s domestic income tax law. ***Royalties*** includes payments for the supply of scientific, technical, industrial or commercial knowledge but not payments for services rendered, except as provided for in subparagraph 3(c). The definition also includes payments for the use of intellectual property stored on various media and used in connection with television, radio or other broadcasting (eg, satellite, cable and Internet broadcasting). [Article 12, paragraph 3]

1.197 Payments for the use of, or the right to use industrial, commercial or scientific equipment, do not appear in the definition under this Convention. Such amounts will either be treated as business profits under Article 7 (*Business Profits*) or as profits from international transport operations (for certain leases of ships, aircraft and containers) under Article 8 (*Shipping and Air Transport*). The exclusion of payments for the use of equipment from the *Royalties* Article reflects common international tax treaty practice and recognises that source country taxation on a gross basis may be excessive given low profit margins.

1.198 Payments for the use of spectrum licences shall not be included within the definition of ‘royalties’. Such payments will be taxed in accordance with Article 7 (*Business Profits*). [Protocol, item 16]

Payments for the supply of know-how versus payments for services rendered

1.199 The OECD Model Commentary deals with the need to distinguish these two types of payments in paragraph 11.3 of the Commentary on Article 12 (*Royalties*). The Commentary cites the following criteria as relevant for the purpose of making the distinction:

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 (of the Commentary) that already exists, or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a much greater level of expenditure by the supplier in order to perform their contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

1.200 Payments for design, engineering or construction of plant or building, feasibility studies, component design and engineering services may generally be regarded as being in respect of a contract for services, unless there is some provision in the contract for imparting techniques and skills to the buyer.

1.201 In cases where both know-how and services are supplied under the same contract, if the contract does not separately provide for payments in respect of know-how and services, an apportionment of the two elements of the contract may be appropriate.

1.202 Payments for services rendered are to be treated under Article 7 (*Business Profits*).

Image or sound reproduction or transmission

1.203 The ‘royalties’ definition includes payments made for the use of, or the right to use, motion picture films. It also covers payments for the use of, or the right to use, images or sounds, however reproduced or transmitted, for use in connection with broadcasting. Such images or sounds may be reproduced on any form of media, such as film, tape, CD or DVD, or transmitted electronically, such as by satellite, cable or Internet. Where the images or sounds are for use in connection with any form of broadcasting, such as television, radio or web-casting, the payments will constitute a royalty. [Article 12, subparagraph 3(d)]

Forbearance

1.204 Consistent with Australian tax treaty practice, subparagraph 3(e) expressly treats as a royalty, amounts paid or credited in respect of forbearance to grant to third persons, rights to use property covered by this Article. This is designed to address arrangements along the lines of those contained in *Aktiebolaget Volvo v Federal Commissioner of Taxation* (1978) 8 ATR 747; 78 ATC 4316, where instead of amounts being payable for the exclusive right to use the property they were made for the undertaking that the right to use the property will not be granted to anyone else. This provision ensures that such payments are subject to tax as a royalty payment under the terms of the *Royalties* Article. [Article 12, subparagraph 3(e), Protocol, item 17]

Other royalties effectively treated as business profits

1.205 As in the case of interest income, it is specified that the withholding tax rate limitation does not apply to royalties paid in respect of property or rights which are effectively connected with a permanent establishment in the country in which the income is sourced. Such income is subject to full taxation under Article 7 (*Business Profits*). [Article 12, paragraph 4]

Deemed source rules

1.206 The source rules which determine where royalties arise for the purposes of this Article effectively correspond, in the case of Australia, with the deemed source rule contained in section 6C (source of royalty income derived by a non-resident) of the ITAA 1936 for royalties paid to non-residents of Australia. They broadly mirror the source rule for interest income contained in paragraph 7 of Article 11 (*Interest*).

1.207 Consistent with Australia's royalty withholding tax provisions, royalty payments that are an expense incurred by an Australian resident (for the purposes of its Australian tax), in carrying on a business through a permanent establishment outside both Australia and Japan (ie, the permanent establishment is in a third country) will not be subject to tax in Australia. Those royalties are not deemed to be sourced in either Contracting State. *[Article 12, paragraph 5]*

1.208 In determining whether a permanent establishment exists in a third country, the principles set out in Article 5 (*Permanent Establishment*) apply. *[Article 5, paragraph 10]*

Related persons

1.209 Where a special relationship exists between the payer and the beneficial owner of the royalties, the 5 per cent source country tax rate limitation will apply only to the extent that the royalties are not excessive. Any excess part of the royalty remains taxable according to the domestic law of each country but subject to the other Articles of this Convention.

1.210 Examples of special relationships have been provided in respect of the corresponding paragraph in Article 11. *[Article 12, paragraph 6]*

Back-to-back arrangements

1.211 Paragraph 7 is an anti-treaty-shopping provision which has been inserted at the request of Japan to ensure that residents of third States are not entitled to the benefits of the Convention through the granting the use of property or rights in a back-to-back arrangement. *[Article 12, paragraph 7]*

1.212 The paragraph is intended to capture cases where a third State resident grants the use of property or right to an interposed resident of a Contracting State who in turn grants the use of the same property or rights to a resident of the other Contracting State, with a view to obtaining benefits that would not otherwise be available where the grant of the use of the property or right was made directly by the third State resident to a resident of the other Contracting State.

1.213 Similar rules are provided in paragraph 10 of Article 10 (*Dividends*), and paragraph 9 of Article 11 (*Interest*).

Limitation of benefits

1.214 The source country rate limit available under this Article will not apply where the assignment of the royalties, the creation or assignment of the property or right in respect of which the royalty is paid, or the establishment, acquisition or maintenance of the company which is

the beneficial owner of the royalties or the conduct of its operations has been made or performed with the main objective, or one of the main objectives, of accessing the relief otherwise available under this Article. [Article 12, paragraph 8]

Article 13 — Alienation of Property

Taxing rights

1.215 This Article allocates between the respective countries taxing rights in relation to income, profits or gains arising from the alienation of real property and other items of property.

1.216 The reference to ‘income, profits or gains’ in this Article is designed to put beyond doubt that a gain from the alienation of property, which in Australia may be income or a profit under ordinary concepts, will be taxed in accordance with this Article, rather than Article 7 (*Business Profits*), together with relevant capital gains.

Real property

1.217 Income, profits or gains from the alienation of real property may be taxed by the country in which the property is situated. [Article 13, paragraph 1]

1.218 For the purpose of this Article, the term ‘real property’ has the same meaning as it has under paragraph 2 of Article 6. Where the property is situated is clarified under paragraph 3 of Article 6 (*Income from Real Property*).

Shares and other interests in land-rich entities

1.219 Paragraph 2 applies to situations involving the alienation of shares or other interests in companies and other entities, where at least 50 per cent of the value of the shares of that company or other entity is derived, whether directly or indirectly through one or more other interposed entities, from real property situated in the other country. Income, profits or gains from the alienation of such shares or interests may be taxed by the country in which the real property is situated. Paragraph 2 complements paragraph 1 of this Article and is designed to cover arrangements involving the effective alienation of incorporated real property, or like arrangements.

1.220 This provision is in line with international practice and ensures that capital gains on a non-resident’s indirect, as well as direct, interests in certain targeted assets are taxable by Australia. (Such treatment applies

whether the real property is held directly or indirectly through a chain of interposed entities.)

1.221 This provision responds to tax planning opportunities exposed by the decision of the Full Federal Court in the *Commissioner of Taxation v Lamesa Holdings BV* (1997) 77 FCR 597. It is designed to protect Australian taxing rights over income, profits or gains on the alienation or effective alienation of Australian real property (as defined) despite the presence of interposed bodies corporate, or other entities.
[Article 13, paragraph 2]

Prevention of double non-taxation

1.222 Paragraph 3 was inserted at the request of Japan in order to prevent double non-taxation of income, profits or gains arising from the disposal of shares in a company (other than a land-rich company) in certain circumstances. For example, such double non-taxation could arise in the context of shares which are not subject to tax in Australia due to the application of the participation exemption in Division 768 of the ITAA 1997.

1.223 Income, profits or gains of a resident of a Contracting State which arise from the alienation of shares issued by a company which is resident of the other Contracting State, where such amounts are exempt from tax in the first-mentioned Contracting State, may be taxed in the other Contracting State where:

- the alienator (together with connected persons) owned at least 25 per cent of the total issued shares of the company at any time during the taxable year in which the alienation takes place; and
- the alienator (together with connected persons) disposes of at least 5 per cent of the total issued shares of the company during the taxable year.

[Article 13, paragraph 3]

1.224 This paragraph does not apply to deferral of tax on capital gains in the first-mentioned Contracting State in the case of corporate reorganisations (unless the deferred gains will be exempt from taxation at a future point in time under the laws of that Contracting State). *[Protocol, item 18]*

Permanent establishment

1.225 Paragraph 4 deals with income, profits or gains arising from the alienation of property (other than real property covered by paragraph 1)

forming part of the business assets of a permanent establishment of an enterprise. It also applies where the permanent establishment itself (alone or with the whole enterprise) is alienated. Such income, profits or gains may be taxed in the country in which the permanent establishment is situated. This corresponds to the rules for taxation of business profits contained in Article 7 (*Business Profits*). [Article 13, paragraph 4]

1.226 The Protocol clarifies that income, profits or gains may continue to be taxed in the country where the permanent establishment was situated after an enterprise ceases to carry on business through that permanent establishment, provided the amount is attributable to that permanent establishment. [Protocol, item 9]

Disposal of ships or aircraft

1.227 Income, profits or gains derived by a resident of a country from the disposal of ships or aircraft operated by that resident in international traffic, or of associated property (other than real property covered by paragraph 1), are taxable only in that country. This rule corresponds to the operation of Article 8 (*Shipping and Air Transport*) in relation to profits from the international operation of ships or aircraft. [Article 13, paragraph 5]

1.228 For the purposes of this Article, the term ‘international traffic’ does not include any transportation which commences at a place in a country and returns to another place in that country, after travelling through international airspace or waters (eg, so-called ‘voyages to nowhere’ by cruise ships). [Article 3, subparagraph 1(i)]

Capital gains

1.229 This Article contains a sweep-up provision which reserves the right to tax any capital gains from the alienation of other types of property to the country of which the person deriving the gains is a resident. These would include, for example, gains from the disposal of shares or other interests in an entity (other than a land-rich entity or a company to which paragraph 3 applies). Such gains derived by Australian residents will be taxable only in Australia, regardless of where the property is situated, and will not be taxed in Japan. The liability of the Australian resident to taxation on such gains will be determined in accordance with Australia’s domestic law. [Article 13, paragraph 6]

Article 14 — Income from Employment

Basis of taxation

1.230 This Article generally provides the basis upon which the remuneration of visiting employees is to be taxed. However, this Article does not apply in respect of income dealt with separately in:

- Article 15 (*Directors' Fees*);
- Article 16 (*Entertainers and Sportspersons*);
- Article 17 (*Pensions and Annuities*); and
- Article 18 (*Government Service*).

