Policy Forum: Australia’s Twin-Track Approach to Treaty Shopping

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INTRODUCTION

Treaty shopping is not a new problem, but it has recently achieved a degree of public prominence that it used to enjoy only in academic circles. Canada has obviously been grappling with the problem of treaty shopping—it released a 2013 consultation paper on treaty shopping1 and announced a series of measures in the 2014 budget,2 actions prompted no doubt by the decisions in MIL (Investments),3 Prévost

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3 Canada v. MIL (Investments) SA, 2007 FCA 236.
Car,\textsuperscript{4} and Velcro.\textsuperscript{5} Somewhat earlier, the 2011 UK budget proposed new legislation to deny benefits in cases of treaty abuse. Although the measure was later withdrawn, the United Kingdom claims that it still intends to address the issue.\textsuperscript{6}

Canada and the United Kingdom are not alone in being troubled by treaty shopping. One of the action items in the OECD’s 2013 action plan on base erosion and profit shifting (BEPS) is to prevent treaty abuse by developing “model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.”\textsuperscript{7} It is more than a little curious, therefore, that the activity elsewhere in the world has not been matched by similar pronouncements from the Australian government. The government has been a vocal supporter of the OECD’s BEPS project since its inception, and the silence from our politicians and Treasury officials (though not from our tax administrators) on treaty shopping is odd.

In this article, I address Australia’s approach to treaty shopping and some possible explanations for the government’s silence. Australia adopts a two-pronged approach to the problem of treaty shopping. Australia’s treaty practice certainly adopts many of the current recommendations: attempting to buttress treaties through limitation-on-benefits (LOB) provisions, embedding anti-abuse rules, and enlisting domestic anti-avoidance rules to the task. But a second aspect of Australia’s approach changes the incentives for treaty shopping, with the intended result that the practice becomes largely pointless: it changes the returns, not just the rules. How this occurs is described below.

**AUSTRALIA’S NETWORK OF TAX TREATIES**

By international standards, Australia has a relatively modest network of bilateral income tax treaties. At the time of writing, Australia has only 44 comprehensive income tax treaties, none with any of the notorious tax havens.\textsuperscript{8} One reason for the

\textsuperscript{4} Canada v. Prévost Car Inc., 2009 FCA 57.
\textsuperscript{5} Velcro Canada Inc. v. The Queen, 2012 TCC 57.
\textsuperscript{8} There is some pressure for Australia to negotiate a treaty with Hong Kong in light of the recently concluded treaty between Hong Kong and New Zealand. Australia has negotiated 36 tax information exchange agreements with countries such as the British Virgin Islands, the Bahamas, the Cayman Islands, Liechtenstein, Jersey, Guernsey, Vanuatu, the Cook Islands, and Mauritius.
small number of treaties is that Australia, unlike Canada, has no institutionalized mechanism akin to the “exempt surplus” concept that makes the existence of a treaty significant for residents under domestic law. Consequently, Australia can afford to have a small treaty network directed mostly at encouraging inbound investment; a handful of treaties are with developing countries that are trying to attract investment from Australia. Australia’s decision to sign the Convention on Mutual Administrative Assistance in Tax Matters9 also removes some of the pressure for a larger network: this instrument offers a simple and wide-reaching method for securing the exchange of information, a mutual agreement procedure, assistance in the collection of taxes, and other administrative benefits that Australia might once have sought through a bilateral income tax treaty.

It is worth noting that Australia’s recent tax treaties are also relatively consistent. Although some treaties—for example, those with Germany and the Netherlands—are quite old, the recent treaties do not display significant disparities in their major features.10 And in cases where important differences have been identified and exploited, Australia has not been reluctant to enact tax treaty overrides to impose uniformity on non-uniform treaties. This point is discussed further below.

When it comes to treaty shopping, these two features—a relatively small treaty network and a reasonable degree of consistency between the treaties—seem to pull in opposite directions. One might expect that the relatively small number of treaties would lead to many instances of investors from non-treaty countries trying to gain access to a treaty. On the other hand, investors from one treaty country are not likely to be advantaged by trying to shop into a different treaty. As it turns out, Australia has seen some examples of treaty shopping, but they have involved substitutions between treaties.

**EXAMPLES OF TREATY SHOPPING IN AUSTRALIA’S RECENT PAST**

Treaty shopping is not unknown in Australia, though the jurisprudence reveals only a handful of examples. Both the 1997 case of *Lamesa Holdings BV*11 and the Myer transaction in 2009 (described below) involved US private equity firms acquiring and then selling Australian companies through Dutch companies, arguably enlivening the Australia-Netherlands treaty in lieu of the Australia-US treaty. In 1997, the treaty-shopping issue was largely ignored in *Lamesa*; in 2009, it was one of the most important issues on which the Australian Taxation Office (ATO) focused.

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10 There are some differences between Australia’s pre- and post-2000 treaties, but many of the treaties with the major capital-exporting countries were renegotiated or amended after 2000.

11 *Commissioner of Taxation v. Lamesa Holdings BV* (1997), 157 ALR 290 (Full FC).
The structure in *Lamesa* was comparatively simple. Leonard Green & Associates LP, a US private equity firm, became interested in acquiring the apparently under-valued shares in Arimco and its subsidiaries, which were involved in gold mining in Australia. It formed Green Equity Investors LP with other partners described as “institutional, investment and financial entities resident in the US.” In January 1992, Green Equity Investors acquired all of the shares in an Australian-resident company, Australian Resources Ltd. (“Resources”). Resources then acquired all of the shares in Australian Resources Mining Ltd. (“Mining”).

At this stage, Resources was owned directly from the United States. In early February 1992, however, Green equity Investors acquired the shares in Lamesa, a company incorporated in the Netherlands, and transferred to it the shares in Resources. As a result, Resources was now owned by a resident of the Netherlands, not by a resident of the United States.

In late February 1992, Mining acquired all of the shares in Arimco. In 1994 and 1996, Lamesa sold the shares in Resources (divesting Mining, Arimco, and Arimco’s subsidiaries) in two tranches for a profit of $200 million. The ATO assessed Lamesa on the basis that the profit was ordinary trading income derived from sources in Australia. Lamesa successfully argued that the profit was not liable to tax in Australia under the 1976 Australia-Netherlands treaty.12 The court concluded that Australia could not retain tax on the profit under either article 7 or article 13. Article 13 of the treaty, as drafted, looked at whether the assets of the company being sold were predominantly real estate. Although it was undoubtedly the case that the main assets of Arimco and its subsidiaries were natural resources in Australia, Lamesa was not selling the shares of those companies; it was selling the shares in Resources.

Australia’s response was to enact a treaty override.13 If the shortcoming identified in *Lamesa* existed in article 13 of any of Australia’s other treaties, the defect was now overturned by the unilateral act of Australia’s Parliament.

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12 Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Canberra on March 17, 1976. The treaty issue revolved around whether the provisions of article 7 or article 13 should be applied. The parties in *Lamesa* agreed that if the provisions of article 7 were applied, Australia would not be entitled to sustain the tax assessed because Lamesa did not have a permanent establishment in Australia through which it carried on business. With respect to article 13 the ATO argued that Lamesa was deriving “income from the alienation of real property” when it sold the shares in Resources, so that Australia’s claim to tax could be sustained. The Federal Court disagreed because Lamesa did not itself have “rights to exploit, or to explore for, natural resources,” nor was Lamesa selling “shares . . . in a company, the assets of which consist wholly or principally of” real property or resources in Australia. The only assets of Resources were shares in other companies, and the court was not willing to read the provision as extending to real property held below one corporate tier: *Lamesa*, supra note 11, at 293-94.