1.231 Generally, salaries, wages and similar remuneration derived by a resident of one country from an employment exercised in the other country may be taxed in that other country. However, subject to specified conditions, there is a conventional provision for exemption from tax in the country being visited where visits of only a short-term nature are involved. [*Article 14, paragraphs 1 and 2*]

Short-term visit exemption

1.232 The conditions for this exemption are that:

- the period of the visit or visits does not exceed, in the aggregate, 183 days in any 12-month period commencing or ending in the taxable year of the visited country;
- the remuneration is paid by, or on behalf of, an employer who is not a resident of the visited country; and
- the remuneration is not borne by a permanent establishment which the employer has in the country being visited.

1.233 Where all of these conditions are met, the remuneration so derived will be liable to tax only in the country of residence of the recipient. [*Article 14, paragraph 2*]

1.234 Where a short-term visit exemption is not applicable, remuneration derived by a resident of Australia from employment in Japan may be taxed in Japan. However, this Article does not allocate sole taxing rights to Japan in that situation.

1.235 Accordingly, Australia would also be entitled to tax that remuneration, in accordance with the general rule of the ITAA 1997 that a resident of Australia remains subject to tax on worldwide income. However, in accordance with Article 25 (*Elimination of Double Taxation*) Australia would be required in this situation to relieve any resulting double taxation.

1.236 Although Article 25 provides for the double tax relief to be provided by Australia to be in the form of the grant of a credit against the Australian tax for the Japanese tax paid, the *exemption with progression* method of providing double tax relief in relation to employment income derived in the situation described would normally be applicable in practice pursuant to the foreign service income provisions of section 23AG of the ITAA 1936. This method exempts the income from foreign employment from tax in Australia, but takes into account the foreign earnings when calculating the Australian tax on other assessable income the person has derived.

Employment on a ship or aircraft

1.237 Income from an employment exercised aboard a ship or aircraft operated in international traffic may be taxed in the country of which the enterprise operating the ship or aircraft is a resident. [Article 14, paragraph 3]

Article 15 — Directors’ Fees

1.238 This Article relates to remuneration received by a resident of one country in the person’s capacity as a member of a board of directors of a company which is a resident of the other country. To avoid difficulties in such cases of ascertaining in which country a director’s services are performed, and consequently where the remuneration is to be taxed, the Article provides that directors’ fees and similar payments may be taxed in the country of residence of the company. [Article 15]

Article 16 — Entertainers and Sportspersons

Personal activities

1.239 Income derived by visiting entertainers and sportspersons from their personal activities as such may be taxed in the country in which the activities are exercised, irrespective of the duration of the visit. The term ‘entertainer’ is intended to have a broad meaning and would include, for example, actors and musicians as well as other performers whose activities have an entertainment character, such as comedians, talk-show hosts, participants in chess tournaments or racing drivers. The application of this Article extends to income generated from promotional and

associated kinds of activities engaged in by the entertainer or sportsperson while present in the visited country. *[Article 16, paragraph 1]*

Safeguard

1.240 Income in respect of personal activities exercised by an entertainer or sportsperson, where derived by another person (eg, a separate enterprise which formally enters into the contractual arrangements relating to the provision of the entertainer's or sportsperson's services), may be taxed in the country in which the entertainer or sportsperson performs, whether or not that other person has a permanent establishment in that country. *[Article 16, paragraph 2]*

Article 17 — Pensions and Annuities

1.241 Pensions (other than government service pensions), other similar remuneration paid periodically and annuities (the term 'annuity' as used in this Article is defined in paragraph 4) are taxable only by the country of which the recipient is a resident. The application of this Article extends to pensions, similar periodical remuneration and annuity payments made to dependants, for example, a widow, widower or children of the person in respect of whom the pension, similar periodical payment or annuity entitlement accrued where, upon that person's death, such entitlement has passed to that person's dependants. *[Article 17, paragraphs 1 and 2]*

Lump sum payments

1.242 Paragraphs 1 and 2 only cover amounts paid periodically; they do not cover lump sum superannuation payments. Paragraph 3 deals with lump sum payments which are paid in lieu of a pension or annuity to a resident of a Contracting State. Such amounts will be taxable only by that residence state, unless the lump sum arises in the other Contracting State, in which case that other Contracting State may also tax the lump sum. A lump sum will be considered to arise in a Contracting State where the fund is located. *[Article 17, paragraph 3]*

Article 18 — Government Service

Salary and wage income

1.243 Salary and wage type income, other than government service pensions, paid to an individual for services rendered to a government (including a government of a political subdivision or local authority) in the discharge of functions of a governmental nature, of one of the Contracting States, is to be taxed only in that country. However, such

remuneration will be taxable only in the other country if the services are rendered in that other country and:

- the recipient is a resident of, and a national of that other country; or
- the recipient is a resident of that other country and did not become a resident of that other country solely for the purpose of rendering the services (eg, if the recipient is a permanent resident of that other country).

[Article 18, paragraph 1]

Government service pensions

1.244 Pensions and other similar remuneration which is periodically paid by a government (including a government of a political subdivision or local authority) of one of the countries to an individual in respect of services rendered to that government, are taxable only by that country. However, these rules do not apply if the individual receiving the pension is both a resident and national of the other country. In such case, the pension is taxable only in the country of which the pensioner is a resident.

Business income

1.245 Remuneration or pensions paid in respect of services rendered in connection with a business carried on by any governmental authority referred to in paragraph 1 of this Article is excluded from the scope of the Article. Such remuneration will remain subject to the provisions of Article 14 (*Income from Employment*), Article 15 (*Directors' Fees*), Article 16 (*Entertainers and Sportspersons*) or Article 17 (*Pensions and Annuities*). *[Article 18, paragraph 3]*

Article 19 — Students

Exemption from tax

1.246 This Article applies to students and business apprentices who are temporarily present in one of the countries solely for the purpose of their education or training if they are, or immediately before the visit were, a resident of the other country. In these circumstances, payments from abroad received by the students or business apprentices solely for their maintenance, education or training will be exempt from tax in the country visited. This will apply even though the student or apprentice may qualify as a resident of the country visited during the period of their visit.

[Article 19]

1.247 The exemption from tax provided by the visited country extends to maintenance payments received by the student or apprentice that are made for maintenance of dependent family members who have accompanied the student or apprentice to the visited country.

1.248 The exemption provided by the Article is limited to one year for business apprentices. This reflects the ambiguous meaning of business apprentice in Japan, and is intended to limit opportunities for the abuse of this exemption. This is consistent with Japan's recent treaties with the United States of America and the United Kingdom of Great Britain and Northern Ireland.

Employment income

1.249 Where a Japanese student visiting Australia solely for educational purposes undertakes any employment in Australia, for example:

- some part-time work with a local employer; or
- during a semester break undertakes work with a local employer,

the income earned by that student as a consequence of that employment may, as provided for in Article 14 (*Income from Employment*), be subject to tax in Australia.

1.250 For business apprentices, the exemption provided under this Article only applies where the apprentice's remuneration consists solely of subsistence payments to cover training or maintenance. Remuneration for service, that is, salary equivalents, fall for consideration under Article 14.

1.251 In the case of a Japanese business apprentice visiting Australia solely for training purposes, it may therefore be necessary to distinguish between remuneration for service and a payment for the apprentice's maintenance or training. The quantum of the payment will be relevant in such cases.

1.252 A payment for maintenance or training would not be expected to exceed the level of expenses likely to be incurred to ensure the apprentice's maintenance and training (ie, a subsistence payment). Whereas, if the remuneration is similar to the amounts paid to persons who provide similar services that are not business apprentices (ie, a salary equivalent), this would generally indicate that the payments constitute income from employment that would fall for consideration under Article 14. Likewise, if that business apprentice undertakes any other

employment in Australia, the income earned from that employment may be subject to tax in Australia in accordance with Article 14.

1.253 In these situations, the payments received from abroad for the student's or apprentice's maintenance, education or training will not be taken into account in determining the tax payable on the employment income that is subject to tax in Australia. No Australian tax would be payable on the employment income if the student or apprentice qualifies as a resident of Australia during the visit and the taxable income of the student or apprentice does not exceed the tax-free threshold applicable to Australian residents for income tax purposes.

Article 20 — Sleeping partnership-Tokumei Kumiai

1.254 Article 20 provides that income, profits or gains from a 'sleeping partnership-Tokumei Kumiai' or other similar contractual arrangement may be taxed in the country where income, profits or gains arise.
[Article 20]

1.255 The provision was inserted at the request of Japan to ensure source country taxing rights over payments from a 'sleeping partnership-Tokumei Kumiai' contract. This ensures that even where another provision of the treaty might otherwise limit the tax that may be imposed by Japan, Japan may still tax income profits or gains in accordance with this article.

1.256 A 'sleeping partnership-Tokumei Kumiai' is a contractual arrangement based in Japanese Commercial Law between a business proprietor (the Tokumei Kumiai operator) and a sleeping partner, where the Tokumei Kumiai operator invests property contributed by the sleeping partner.

1.257 The phrase 'other similar contract' refers to a consensual contract under Japanese income tax law and corporate tax law between two parties where one party invests on behalf of the other.