13 Section 3A was inserted into the International Tax Agreements Act 1953 (Cth) in 2000 to apply to Australia’s treaties in force before 1998. The section purported to apply to any treaty that
Would *Lamesa* have been decided differently if it had been analyzed under the terms of the 1982 Australia-US treaty?\(^{14}\) It is not clear that the result would have changed. Article 7 of the Australia-US treaty was, in this respect, identical to the Dutch treaty, and Australia could not have sustained its claim to tax if article 7 of the US treaty had been applied. Although article 13 was presented slightly differently in the US treaty, the text, which bore on the key issue—namely, whether Lamesa was selling “real property situated in Australia” when it sold the shares in Resources—was identical.\(^{15}\) This may explain why the treaty-shopping dimension in *Lamesa* was never ventilated in court.

By 2009, however, the ATO was alive to treaty-shopping concerns. The Myer structure was somewhat more complex than that in *Lamesa* but the issue was essentially the same. In June 2006, one of Australia’s largest retailing groups, Coles Myer Ltd., decided to focus on its supermarket operations and sold its department store chain, Myer, to entities connected with Texas Pacific Group for $1.4 billion. An Australian company, Flinders Pty. Ltd. (“Flinders”), acquired Myer. Flinders was owned by a Dutch company, NB Swanston (“Swanston”), which was owned by a Luxembourg company, NB Queen SaRL (société à responsabilité limitée), which was owned by a Cayman Islands company, TPG Newbridge Myer, which was owned by Texas Pacific entities in the United States and probably by other investors whose residence is not clear.

In 2009, Texas Pacific decided to float Myer on the Australian Stock Exchange. An Australian float vehicle raised funds by issuing shares on market and used the proceeds to buy the shares in Flinders from Swanston. The gain made by Swanston on the sale of its shares was said to be about $1.5 billion. In November 2009, the ATO issued assessments for unpaid tax and penalties against Swanston, relying on Australia’s general anti-avoidance rule (GAAR) to strike down the application of the

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\(^{15}\) Article 13 of the US treaty, ibid., provided that

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for the purposes of this Article . . . (b) the term “real property,” in the case of Australia, shall have the meaning which it has under the laws in force from time to time in Australia and, without limiting the foregoing, includes: (i) real property referred to in Article 6 [and] (ii) shares or comparable interests in a company, the assets of which consist wholly or principally of real property situated in Australia.
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The definition of “real property” in article 6 included “rights to exploit or to explore for natural resources.”
Netherlands treaty on the basis of treaty shopping. 16 Exactly what has happened since those events is unclear—some procedural skirmishes before the courts have been reported, 17 but the primary issue of Swanston’s liability to Australian tax has not been resolved in a public forum.

The ATO, however, has not remained silent. It issued a series of public taxation rulings in the next year, all directed at the Myer transaction. One ruling declared that the ATO could invoke Australia’s GAAR to strike down an arrangement “designed to alter the intended effect of Australia’s International Tax Agreements network.” 18 Another ruling declared that the profit made by a private equity firm could be assessed as ordinary trading profits rather than as a capital gain. 19 A third ruling declared that the source of the profit on the sale of shares in an Australian company was not determined solely by the place where the contract was executed. 20

The flurry of rulings was primarily directed at buttressing the elements of the ATO’s substantive argument—that private equity houses earn ordinary income rather than capital gains from their activities; that the source of that income is

16 The ATO also sought an order freezing Swanston’s Australian bank account. Swanston apparently collected $3.9 billion on the float of Myer during October and November, but by the time the freezing order was sought the funds had already been remitted offshore and the balance of the bank account was a mere $45. See “ATO Pursues TPG for $452m Tax Bill Related to Myer Float,” News.com.au, November 13, 2008 (news.com.au/finance/ato-pursues-tpg-for-452m-tax-bill-related-to-myer-float/story-e6frfn1i-1225797140510).

17 For example, TPG Newbridge Myer Ltd. v. The Deputy Commissioner of Taxation, [2011] FCA 1157, ruling that the ATO could not serve documents affecting the offshore companies on officers of TPG’s Australian subsidiary.