Article 21 — Other Income

Allocation of taxing rights

1.258 This Article provides rules for the allocation between the two countries of taxing rights with respect to items of income not dealt with in the preceding Articles of this Convention. The scope of the Article is not confined to such items of income arising in one of the countries — it extends also to income from sources in a third country.

1.259 Broadly, such income derived by a resident of one country is to be taxed only in the country of residence unless it is from sources in the other country, in which case the income may also be taxed in the other country. This is consistent with Australia's reservation to Article 21 (*Other Income*) of the OECD Model. [Article 21, paragraphs 1 and 3]

1.260 Where the income may be taxed in both countries in accordance with this provision, the country of residence of the recipient of the income is obliged by Article 25 (*Elimination of Double Taxation*) to provide double taxation relief.

1.261 This Article does not apply to income (other than income from real property as defined in paragraph 2 of Article 6 (*Income from Real Property*)) where the right or property in respect of which the income is paid is effectively connected with a permanent establishment which a resident of one country has in the other country. In such a case, Article 7 (*Business Profits*) will apply. [Article 21, paragraph 2]

1.262 This Article will not prevent a Contracting State applying domestic law to tax a resident who derives income from real property situated in that Contracting State, regardless of whether that property is effectively connected with a permanent establishment in the other Contracting State. [Protocol, item 7]

1.263 This Article does not apply in the situation where business profits are not taxed in the country of source because of the absence of a permanent establishment. That is, in the absence of a permanent establishment, Article 7 (*Business Profits*) provides that the profits of an enterprise of a Contracting State shall be taxable only in that Contracting State.

Example 1.12

A Co, an Australia resident company, derives business profits from the sale of merchandise through an independent agent located in Japan. As A Co does not have a permanent establishment in Japan, the business profits will be taxable in Australia pursuant to Article 7 (*Business Profits*) and not under Article 21 (*Other Income*).

Article 22 — Source of Income

Deemed source

1.264 This Article effectively deems income, profits or gains derived by a resident of a country which, in accordance with this Convention, may be taxed in the other country, to have a source in that other country. It therefore avoids any difficulties arising under domestic law source rules in

respect of the exercise by Australia of the taxing rights allocated to Australia by this Convention over income derived by residents of Japan.
[Article 22, paragraph 1]

1.265 In accordance with item 7 of the Protocol, income from real property will have its source in the Contracting State where the real property is located, regardless of whether that property is effectively connected with a permanent establishment in the other Contracting State.
[Protocol, item 7]

Source of income — double taxation relief

1.266 Income, profits or gains of a resident of one country that may be taxed in the other country under this Convention are deemed to arise in that other country. This applies for both the purposes of Article 25 (*Elimination of Double Taxation*) and for the purposes of the domestic tax laws of the country in which the recipient of the income is resident.
[Article 22, paragraph 2]

1.267 This provision is variously included in the *Source of Income* Article or the *Relief from Double Taxation* Article of Australia's tax treaties. It is intended to ensure that where an item of income, profit or gain is taxable in both countries, double taxation relief will be given by the recipient's country of residence in accordance with Article 25, regardless of whether the amount would be regarded as having a source in the country of residence under its ordinary source rules. In this way, income, profits or gains derived by a resident of Australia, which may be taxed by Japan under this Convention, will be treated as being foreign income for the purposes of the ITAA 1936 and the ITAA 1997.

Article 23 — Limitation on Benefits

1.268 Treaty benefits under Article 7, paragraph 3 of Article 10, paragraph 3 of Article 11 or Article 13, will generally only be available for qualified persons specified in the *Limitation on Benefits* Article.
[Article 23, paragraph 1]

1.269 However, certain other persons may also qualify for treaty benefits under these Articles in respect of income, profits or gains derived in connection with, or incidental to, a business (other than certain investment activities) carried on in a Contracting State by that person.
[Article 23, paragraph 4]

1.270 Persons other than qualified persons may also be granted the benefits of the above-mentioned provisions if the relevant competent authority is satisfied that the establishment, acquisition or maintenance of

such person and the conduct of its operations did not have as one of its principal purposes the obtaining of treaty benefits. *[Article 23, paragraph 5]*

Qualified person

1.271 Qualified persons entitled to claim treaty benefits are specified in paragraph 2. Only residents of Australia or Japan for the purposes of this Convention can be qualified persons. *[Article 23, paragraph 2]*

Individuals

1.272 Individuals who are residents of Australia or Japan are qualified persons. *[Article 23, subparagraph 2(a)]*

Qualified governmental entity

1.273 Qualified governmental entities of Australia or Japan will be treated as qualified persons. *[Article 23, subparagraph 2(b)]*

1.274 Subparagraph 6(a) provides that ***qualified governmental entity*** means those entities referred to in subparagraphs (a) and (c) of paragraph 3 of Article 11. As such, the Government of Australia or Japan or of a political subdivision or local authority of either country, or, any other body exercising governmental functions (according to the law of the Contracting State in which the interest arises), will be qualified persons. In the case of Japan, the Bank of Japan, the Reserve Bank of Australia, the Japan Bank for International Cooperation, and the Nippon Export and Investment Insurance are also qualified persons. Similarly, in the case of Australia, the Export Finance and Insurance Corporation, or a public authority that manages the investments of the Future Fund, shall be qualified persons, as will be any similar institutions agreed between the Governments of the Contracting States. *[Article 23, subparagraph 6(a)]*

Publicly traded companies

1.275 A company (including a company participating in a dual listed company arrangement) that is a resident of Australia or Japan will be treated as a qualified person if the company's principal class of shares is listed or registered on a recognised Australian or Japanese stock exchange and is regularly traded on one or more recognised stock exchanges. *[Article 23, subparagraph (2)(c)]*

1.276 The term **dual listed company arrangement** is defined in paragraph 6 of the Article to mean an arrangement pursuant to which two publicly listed companies, while maintaining separate legal entity status, shareholdings and listings, align their strategic directions and the economic interests of their respective shareholders through:

- appointment of common (or almost identical) boards of directors;
- unified management of the operations of the two companies;
- distributions to shareholders in accordance with an equalisation ratio;
- shareholders of both companies voting as a single decision-making body on substantial issues; and
- cross-guarantees as to, or similar financial support for, each other's material obligations or operations.

[Article 23, subparagraph 6(c)]

1.277 A company that participates in a dual listed company arrangement will be a qualified person where it meets the conditions specified in subparagraph (2)(c). The relevant arrangement may be between an Australian resident company and a Japanese resident company, or between a company that is resident in one Contracting State and a third State resident company.

1.278 The term **principal class of shares** is defined in subparagraph 6(b) of the Article to mean the ordinary shares of the company, provided that such class of shares represents the majority of the voting power and value of the company. Where no single class of ordinary shares represents the majority of the voting power and value of the company, the principal class of shares is that class or those classes that in the aggregate represent a majority of the voting power and value of the company. For dual listed arrangements the principal class of shares will be determined after excluding special voting shares issued for the purposes of establishing the dual listed company arrangement. [Article 23, subparagraph 6(b)]

1.279 The term **recognised stock exchange** is defined in paragraph 6(d) of the Article to mean:

- stock exchanges established by a Financial Instruments Exchange or an approved-type *financial instruments firms association* under the terms of the Financial Instruments and

Exchange Law (Law No. 25 of 1948) of Japan, which includes the Tokyo Stock Exchange, the Nagoya Stock Exchange, the Fukuoka Stock Exchange, the Sapporo Securities Exchange and the Jasdaq Securities Exchange;

- the Australian Securities Exchange and any other securities exchange recognised as such under the *Corporations Act 2001* of Australia, being, at the time of signature, the National Stock Exchange of Australia Limited, the Bendigo Stock Exchange Limited, and the Australian Pacific Exchange Limited; and
- any other stock exchange which the competent authorities of Australia or Japan agree to recognise for the purposes of this Article.

[Article 23, subparagraph 6(d)]

Other publicly traded entities

1.280 A person other than an individual or a company (eg, a public unit trust) that is a resident of Australia or Japan will be treated as a qualified person if the person's 'principal class of units' is listed or admitted to dealings on a recognised Australian or Japanese stock exchange and is regularly traded on one or more recognised stock exchanges. *[Article 23, subparagraph 2(d)]*

1.281 The term *principal class of units* is defined in subparagraph 6(f) of the Article to mean the class of units which represents the majority of the value of the person. Where no single class of units represents the majority of the value of the person, the principal class of units is that class or those classes that in the aggregate represent the majority of the value of the person. *[Article 23, subparagraph 6(f)]*

1.282 The term *units* is defined in subparagraph 6(e) of the Article to mean any instrument, not being a debt-claim, granting an entitlement to share in the asset or income of, or receive a distribution from, the person. *[Article 23, subparagraph 6(e)]*

1.283 The use of the term 'debt-claims' in this Article is intended to have the same meaning as the term 'indebtedness' as used in Australia's other treaties. The two terms are intended to encompass the same kinds of debt.

1.284 The term 'recognised stock exchange' is discussed in paragraph 1.279.

Pension funds

1.285 A pension fund, which at the end of the prior taxable year has more than 50 per cent of its beneficiaries, members or participants who are resident individuals of either Australia or Japan shall be seen as a qualified person for the purpose of the treaty. [Article 23, subparagraph 2(e)]

1.286 A **pension fund** is defined in subparagraph 6(g) of the Article to mean any person established under the law of Australia or Japan operated principally to administer or provide pensions, retirement benefits or other similar remuneration or to earn income, profits or gains for the benefit of other pension funds. [Article 23, subparagraph 6(g)]

1.287 For the purposes of Australia, a pension fund would include, for example, superannuation funds regulated under the *Superannuation Industry (Supervision) Act 1993*.

Benevolent organisations

1.288 Benevolent organisations established and maintained in Australia or Japan are also specified as qualified persons. The provision applies to organisations established and operated exclusively for religious, charitable, educational, scientific, artistic, cultural or public purposes notwithstanding that the organisation may be exempt from tax in its home country. [Article 23, subparagraph 2(f)]

1.289 Thus, for example, a charitable institution that is a resident of Australia will be a qualified person even if some or all of its income is exempt from Australian tax or it is an exempt entity for the purposes of section 50-5 of the ITAA 1997.

Entities principally owned by qualified persons

1.290 Entities that are residents of Australia or Japan and are principally owned, directly or indirectly, by specified qualified persons may be treated as qualified persons if the entities satisfy requirements set out in paragraph 3. [Article 23, subparagraph 2(g)]

1.291 According to paragraph 3, in order for an entity to be regarded as a qualified person for a taxable year it must satisfy the ownership requirements in subparagraph 2(g):

- for taxes withheld at source, in the 12-month period preceding the date of payment of an item of income, profits or gains, or, in the case of dividends, the date on which entitlement to the dividends is determined; or

- in other cases, on at least half the days of the taxable year.

[Article 23, subparagraphs 3(a) and (b)]

1.292 In the case of Australia, ‘the date on which entitlement to the dividends is determined’ is the date on which the dividends are declared. For the purposes of Japan, the phrase will be interpreted as meaning the end of the accounting period for which the distribution of profits takes place. *[Exchange of Notes, paragraph 3]*

Persons carrying on an active business

1.293 Persons resident in Australia or Japan who are not qualified persons will nevertheless generally be entitled to treaty benefits with respect to business profits, intercorporate dividends, certain interest, or income arising from alienation of property if:

- the person is carrying on business in the country of which they are resident;
- the income, profits or gains derived from the other Contracting State are derived in connection with, or are incidental to, the business; and
- the person satisfies any other specified conditions in the Business Profits, Dividends, Interest, and Alienation of Property paragraphs or Articles for the obtaining of such benefits.

1.294 Relevant treaty benefits will not be available where the income profits or gains arise from a business of making or managing investments for the resident’s own account, unless the business is banking, insurance or securities business carried on by a bank, insurance company or securities dealer. *[Article 23, subparagraph 4(a)]*

Substantial business requirement

1.295 In cases where the business generating the item of income, profits or gains in subparagraph (a) is carried on by the person in the other country or the income is derived from an associated person then the business carried on by the person in their country of residence must be substantial in relation to the business carried on in the other Contracting State. A person will be regarded as ‘associated’ for these purposes where it would be an associated enterprise under Article 9. *[Article 23, subparagraph 4(b)]*

1.296 Whether the business in the person’s country of residence is substantial when compared to the business in the other Contracting State

shall be determined on the basis of all the facts and circumstances.
[Article 23, subparagraph 4(b)]

Partnerships carrying on an active business

1.297 For purposes of determining whether a person is carrying on business in a Contracting State, the activity grouping rules for related persons will deem a business carried on by a connected person, or by a partnership in which the person is a partner, to be business conducted by the first-mentioned person. The activities of these persons will therefore be taken together in determining whether a business is being carried on in a person's country of residence and whether the activities are substantial relative to a business activity being conducted in the other treaty country.
[Article 23, subparagraph 3(c)]

1.298 A person will be taken to be connected to another if, based on the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons. This general rule is not limited by the specific connected person tests provided in the subparagraph.

1.299 The specific connected person tests provide that a person will be connected with a trust if the person holds at least half of the beneficial interests in the trust. Similarly, a person will be connected with a company if the person holds at least half of the aggregate vote and value of the company's shares. Each person in a group of entities that share 50 per cent common ownership held directly or indirectly by a head entity are also to be treated as connected.

Competent authority discretion to grant treaty benefits

1.300 Persons who are residents of Japan or Australia and who are not qualified persons may be granted benefits of this Convention with respect to Article 7 (*Business Profits*), paragraph 3 of Article 10 (*Dividends*), paragraph 3 of Article 11 (*Interest*) or Article 13 (*Alienation of Property*), if the competent authority of the other treaty country determines that the establishment, acquisition or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the gaining of benefits under this Convention. This discretion recognises that there may be cases where significant participation by third country residents in an enterprise that is a resident of one of the treaty countries may be warranted by sound business practice or long-standing business structures and does not necessarily indicate a treaty shopping motive. [Article 23, paragraph 5]

Anti-avoidance

1.301 Paragraph 7 clarifies that the *Limitation on Benefits* Article will not restrict the application of domestic anti-avoidance rules. In the case of Australia, these will include the general anti-avoidance rule in Part IVA of the ITAA 1936 and other specific anti-avoidance provisions such as those addressing thin capitalisation in Division 820 of the ITAA 1997, transfer pricing in Division 13 of Part III of the ITAA 1936 or transferor trusts in Division 6AAA of Part III of the ITAA 1936. [Article 23, paragraph 7]

1.302 It is noted that subsection 4(2) of the Agreements Act 1953 preserves the operation of Part IVA of the ITAA 1936, notwithstanding anything inconsistent in this Convention.

Article 24 — Limitation of Relief

1.303 The treaty provides that where income, profits or gains derived by a resident of a country are taxed in that country only to the extent that such amounts are remitted to the country, then any relief (such as exemption from taxation or reduction in tax rates) that the other country may be required to provide under the treaty will only apply to the amount remitted. [Article 24, paragraph 1]

1.304 Japan operates a remittance-based system in respect of the income of taxpayers who are resident but considered non-permanent residents of Japan. Under Japan's domestic law, such taxpayers are only subject to tax in Japan on the amount actually remitted to Japan. An example of the operation of this Article might be where only half of the total amount of a dividend payable to a Japanese shareholder is remitted to Japan. In these circumstances, as the recipient is taxed in Japan only on that part of the dividend that is remitted to Japan, Australia would only be required to limit its tax under the treaty with respect to half the dividend.

1.305 The treaty also provides that where an individual is a temporary resident of a country and is, for that reason, exempt from tax in that country on certain income, profits or gains in that country, then the other country will not be required to provide any relief specified in the treaty in respect of such income, profits or gains. [Article 24, paragraph 2]

Article 25 — Elimination of Double Taxation

1.306 Double taxation does not arise in respect of income flowing between Australia and Japan:

- where the terms of this Convention provide for the income to be taxed only in one country; or

- where the domestic taxation law of one of the countries exempts the income from its tax.

Tax credit

1.307 It is necessary, however, to prescribe a method for relieving double taxation for other classes of income, profits or gains which, under the terms of this Convention, remain subject to tax in both countries. In accordance with international practice, Australia's tax treaties provide for double tax relief to be provided by the country of residence of the taxpayer by way of a credit basis of relief against its tax for the tax of the country of source. This Article also reflects that approach.

Australian method of relief

1.308 This Article requires Australia to provide Australian residents a credit against their Australian tax liability for Japanese tax paid in accordance with this Convention on income derived from Japanese sources which are taxable in Australia. The term 'income' in this context is intended to have a broad meaning and includes items of profit or gains which are dealt with under the income tax law. [Article 25, paragraph 2]

1.309 Australia's general foreign income tax offset rules, together with the terms of this Article and of this Convention generally, will form the basis of Australia's arrangements for relieving a resident of Japan from double taxation on income, profits or gains arising from sources in Japan.

1.310 Accordingly, effect is to be given to the tax credit relief obligation imposed on Australia by paragraph 1 of this Article by application of the general foreign income tax offset provisions (Division 770 of the ITAA 1997).

1.311 Notwithstanding the credit basis of relief provided for by paragraph 1 of this Article, in relation to salary and wages and like remuneration derived by a resident of Australia during a continuous period of 'foreign service' (as defined in subsection 23AG(7) of the ITAA 1936) in Japan, the *exemption with progression* method of relief will be applicable.

1.312 Dividends and branch profits derived from Japan by an Australian resident company that are exempt from Australian tax under the foreign source income measures (eg, section 23AH or 23AJ of the ITAA 1936) will continue to qualify for exemption from Australian tax under those provisions. As double taxation does not arise in these cases, the credit form of relief will not be relevant.

Japanese relief

1.313 In the case of a resident of Japan who is taxable in Japan on income which is also taxable in Australia under this Convention, this Article requires Japan to allow the Japanese resident a credit against Japanese tax payable on that income, but only up to the amount of Japanese tax paid. [*Article 25, subparagraph 1(a)*]

1.314 Consistent with Australia's recent treaty practice and Article 2 of this Convention, the Protocol makes it clear that the petroleum resource rent tax is included as part of the income tax for the purposes of the Japanese credit. [*Protocol, item 19*]

1.315 Where dividends are paid by an Australian resident company to a Japanese resident company which directly controls, for more than six months before the obligation to pay the dividend arises, at least 10 per cent of the voting shares or total issued shares in the Australian resident company paying the dividends, the underlying tax paid by the Australian company will be included in calculating the credit against the Japanese tax. [*Article 22, subparagraph 1(b)*]

Article 26 — Non-Discrimination

1.316 This Convention includes rules to prevent tax discrimination. The Australian tax system is generally non-discriminatory. However, for clarity the Protocol to this Article provides that certain features of the Australian tax system should not be seen as coming within the Article's terms.

Discrimination based on nationality

1.317 This Article prevents discrimination on the grounds of nationality by providing that nationals of one country may not be less favourably treated than nationals of the other country in the same circumstances. [*Article 26, paragraph 1*]

1.318 The discrimination that the Article precludes applies to both taxation and any requirement connected therewith. Accordingly, discrimination in the administration of the tax law is also generally precluded.

1.319 The term ***national*** is defined in Article 3 (*General Definitions*) of this Convention and covers both an individual who is a citizen or national of one country or the other and a juridical or legal person which is created or organised under the laws in force in that Contracting State. Accordingly, a company that is incorporated in Australia would be a national of Australia while a company that is incorporated and registered

under a law of Japan would be a national of Japan for the purposes of this paragraph. [Article 3, subparagraph 1(j)]

The meaning of ‘in the same circumstance’ and ‘in particular with respect to residence’

1.320 The expression ‘in the same circumstances’ refers to persons who, from the point of the application of the ordinary taxation laws and regulations, are in substantially similar circumstances both in law and in fact.

1.321 Where a person operates in an industry that is subject to government regulation such as prudential oversight, another person undertaking similar transactions but not subject to the same oversight, would not be in the same circumstances.