19 Taxation Determination TD 2010/21, “Income Tax: Can the Profit on the Sale of Shares in a Company Group Acquired in a Leveraged Buyout Be Included in the Assessable Income of the Vendor Under Subsection 6-5(3) of the Income Tax Assessment Act 1997?” December 1, 2010. This ruling is significant principally for its domestic-law effect. The jurisdictional reach of Australia’s capital gains tax is much more limited than the jurisdiction asserted when the amount in question is ordinary trading profits.


A fourth ruling provided that Australia’s treaties could apply to the partners of a foreign limited partnership if the limited partnership was fiscally transparent so that the partners were taxable, provided that the partners were resident in a treaty jurisdiction: Taxation Determination TD 2011/25, “Income Tax: Does the Business Profits Article (Article 7) of Australia’s Tax Treaties Apply to Australian Sourced Business Profits of a Foreign Limited Partnership (LP) Where the LP Is Treated as Fiscally Transparent in a Country with Which Australia Has Entered into a Tax Treaty (Tax Treaty Country) and the Partners in the LP Are Residents of That Tax Treaty Country?” October 26, 2011.
Australia; and that, to the extent that a treaty might be relied on to defeat Australia’s claim to tax, the treaty can be ignored if treaty shopping has occurred:

Where an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structuring arrangement, this may be a scheme or a part of a scheme which otherwise satisfies the terms of [Australia’s general anti-avoidance rule] and any tax benefit obtained in relation to such a scheme may be cancelled.21

The obvious question is what happens next. The rulings do not offer a coherent answer. They claim that the benefit of the Australia-Netherlands treaty could be switched off, but they do not substitute the application of the Australia-US treaty, which is presumably available if everything between Australia and the United States is artificial and contrived. Instead, ruling TD 2010-20 disregards two entities, but not three:

In the circumstances discussed above [US investors own a Caymans entity, which owns a Luxembourg entity, which owns a Dutch entity, which sells an Australian company], a scheme involving the mere interposition of holding companies between an entity resident in the Cayman Islands and an Australian holding company of the target assets, may give rise to a tax benefit for the Cayman Islands entity in respect of an otherwise assessable Australian sourced business profit. [The benefit is the non-inclusion in the Cayman resident’s assessable income of the Australian-source business profit].22

The ruling does not explain why the Dutch and Luxembourg companies are disregarded but the Cayman Islands entity is not. The ATO clearly wants to present the structure as abusive, and so it asserts that it involves a non-treaty entity (a Cayman Islands company) shopping into Australia’s treaty network. If the substance of the matter is instead a US entity investing into Australia (relying on the Australia-Netherlands treaty instead of the Australia-US treaty), whether that was abusive would presumably depend on whether the result under the Australia-US treaty involved less Australian tax than the result under the Australia-Netherlands treaty. That is an interesting and complex question which I will not pursue further here. The important point is that none of the rulings asks this question, impliedly insisting that it does not arise.

Lamesa and the Myer transaction are both instructive, but neither grapples with the fundamental concern of treaty shopping—that less tax was paid in Australia because of the decision to apply the Netherlands treaty in lieu of the US treaty. In Lamesa, it is not obvious whether a different outcome would have followed if the US treaty had been applied. In the Myer transaction, the ATO refuses to ask the question by stopping the analysis at the Cayman Islands.

21 TD 2010/20, supra note 18, at paragraph 18.
22 Ibid., at paragraph 19 (emphasis added).
THE POLICY SILENCE ON TREATY SHOPPING

Although the ATO has been particularly exercised about this problem, Australia’s politicians, Treasury officials, and tax policy committees have been remarkably silent. As noted above, Australia’s tax reform projects have all but ignored the problem of treaty shopping. The issue was not mentioned in the 1975 Asprey committee report,23 the 1985 tax reform white paper,24 or the 1998 “New tax system” proposals.25 The 1999 review of business tax considered some international tax issues, but not treaty shopping.26 The 2003 review of international taxation arrangements,27 which was the obvious forum in which to examine treaty shopping, did not mention it. Finally, the 2009 future tax system report28 contained no discussion of international tax.