1.322 The inclusion of the further clarification ‘in particular with respect to residence’ makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. Therefore, different treatment accorded to a Japanese resident compared to an Australian resident will not constitute discrimination for purposes of this Article. A potential breach of paragraph 1 of this Article only arises if two persons who are residents of the same country are treated differently solely by reason of one being a national of Australia and the other a national of Japan.

The meaning of ‘other’ and ‘more burdensome’

1.323 The words ‘more burdensome taxation’ refer to the quantum of taxation while ‘other taxation’ may refer to some form of income tax other than the form of income tax to which a national of the country is subject (*Woodend Rubber Co. v Commissioner of Inland Revenue* [1971] A.C. 321 at 332).

1.324 The phrase is also applicable to administrative or compliance requirements that a taxpayer may be called upon to meet where those requirements differ based on nationality grounds.

Non-residents of Australia/Japan

1.325 Consistent with paragraph 1 of Article 24 (*Non-Discrimination*) of the OECD Model, paragraph 1 of this Article applies to persons who are residents of neither Australia nor Japan. Consequently, residents of third countries are able to seek the benefits of this provision. Paragraph 1 does not, however, extend to residents of either country who are not ‘nationals’ (as defined in Article 3 (*General Definitions*)) of either country.

Non-Discrimination and permanent establishments

1.326 The tax on permanent establishments of enterprises of the other country shall not be levied less favourably than on the country's own enterprises carrying on the same activities in similar circumstances. This applies to all residents of a treaty country, irrespective of their nationality, who have a permanent establishment in the other country. [*Article 26, paragraph 2*]

1.327 For this paragraph to apply, the enterprises of both countries must be 'in similar circumstances'. Therefore, the comparison must be made between a permanent establishment and local enterprises which are not only carrying on the same activities but are also carrying on those activities 'in similar circumstances'. This is to address situations where resident and non-resident enterprises may be carrying on the same activities but the circumstances in which they do so are very different. For example, one may be conducting dealings on a non-arm's length basis and the other on an arm's length basis. The provision recognises that appropriate differences in taxation treatment are not precluded because of the differing circumstances.

1.328 Permanent establishments of non-resident enterprises may be treated differently from resident enterprises as long as the treatment does not result in more burdensome taxation for the former than for the latter. That is, a different mode of taxation may be adopted with respect to non-resident enterprises, to take account of the fact that they often operate in different conditions to resident enterprises. The provision would not affect, for example, domestic law provisions that tax a non-resident by withholding, provided that calculation of the tax payable is not greater than that applying to a resident taxpayer.

Non-resident individuals

1.329 Non-resident individuals do not have to be granted the personal allowances, reliefs or reductions available to residents of the tax treaty countries. [*Article 26, paragraph 2*]

1.330 This means that Australia will continue to be able to grant only to resident individuals rebates such as the dependent spouse rebate (under section 159J of the ITAA 1936).

1.331 Unlike paragraph 3 of Article 24 (*Non-Discrimination*) of the OECD Model, this Article is not just limited to those benefits conferred by a country relating to civil status or family responsibilities of the individual. For Australian tax purposes, it also extends, for example, to the tax-free threshold which may be considered not to be based either on civil status or family responsibilities.

Deductions for payments to non-residents

1.332 The treaty partner countries must allow the same deductions for interest, royalties and other disbursements paid to residents of the other country as it does for payments to its own residents. However, the treaty countries are allowed to reallocate profits between related enterprises on an arm's length basis under Article 9 (*Associated Enterprises*) and to limit deductions in accordance with paragraph 8 of Article 11 (*Interest*), and paragraph 6 of Article 12 (*Royalties*). [*Article 26, paragraph 3*]

Companies owned or controlled abroad

1.333 A country must not give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other country. That is, Australian companies owned or controlled by Japanese residents may not be given other or more burdensome treatment than locally owned or controlled Australian companies. [*Article 26, paragraph 4*]

1.334 Differential tax treatment based on residency is not affected by this paragraph. Nor does the paragraph require the same treatment of non-resident shareholders in the company as resident shareholders. Accordingly, there is no obligation under paragraph 4 or any other provision of this Article to allow imputation credits to non-resident shareholders.

Exclusions

1.335 Certain provisions of the law of Australia which are important for the purposes of economic regulation and the integrity of the tax system are excluded from the operation of this Article by item 20 of the Protocol. The provisions that are excluded deal with deductions for research and development and measures to ensure effective collection of taxes (such as 'matching' rules that deny deductions until withholding tax has been paid) under the ITAA 1997, and conservancy measures under the general law. [*Protocol, item 20*]

1.336 In addition, although most are generally recognised by the international community as not being discriminatory, certain other provisions which are understood to be unrestricted by the Article are documented in the Protocol to ensure that they can continue to operate for their intended purpose. The provisions of Australian law which are considered unrestricted by the operation of the Article are those provisions which:

- deal with:
 - transfer pricing;
 - dividend stripping arrangements;
 - controlled foreign companies, foreign investment funds and transferor trusts; and
 - thin capitalisation;
- do not allow tax rebates or credits in relation to dividends paid by a company;
- defer tax where an asset is transferred out of the jurisdiction;
- provide for consolidation of group entities,

and any substantially similar provisions. Item 21 of the Protocol lists provisions covered by the exclusions. [*Protocol, item 21*]

Taxes to which this Article applies

1.337 This Article applies to ‘taxes of every kind and description imposed on or on behalf of the Contracting States, or their political subdivision or local authorities’. [*Article 26, paragraph 5*]

1.338 In the case of Australia, the relevant taxes include the income tax (including the petroleum resource rent tax and tax on capital gains), and the GST and the fringe benefits tax. The provisions of this Article also apply to taxes imposed by the Australian states and territories.

1.339 In the case of Japan, the relevant taxes include the income tax, the corporation tax, the inhabitants tax and the value added tax.

More favourable treatment

1.340 Nothing in this Article prevents either country from treating residents of the other country more favourably than its own residents.

Article 27 — Mutual Agreement Procedure

Consultation on specific cases

1.341 This Article provides for consultation between the competent authorities of the two countries with a view to reaching a solution in cases where a person is able to demonstrate actual or potential imposition of taxation contrary to the provisions of this Convention. [Article 27, paragraph 2]

1.342 In the case of Australia, the competent authority is the Commissioner or an authorised representative of the Commissioner. [Article 3, sub-subparagraph 1(k)(ii)]

1.343 A person wishing to use this procedure may present a case to the competent authority of the country of which the person is a resident. If the case comes under paragraph 1 of Article 26 (*Non-Discrimination*) of this Convention, the person may present a case to the competent authority of the country of which the person is a national.

1.344 Presentation of a case by a person to a competent authority must be made within three years of the first notification of the action which the taxpayer considers gives rise to taxation not in accordance with this Convention. Presentation of a case does not deprive the person of access to, or affect their rights in relation to, other legal remedies available under the domestic laws of the countries. [Article 27, paragraph 1]

1.345 If the person's claim seems to the competent authority to which the case has been presented to be justified, and that competent authority is not itself able to solve the problem, then the competent authority is required to seek to resolve the case by mutual agreement with the competent authority of the other country, with a view to avoiding taxation not in accordance with this Convention. [Article 27, paragraph 2]

1.346 If, after consideration by the competent authorities, a solution is reached, it must be implemented in accordance with the provisions of the Article.

Implementation of a solution

1.347 The solution reached by mutual agreement between the competent authorities of the relevant countries must be implemented notwithstanding any time limits in the domestic laws of the tax treaty countries. This allows the competent authorities the flexibility to reach a satisfactory solution and avoids problems that might arise where each country has a different time limit in their domestic law. [Article 27, paragraph 2]

Consultation on general problems

1.348 This Article also authorises consultation between the competent authorities of the two countries for the purpose of resolving any difficulties that arise regarding the interpretation or application of this Convention. This may allow, for example, the competent authorities to agree to apply an agreed solution to a broader range of taxpayers, notwithstanding that the original uncertainty may have arisen in connection with an individual case that comes under the procedure outlined in paragraphs 1 and 2 of this Article.

1.349 The competent authorities may also consult together with a view to eliminating double taxation in cases where this Convention does not provide a solution. *[Article 27, paragraph 3]*

Methods of communication between competent authorities

1.350 The competent authorities are permitted to communicate directly with each other without having to go through diplomatic channels. This may be done by letter, facsimile transmission, telephone, direct meetings or any other convenient means. *[Article 27, paragraph 4]*

General Agreement on Trade in Services dispute resolution process

1.351 This Article also deals with disputes that may be brought before the World Trade Organisation Council for Trade in Services under the dispute resolution processes of the *General Agreement on Trade in Services* (GATS). *[Article 27, paragraph 5]*

Background

1.352 Australia and Japan are both parties to the GATS. Article XVII (*National Treatment*) of the GATS requires a party to accord the same treatment to services and service suppliers of other parties as it accords to its own like services and service suppliers.

1.353 Articles XXII (*Consultation*) and XXIII (*Dispute Settlement and Enforcement*) of the GATS provide for discussion and resolution of disputes. Where a measure of another party falls within the scope of a tax treaty, paragraph 3 of Article XXII (*Consultation*) provides that the other party to the tax treaty may not invoke Article XVII (*National Treatment*). However, if there is a dispute as to whether a measure actually falls within the scope of a tax treaty, either country may take the matter to the Council on Trade in Services for referral to binding arbitration.

1.354 Notwithstanding paragraph 3 of Article XXII (*Consultation*) of the GATS, Australia and Japan have agreed that the consent of both

countries is required before a dispute as to whether a measure falls within the scope of this Convention may be brought before the Council on Trade in Services. This is seen as the most effective way of dealing with such disputes, and avoids difficult questions as to when a disputed issue falls within the dispute resolution mechanism of this Convention or of the GATS.

1.355 This provision is based, in all essential respects, on an OECD Model Commentary recommendation, and is common in recent international treaty practice. *[Article 27, paragraph 5]*

Article 28 — Exchange of Information

1.356 This Convention aligns the information exchange provisions to the 2005 OECD standard. The Article differs from the previous approach in a number of ways, including:

- the scope is expanded to a wider range of taxes;
- the new provision clarifies that the Commissioner is obliged to obtain information for Japanese tax authorities regardless of whether Australia has a domestic tax interest in the information sought or whether the information concerns a resident of either Contracting State; and
- bank secrecy laws do not limit the exchange of information.