One might have expected that this silence on treaty shopping in tax policy circles would have been broken with the emergence of the OECD’s BEPS project. The revelations about the tax practices of various multinationals emerging from the UK House of Commons Public Accounts Committee29 and the US Senate Permanent Subcommittee on Investigations30 did not pass unnoticed. Newspaper reports in 2012 drew parallels between the practices being reported offshore and tax outcomes

26 Australian, Review of Business Taxation, A Tax System Redesigned—More Certain, Equitable and Durable (Canberra: Review of Business Taxation, July 1999). The review devoted much attention to transfer pricing and thin capitalization. It included four recommendations with respect to treaties: (1) to reduce withholding tax on non-portfolio investors; (2) to include a non-discrimination article in Australia’s future treaties; (3) to renegotiate some of the older treaties with Australia’s major trading partners; and (4) more generally, to review Australia’s treaty policy “to ensure that it reflects a balanced taxation of international investment and changed investment patterns.”
27 Australia, Board of Taxation, International Taxation: A Report to the Treasurer (Canberra: Board of Taxation, 2003).
in Australia, claiming that Google earned $1 billion from sales in Australia but paid only $780,000 tax there.31

Once tax compliance hit the headlines, politicians began to pay far greater attention to treaty shopping. In November 2012, the assistant treasurer promised “to take action where necessary to ensure the integrity and sustainability of the tax system, including our corporate income tax base.”32 He created a specialist group in December 2012,33 gave further speeches,34 and wrote an opinion piece for the financial press.35 Treasury produced an issues paper in May 201336 and a scoping paper in July 2013.37

Yet amid all this activity, the issue of treaty shopping did not warrant a mention. Australian academics and revenue administrators have been puzzling over the problem of treaty shopping, but Australia’s tax policy makers have been, and remain, focused on improving the exchange-of-information regime; curtailing the activities of tax havens; challenging corporate tax compliance culture; pondering the problems of e-commerce and the concept of a permanent establishment as the threshold

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requirement for the ability to tax; and handling transfer pricing, especially with respect to intangibles transferred to havens.

**AUSTRALIA’S CURRENT TREATY PRACTICE**

Australia’s current treaty practice relies on some of the existing provisions in the OECD model but supplements them with a combination of targeted anti-treaty-shopping rules.

**OECD Model and Commentary**

Australia’s treaties largely follow the OECD model, but with reservations and supplemented by other provisions. Australia’s courts have accepted that the commentary to the OECD model can be consulted in the interpretation of an Australian treaty, and one might expect that an Australian court would be influenced by the discussion in the commentary to article 1 on the improper use of treaties. Unlike the United States, Australia does not publish a model treaty. However, the 2009 Australia-New Zealand treaty is generally accepted as a good indicator of Australia’s preferred treaty positions.

**Resident**

Article 4 of Australia’s treaties typically follows the OECD model and defines a person as a “resident” for treaty purposes initially by reference to the domestic law of the treaty partner, excluding persons that are liable to tax in a state only on the basis of source.

Australia makes some adjustments to article 4 of the OECD model convention, principally to deal with two peculiarities of the Australian economy—the prominence of trusts in the commercial property and funds management industries, and the existence of significant dual-listed multinational enterprises (BHP Billiton and Rio Tinto) in the mining industry. With regard to trusts, rather than rely simply on the OECD’s partnership report to address the question of entitlement to treaty benefits, Australia sometimes elaborates on the definition of “resident” to make explicit the treatment of fiscally transparent entities and to articulate a means of handling disagreements about the transparent status of entities. For example, Australia’s 2008 treaty with Japan contains a complex provision explaining what happens when income is derived by an entity that is established in the other state (or even in a third state) when the income is attributed and taxed in the hands of the investors (or taxed