Foreseeably relevant information

1.357 Article 28 authorises and limits the exchange of information by the two competent authorities to information foreseeably relevant to the administration or enforcement of the relevant taxes. The exchange of information is not restricted by Article 1 (*Persons Covered*) of this Convention, and may therefore cover persons who are not residents of Australia or Japan.

1.358 The standard of foreseeable relevance is intended to ensure that information may be exchanged to the widest possible extent. However, competent authorities are not entitled to request information from the other country which is unlikely to be relevant to the tax affairs of a taxpayer, or to the administration and enforcement of tax laws. *[Article 28, paragraph 1]*

1.359 The change in wording from ‘necessary’ used in the previous version of the Article to a ‘foreseeably relevant’ standard reflects the wording in Article 26 (*Exchange of Information*) of the OECD Model and no difference in effect is intended.

Taxes to which this Article applies

1.360 Under the corresponding Article in the existing Agreement, the information that could be requested and obtained between the two countries was limited to information in relation to taxes to which that Agreement applied (generally income taxes).

1.361 Under this Convention, the range of taxes for which information may be exchanged has been expanded. The Australian competent authority can now request and obtain information concerning all federal taxes administered by the Commissioner from the competent authority in Japan. This means, for example, that information concerning Australian indirect taxes (ie, the GST) may be requested and obtained from Japan. *[Article 28, paragraph 1, Protocol, item 22]*

1.362 Similarly, in the case of Japan, the Japanese competent authority can now request and obtain information concerning taxes of every kind and description imposed under Japanese tax laws, from the Australian competent authority to the extent that the requested information relates to taxes administered by the Commissioner.

Use of exchanged information

1.363 The purposes for which the exchanged information may be used and the persons to whom it may be disclosed are restricted in a manner which is consistent with the approach taken in the OECD Model. Any information received by a country must be treated as secret in the same manner as information obtained under the domestic law of that country, and can only be disclosed to the persons identified in paragraph 2 of the Article. *[Article 28, paragraph 2]*

No domestic tax interest required

1.364 When requested, a country is required to obtain information in the same manner as if it were administering its domestic tax system, notwithstanding that the country may not require the information for its own purposes. Australia would recognise this obligation to obtain relevant information for treaty partner countries, even in the absence of an explicit provision to this effect. *[Article 28, paragraph 4]*

Limitations

1.365 The country requested to provide information under this Article is not obliged to do so where:

- it would be required to carry out administrative measures at variance with the law and administrative practice of either Australia or Japan; or
- such information is not obtainable under the domestic law or in the normal course of administration.

[Article 28, subparagraphs 3(a) and (b)]

1.366 Also, in no case is the country receiving the request obliged to supply information under this Article that would:

- disclose any trade, business, industrial, commercial or professional secret or trade process; or
- be contrary to public policy.

[Article 28, subparagraph 3(c)]

Information held by banks, other financial institutions or nominees etc

1.367 Paragraph 5 ensures that paragraph 3 of this Article cannot be used to prevent the supply of information solely because the information is held by banks, other financial institutions or nominees etc. The inclusion of this paragraph should not be interpreted as suggesting the corresponding Article of the existing Agreement did not cover the exchange of such information. Inclusion of paragraph 5 merely clarifies Australia's current treaty practice, and reflects recent changes to Article 26 (*Exchange of Information*) of the OECD Model. *[Article 28, paragraph 5]*

1.368 The Protocol clarifies that a refusal to supply information held by a bank, other financial institution, nominee or person acting in an agency capacity, or information relating to ownership interests must be based on reasons unrelated to the person's status as such, or the fact that the information relates to ownership interests. *[Protocol, item 23]*

1.369 The Protocol also clarifies that paragraph 5 does not prevent a Contracting State declining to supply information under subparagraph 3(a) where it relates to confidential communications between lawyers and their clients in their role as lawyers, to the extent such information is protected from disclosure under the domestic laws of the Contracting States. This Protocol item reflects the internationally accepted position set out in the

OECD Model Commentary at paragraph 19.4 on paragraph 5 of Article 26 (*Exchange of Information*). [*Protocol, item 23*]

Information that exists prior to the entry into force of this Convention

1.370 This Article will apply to the exchange of information after the date of entry into force, including where the relevant information existed prior to that date.

Article 29 — Members of Diplomatic Missions and Consular Posts

1.371 The purpose of this Article is to ensure that the provisions of this Convention do not result in members of diplomatic missions or consular posts receiving less favourable treatment than that to which they are entitled in accordance with international conventions. Such persons are entitled, for example, to certain fiscal privileges under the *Diplomatic Privileges and Immunities Act 1967* and the *Consular Privileges and Immunities Act 1972* which reflect Australia's international diplomatic and consular obligations. [*Article 29*]

Article 30 — Headings

1.372 It is not Japan's practice to include Article headings in treaties; however they were included in this treaty, at Australia's insistence, to aid navigation. This Article provides, in accordance with Japan's preferred position, that the titles are not to be given interpretive value in this treaty.

Article 31 — Entry into Force

Date of entry into force

1.373 This Article provides for the entry into force of this Convention. This Convention will enter into force 30 days after the last date on which diplomatic notes are exchanged notifying that the domestic processes to approve this Convention in the respective countries have been completed. In Australia, enactment of the legislation giving the force of law in Australia to this Convention along with tabling this Convention in Parliament are prerequisites to the exchange of diplomatic notes. [*Article 31, paragraph 1*]

Date of application for Australian taxes

Withholding taxes

1.374 Once it enters into force, this Convention will apply in Australia in respect of withholding tax on income that is derived by a non-resident

in relation to income derived on or after 1 January in the calendar year next following the date on which this Convention enters into force.

[Article 31, sub-subparagraph 2(b)(i)]

Other Australian taxes

1.375 This Convention will first apply to other Australian taxes as regards any year of income beginning on or after 1 July in the calendar year next following the date on which this Convention enters into force.

1.376 Where a taxpayer has adopted an accounting period ending on a date other than 30 June, the accounting period that has been substituted for the year of income beginning on 1 July in the calendar year next following the date on which this Convention enters into force will be the relevant year of income for the purposes of the application of such Australian tax. *[Article 31, sub-subparagraph 2(b)(ii)]*

Date of application in Japan

Withholding taxes

1.377 In Japan, this Convention will apply to taxes withheld at source on income derived on or after 1 January in the calendar year next following the year in which this Convention enters into force. *[Article 31, sub-subparagraph 2(a)(i)]*

Other Japanese taxes

1.378 This Convention will first apply to other Japanese taxes chargeable for any taxable year beginning on or after 1 January in the calendar year next following the year this Convention enters into force. *[Article 31, sub-subparagraphs 2(a)(ii) and (iii)]*

Termination of the existing Agreement

1.379 The existing Agreement shall cease to have effect from the dates on which this Convention commences to have application for the respective taxes. The existing Agreement shall be terminated on the last of those dates. *[Article 31, paragraphs (3) and (4)]*

Transitional provision

1.380 A transitional provision has been inserted for Article 15 of the existing Agreement which deals with professors and teachers. There is no equivalent to Article 15 in this Convention. However, the transitional provision provided in this Article enables teachers or professors who are entitled to the benefits of the existing Article 15 when the Convention enters into force, to continue to receive those benefits until they would

have ceased to be entitled under that prior Agreement. Teachers and professors who are not so entitled will now fall under Article 14 (*Income from Employment*), or Article 7 (*Business Profits*) if they are independent contractors. [Article 31, paragraph 5]

Article 32 — Termination

1.381 This Convention is to continue in effect until terminated. Either country may terminate the Convention after the expiration of five years from the date of its entry into force. Termination is by notice in writing of termination through the diplomatic channel, six months before termination is to occur. [Article 32]

Cessation in Australia

1.382 In the event of either country terminating this Convention, this Convention would cease to be effective in Australia for the purposes of:

- withholding tax on income derived by a Japanese resident, in relation to income derived on or after 1 January in the calendar year next following the expiration of the six-month period; and
- other Australian taxes, as regards any year of income commencing on or after 1 July in the calendar year next following the expiration of the six-month period.

[Article 32, subparagraph (b)]

Cessation in Japan

1.383 This Convention would correspondingly cease to be effective in Japan for the purposes of:

- taxes withheld at source, for amounts taxable on or after 1 January in the calendar year next following the expiration of the six-month period; and
- other Japanese taxes chargeable for any Japanese tax year commencing on or after 1 January in the calendar year next following the expiration of the six-month period.

[Article 32, subparagraph (a)]

Chapter 2

Regulation impact statement

Background

How tax treaties operate

2.1 Tax treaties reduce or eliminate double taxation caused by the exercise of source and residence country taxing rights on cross-border income flows. They do so by treaty partners agreeing (in certain situations) to limit taxing rights over various types of income. The respective countries also agree on methods of reducing double taxation where both countries exercise their right to tax.

2.2 In addition, tax treaties provide an agreed basis for determining the allocation of profits within a multinational company and whether the profits on related party dealings by members of a multinational group operating in both countries reflect the pricing that would be adopted by independent parties. Tax treaties are therefore an important tool in dealing with international profit shifting through transfer pricing.

2.3 To prevent fiscal evasion, tax treaties include provision for exchange of information held by the respective revenue authorities. Treaties may also provide for cross-border collection of tax debts and may preclude certain types of tax discrimination. Taxpayers can also avail themselves of the mutual agreement procedures provided for in treaties which allow the two revenue authorities to consult with a view to developing a common interpretation and to resolving differences arising out of application of the treaty.

2.4 Australia seeks an appropriate balance between source and residence country taxing rights. Generally, the allocation of taxing rights under Australian tax treaties is similar to international practice as set out in the Organisation for Economic Co-operation and Development (OECD) *Model Tax Convention on Income and on Capital* (OECD Model) (Australia being a member of the OECD and involved in the development of that Model). There are, however, a few instances where Australian practice favours source country taxing rights rather than the residence approach of the OECD Model.

The Japanese tax treaty

2.5 The existing Australia-Japan tax treaty was signed on 20 March 1969 and has been in effect in Australia since the income year commencing 1 July 1970 in respect of income taxes and withholding taxes.

2.6 On 17 November 2006 the then Treasurer announced that it had been agreed that the necessary preparations for discussions to revise the existing tax treaty with Japan, signed in 1969, should commence.

Australia's investment and trade relationship with Japan

Trade

2.7 Japan has been Australia's largest export market for 40 years.

2.8 Bilateral merchandise trade in 2006-07 totalled A\$50 billion, with the balance of trade in Australia's favour.

2.9 Total exports (goods and services) in 2006-07 were valued at A\$35.5 billion, an increase of 11 per cent on 2005. Key exports include coal, beef, and aluminium and iron ores. Japan is a larger buyer of Australian exports than the combined total of exports purchased from Australia by China and the United States of America (US).

2.10 Total imports from Japan in 2006-07 were valued at A\$17.4 billion. Imports were mainly comprised of manufactured items, with major items being passenger motor vehicles (A\$6.2 billion) and transport vehicles (A\$1.4 billion).

Investment

2.11 Japan is Australia's 3rd largest investor, with a total stock of investment worth A\$51 billion at the end of 2006, of which 45 per cent was direct investment, 44 per cent portfolio investment, and 10 per cent other investment (loans, trade credit, derivatives and reserve assets). Japanese direct investment has been essential in many of the export industries that have driven Australia's export performance. Japanese investment has also been important for the development of Australia's export-oriented manufacturing sector. Toyota Motor Corporation Australia, for example, has invested more than US\$1.5 billion in manufacturing and car design facilities since the mid 1990s.

2.12 Australia is Japan's 15th largest source of foreign investment. At the end of 2006, Australia's stock of investment in Japan was A\$39.8 billion, equivalent to 4.6 per cent of total Australian investment abroad.

Specification of policy objectives

2.13 The objective of this measure is to:

- promote closer economic cooperation between Australia and Japan by reducing barriers to trade and investment between the two countries; and
- upgrade the framework through which the tax administrations of Australia and Japan can prevent international fiscal evasion.

Identification of implementation options

2.14 The internationally accepted approach to meeting the policy objectives specified in paragraph 2.13 is to:

- amend parts of the existing treaty to reflect current policies (amending Protocol); or
- conclude a new bilateral tax treaty.

Option 1: Limited amending Protocol — rely on the existing tax treaty measures

2.15 This option would rely on the existing tax treaty measures with an amending Protocol covering both countries' desired changes. However, in view of the age of the existing treaty and its outdated approaches and language, the majority of the existing text would require detailed amendment. An amending Protocol is therefore not practicable in this instance.

Option 2: Conclude a new tax treaty

2.16 This option would replace the existing treaty with a new bilateral tax treaty that reflects the current policies and practices of both countries.

2.17 A new tax treaty would be largely based on the current OECD Model and the United Nations *Model Double Taxation Convention between Developed and Developing Countries*, with some mutually agreed variations reflecting the economic, legal and cultural interests of the two countries.

2.18 Both countries have particular policy objectives to achieve in updating the tax treaty and the end result ultimately represents compromises necessary to achieve a mutually acceptable agreement. The key changes in a new treaty include:

- a reduction in the maximum royalty withholding tax rates from 10 per cent to 5 per cent;
- a reduction in interest withholding tax from 10 per cent to zero where interest is paid to a financial institution, body performing governmental functions, central bank or certain specified Australian and Japanese institutions;
- a reduction of dividend withholding tax from 15 per cent to zero for intercorporate dividends on non-portfolio holdings of more than 80 per cent, subject to certain conditions, 5 per cent dividend withholding tax for other intercorporate non-portfolio holdings and 10 per cent dividend withholding tax for all other dividends;
- a withholding tax rate limit of 15 per cent on certain distributions from real estate investment trusts;
- inclusion of a comprehensive *Alienation of Property* Article which allocates taxing rights over capital gains;
- special provisions confirming Japan's taxing rights over income derived through Japanese 'sleeping partnership-Tokumei Kumiai';
- improved integrity measures — in particular, updated rules for the exchange of information on tax matters and limitations on treaty benefits to prevent treaty shopping and other inappropriate access to the treaty concessions; and
- new rules to prevent tax discrimination against Australian nationals and businesses operating in Japan and vice versa.

Assessment of impacts (costs and benefits)

Difficulties in quantifying the impacts of tax treaties

2.19 Only a partial analysis of costs and benefits can be provided because all the impacts of tax treaties cannot be quantified. While the direct cost to Australian revenue of withholding tax changes can be quantified relatively easily, other cost impacts such as compliance costs are inherently difficult to quantify. There are also efficiency and growth gains and losses to Australia that provide estimation problems. Analysis has been conducted to establish plausible impacts on Australian economic activity and consequent tax revenue flowing from implementation of the tax treaty. The tax revenue estimates are subject to more uncertainty than the estimates of costs but are best estimates given the technology of estimation, the availability of estimates of behavioural responses, and data.

2.20 Benefits that flow to business are generally equally difficult to quantify. The evidence from international consideration (eg, the OECD) and from consultation with business strongly indicates, however, that while the quantum of benefits is very difficult to assess, a modern tax treaty provides a clear positive benefit to trade and investment relationships. Tax treaties provide increased certainty and reduce complexity and compliance costs for business.

Impact group identification

2.21 A revised tax treaty with Japan is likely to have an impact on:

- Australian residents doing business with Japan, including principally:
 - Australian residents investing directly in Japan (either by way of a subsidiary or a branch);
 - Australian real estate investment trusts with Japanese resident investors;
 - Australian residents investing in Japanese real estate investment trusts;
 - Australian banks and the other specified Australian institutions lending to Japanese borrowers;
 - Australians borrowing from Japanese banks and the other specified Japanese institutions;

- Australian residents using technology and know-how supplied by Japanese residents;
- Australian residents supplying consultancy services to Japan; and
- Australian residents exporting to Japan;
- Australian employees working in Japan;
- Australian residents receiving pensions from Japan;
- the Australian Government; and
- the Australian Taxation Office (ATO).

Assessment of benefits

Renegotiation provides a better outcome for all stakeholders

2.22 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or Japan.

2.23 A new bilateral tax treaty would comprehensively modernise and update the existing treaty. As well as revising the allocation of taxing rights between the two countries and the tax rate limits prescribed in the treaty, Australia would also be able to achieve improved integrity measures — in particular, updated rules for the exchange of information on tax matters and updated anti-avoidance and comprehensive limitation of benefit rules.

2.24 A new tax treaty would provide benefits to Australian business and to Australian revenue by ensuring certainty of legislative outcomes based on the treaty. It would be another step forward in providing Australian business with an internationally competitive tax treaty network and business tax system.

2.25 A renegotiated treaty will provide a better outcome for all stakeholders. Given the long-term nature of such arrangements, a revised tax treaty is expected to promote greater certainty than the existing tax treaty. It would also contribute to the updating of Australia's ageing treaty network.

Economic benefits

Withholding tax reductions

2.26 A new bilateral tax treaty would address business concerns about the lack of competitiveness of Australia's tax treaty network with business particularly seeking reductions in withholding tax rates.

2.27 Under its domestic tax law, Australia imposes a final withholding tax on interest, royalty and unfranked dividend payments to non-residents at the rates of 10 per cent, 30 per cent and 30 per cent of the gross payment respectively. However, Australia generally agrees to limit these withholding tax rates, on a reciprocal basis, in its bilateral tax treaties. In the existing Japanese treaty, the withholding tax rates for dividend, interest and royalty payments are limited to 15 per cent, 10 per cent and 10 per cent of the gross payments respectively.

2.28 Withholding tax reductions below the rates reflected in the existing Japanese tax treaty were first included in the 2001 Protocol amending the Convention with the US and have been included in Australia's subsequent tax treaties. Extending similar treatment to Japan aligns treatment, where possible, in Australia's recent tax treaties, maintains the integrity of Australia's treaty network and discourages treaty shopping (and the consequent degradation of the tax base of countries where the costs of capital and intellectual property are higher under their treaties as a result of the higher withholding tax rates). However, this treaty would further reduce the maximum withholding tax rate for all dividends from 15 per cent to 10 per cent, as well as including a withholding tax rate limit of 15 per cent for certain distributions from real estate investment trusts, to respond to business concerns and maintain Australia's competitiveness with our major investment partners.

2.29 While a reduction in maximum withholding tax rates will involve a cost to Government revenue, there are expected to be benefits to the revenue and to the wider economy arising out of increased business and investment activity, with the most direct benefits accruing to business.

Dividends

2.30 An outcome such as that provided to the US and United Kingdom of Great Britain and Northern Island (UK) (ie, no withholding tax on dividends paid to a company with an 80 per cent or greater voting interest in a listed company in the other jurisdiction and 5 per cent withholding tax where the interest is at least 10 per cent of the voting power) would remove distortions in the raising of capital for direct

investment that results from the more favourable terms that currently apply bilaterally in the case of the US and the UK.

2.31 A reduction in the dividend withholding tax rate limit for other dividends from 15 per cent to 10 per cent would align Australia's treaty practice with the current treaty practice of many other countries (such as the US, UK, the Netherlands, Norway and Japan who reduce their treaty dividend rate for other dividends to 10 per cent or below). This would assist in maintaining Australia's attractiveness as a destination for investment, especially in attracting foreign equity investors.

Distributions from real estate investment trusts

2.32 Australia recently introduced a 30 per cent non-final withholding tax on distributions to non-residents from Australian managed investment trusts.

2.33 In response to submissions from Australian business (especially the managed funds industry) and in view of the growing international trend to limit treaty withholding tax rates on distributions from real estate investment trusts, the Senate Standing Committee on Economics recommended in its June 2007 report on the Tax Laws Amendment (2007 Measures No. 3) Bill 2007 that when negotiating tax treaties, Australia seek reciprocal withholding tax treatment for distributions to foreign residents from managed investment trusts (including a 15 per cent withholding tax rate limit on certain distributions from real estate investment trusts). The new treaty with Japan is consistent with the Committee's recommendation. The Government has introduced measures through the *Tax Laws Amendment (Election Commitments No. 1) Act 2008* that will provide a 22.5 per cent final withholding tax for fund payments in relation to income years on or after 1 July 2008; 15 per cent in the following income year; and 7.5 per cent thereafter. The provisions in the Japanese treaty dealing with distributions from Australian real estate investment trusts are consistent with that approach.

Interest

2.34 A zero Australian interest withholding tax rate on interest derived by Japanese financial institutions will be consistent with the exemption currently provided for interest derived from widely distributed arm's length debenture issues. It also recognises that a 10 per cent interest withholding tax rate on gross interest derived by financial institutions may be excessive given their cost of funds. It should, accordingly, lower the costs of borrowing in those cases where the financial institution can pass the cost represented by the withholding tax on to the Australian borrower.

2.35 As is the case in Australia's other recent tax treaties, the new treaty would include an exemption for interest derived by the Governments of either country (including their political subdivisions and local authorities), bodies exercising governmental functions and the countries' central banks (in this case, the Bank of Japan and the Reserve Bank of Australia).

2.36 Consistent with the principles underlying these two exemption clauses but for clarity, a specific provision would also be inserted to expressly exempt interest derived by:

- the Japan Bank for International Cooperation;
- the Nippon Export and Investment Insurance;
- the Australian Export Finance and Insurance Corporation;
- a public authority that manages the investments of the Future Fund; or
- any similar institution agreed in an exchange of notes between the Governments of the two countries.

Royalties

2.37 Australian residents required to meet the cost of Australian royalty withholding tax on royalty payments made to Japanese residents would benefit from a reduced royalty withholding tax rate. Commercial practice indicates that, as with interest, the cost represented by the royalty withholding tax is commonly passed on to the payer of the royalty. This means that they may bear the cost of higher rates of withholding tax and place them at a competitive disadvantage in competing with businesses from other countries with lower rates. The effect of lowering the cost of new technology and intellectual property may encourage the development of Australia's economy through the use of the most up-to-date technology and processes. Additionally it may encourage Japanese residents to use Australian technology and intellectual property.

Alienation of property

2.38 The updating of the *Alienation of Property* Article to address taxing rights over capital gains would provide certainty to taxpayers and reduce the risk of double taxation. Australia's source country taxing rights over capital gains on real property, land-rich companies and assets which form the business property of a permanent establishment in Australia would be retained. More generally, the changes bring into line Australia's treaty practice with international practice. This will

encourage investment in Australia and result in generally lower compliance costs.

Non-Discrimination

2.39 Inclusion of a *Non-Discrimination* Article will insert rules to prevent tax discrimination against Australian nationals and businesses operating in Japan and vice versa.

Other benefits

2.40 Where Australians carry on business activities in Japan, the existing treaty prevents Japan from taxing the business profits of an Australian resident unless that Australian resident carries on business through a permanent establishment (such as a branch) in Japan. A new tax treaty would further refine the concept of when a permanent establishment should be taken to exist and the level of activity that would constitute a permanent establishment. This principle also applies where a Japanese enterprise carries on business activities in Australia.

2.41 Other benefits also include:

- clarifying the residency rules;
- clarifying that treaty relief is not available on certain income, profits or gains that are exempt in a country because the recipient is a temporary resident of that country;
- clarifying the treatment of income derived through trusts;
- special provisions confirming Japan's taxing rights over income derived through Japanese 'sleeping partnership-Tokumei Kumiai';
- refined anti-profit shifting (transfer pricing) rules, including new time limits for initiating audit activity; and
- including anti-avoidance and limitation of benefits rules.

Revenue benefits

2.42 New treaty arrangements with Japan would represent another step in facilitating a competitive and modern treaty network for Australian companies and would help to maintain Australia's status as an attractive place for business and investment. While a reduction in maximum withholding tax rates will involve a cost to revenue, there are expected to be benefits to the revenue and to the wider economy arising

out of increased business and investment activity, with the most direct benefits accruing to business.

2.43 Small revenue benefits should also result from enhanced tax integrity measures over a broader range of taxes.

Compliance and administrative cost reduction benefits

2.44 Tax exemptions in respect of withholding taxes are likely to reduce compliance and administration costs associated with remitting and claiming credits for such tax.

2.45 The closer alignment with more recent Australian and international treaty practice would generally be expected to reduce compliance costs. In particular, interpretative issues relating to the extent Australia can tax capital gains under the existing treaty arrangements has resulted in considerable uncertainty and the risk of costly legal arguments.

2.46 Administrative costs incurred in explaining the ATO view and responding to legal arguments would also be significantly reduced. Clarifying other areas of uncertainty, such as tax treaty tests of 'residency' and updating the treaty text, should also decrease compliance costs and uncertainty.

Improved international relationships

2.47 New treaty arrangements with Japan will also assist the bilateral relationship by updating an important treaty in the existing network of commercial treaties between the two countries. It would also promote greater cooperation between taxation authorities to prevent fiscal evasion and tax avoidance. Updating the tax treaty to take account of changes to the OECD Model would also help to maintain Australia's status as an active OECD member, which in turn would maintain Australia's position in the international tax community.

Assessment of costs — types of costs

Revenue costs

2.48 Treasury has estimated the impact of the first round effects on forward estimates as \$345 million, with the identifiable costs to revenue associated with the reductions in dividend, interest and royalty withholding tax rates. As Australia has a number of 'most favoured nation' clauses regarding dividend withholding tax rates in its existing treaties, Australia would be obliged to enter into negotiations with a view to offering similar withholding tax reductions to those countries

(including the proposed 10 per cent rate limit for other dividends), which may create an additional pressure on revenue cost. Countries that offer bilateral treaty withholding tax reductions for distributions from real estate investment trusts would also be expected to seek the 15 per cent withholding tax rate limit for such payments proposed for Japan, which may also create a pressure on revenue cost.

Administration costs

2.49 The administrative impacts on the ATO from the changes made by any new treaty arrangements are considered to be minimal. Some formal interpretive advice may be required, for example, private binding rulings, concerning the application of the treaty. Staff from the ATO, clients and tax professionals will need to be made aware of the entry into force and changes from the previous treaty. Therefore a number of ATO information products will need to be updated.

2.50 The cost of negotiation and enactment of new tax treaty arrangements with Japan is minimal and have mostly been borne by Treasury and the ATO. There will also be an unquantified but small cost in terms of parliamentary time and drafting resources in enacting the proposed new tax treaty arrangements.

2.51 There are also ‘maintenance’ costs to the ATO associated with tax treaties and mutual agreement procedures (including advance pricing arrangements). These costs also apply to the existing arrangements. By bringing the Japanese treaty into basic conformity with modern treaty practice these costs would be reduced. However, as treaties are deals struck between the two countries that reflect specific features of the bilateral relationship, some level of differential treatment or wording between treaties, which may require interpretation or explanation by the ATO, is inevitable.

Other costs

2.52 Government policy flexibility in relation to taxation of Japanese residents would be further constrained by changes to treaty obligations, for example, with respect to taxation of capital gains. However, such constraints are also placed on Japanese law makers, providing long term certainty to businesses. As such, the cost of such constraints is outweighed by the benefits. Ultimately, the tax treaty could be terminated if it became out of step with Government policy. Such termination is very rare in international tax treaty practice, however, and could be expected to be resisted by the business community and others who benefit from the treaty.

2.53 The impact of new tax treaty arrangements on tax policy flexibility is generally quite minimal as tax treaties are based on broad and generally accepted taxation principles.

Assessment of costs

Taxpayer costs

2.54 No material additional costs to taxpayers have been identified as likely to arise from the renegotiation of the Japanese treaty.

2.55 Businesses that collect withholding taxes would need to make small system changes to change the rate at which they withhold to reflect the new treaty withholding tax rate limits. Previous experience and anecdotal evidence suggests that these changes will be straight forward and easily accommodated.

2.56 No costs for the community or other parties have been identified.

Administration costs

2.57 The requirement on the ATO to exchange information on a broader range of taxes is also considered to be of minimal impact. In most cases the ATO will already have the required information in its possession which will limit the related administrative costs.

Consultation

2.58 The then Treasurer's Press Release No. 124 of 17 November 2006 invited submissions from stakeholders and the wider community in relation to issues that might be raised during negotiations with Japan. Treasury has also sought comments from the business community through the Tax Treaties Advisory Panel.

2.59 In general, business and industry groups support outcomes which are consistent to those in the 2003 Australia-UK Convention and the updated Australia-US tax treaty. They also favour withholding tax reductions for distributions from real estate investment trusts.

2.60 The state and territory governments have been consulted through the Commonwealth/State Standing Committee on Treaties. Information on the negotiation of this treaty was included in the Schedules of treaties to state and territory representatives from August 2006.

2.61 The proposed treaty arrangements will be considered by the Commonwealth Joint Standing Committee on Treaties, which provides for public consultation in its hearings.

Conclusion and recommendation

2.62 While the existing tax treaty has provided a good measure of protection against double taxation and prevention of fiscal evasion since coming into force, it has become outdated and no longer adequately reflects current tax treaty policies and practices of either Australia or Japan, nor modern international norms.

2.63 A new bilateral tax treaty would address long term business concerns about the lack of competitiveness of withholding tax rate limits in Australia's tax treaty network.

2.64 Developments in both countries' domestic law, commercial practices, and treaty policies and practices support a full revision of the treaty. This also provides an opportunity to update the text in accordance with modern OECD practice.

2.65 The proposed new treaty arrangements with Japan are consistent with Australia's recent move towards a more residence-based tax treaty policy and contributing to the updating of Australia's ageing treaty network. It would bring Australia's arrangements with Japan more into line with international norms, as set out in the OECD Model and would provide outcomes similar to Australia's treaties with the US and the UK.

2.66 There is a direct cost to revenue, largely sourced in reduced withholding tax collections. On balance, the benefits of concluding a new treaty outweigh the cost to revenue.

2.67 A new bilateral tax treaty is therefore recommended.