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39 Convention Between Australia and New Zealand for the Avoidance of Double Taxation with Respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion, signed at Paris on June 26, 2009 (herein referred to as “the New Zealand treaty”).
in the hands of the entity).\textsuperscript{41} Article 1(2) of the New Zealand treaty is more typical. It provides as follows:

In the case of an item of income (including profits or gains) derived by or through a person that is fiscally transparent with respect to that item of income under the laws of either State, such item shall be considered to be derived by a resident of a State to the extent that the item is treated for the purposes of the taxation law of such State as the income of a resident.\textsuperscript{42}

Similarly, article 4(7) of the New Zealand treaty confirms that it is the investors in listed publicly traded investment trusts that will enjoy treaty benefits. But article 4(7) tries to do the reverse, presumably as a compliance cost-saving measure—and treat the (transparent) managed investment trust as entitled to the benefits of the treaty if it is listed on a stock exchange and regularly traded and at least 80 percent of the value of units in the trust is owned by Australian residents.

Australia’s treaty practice also attempts to address individuals who are only temporarily resident in Australia. Under Australian domestic law, temporary residents are not taxed on their worldwide income.\textsuperscript{43} Instead, most of their foreign-source income and capital gains will be exempt from Australian tax and they will usually be taxed by Australia just on income from performing services in Australia. Australia’s treaty practice provides that any limitation on source country tax that would ordinarily be triggered for the benefit of a resident is not triggered in the case of a temporary resident if the amount is not taxed in Australia.\textsuperscript{44}

### Beneficial Ownership

Articles 10, 11, and 12 of Australia’s treaties typically refer to the requirement for the dividend, interest, or royalty income to be “beneficially owned” by a resident of the other contracting state if the limitation on tax rates is to be triggered. Sometimes a different term (such as “beneficially entitled”) is used, but the requirement appears.

Again, the proliferation of trusts in the Australian economy poses a difficulty that requires a special provision. Under Australian domestic law, if the income derived through a trust is owned by identifiable beneficiaries, the beneficiaries are taxable

\textsuperscript{41} Convention Between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Protocol and Exchange of Notes, signed at Tokyo on January 31, 2008, at article 4(5).

\textsuperscript{42} Supra note 39, at article 1(2).

\textsuperscript{43} Income Tax Assessment Act 1997 (Cth), at sections 768-910.

\textsuperscript{44} See, for example, the Convention Between Australia and the Kingdom of Norway for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion, signed in Canberra on August 8, 2006, at article 4(5). The provision is expressed to apply in the reverse situation—for example, where a person is temporarily resident in a treaty country and is not taxed in that country because it is a temporary resident, but is claiming relief from Australian tax on the basis that it is a resident.
on that income. But if no beneficiary can be identified as the owner of the income by the end of a year, the trustee pays tax on the income. It might be argued that if the income is taxed in the hands of the trustee, the “beneficial owner” requirement in articles 10, 11, and 12 is not met. Article 3(4) of the New Zealand treaty is directed at solving that problem and is intended to deliver the benefits of the treaty to the trustee even though the trustee might not be regarded as the “beneficial owner” of the income.

**General Limitation on Benefits**

Australia’s treaty practice does not usually include a general LOB provision, although some exceptions exist. For example, the treaties with the United States and Japan include a general LOB article, presumably because they represent the treaty practice of the other country. In addition, Australia has sometimes insisted on such a clause, apparently for its own purposes. It seems that Australia regards it as important to include a general LOB provision when negotiating with certain countries. The protocol to the 2013 treaty with Switzerland contains a general LOB article that was probably included at Australia’s insistence. Clause 1 of the protocol to the new Swiss treaty provides as follows:

> The benefits of this Convention shall not apply if it was one of the principal purposes of any person concerned with the creation or assignment of the property or right in respect of which the income is paid, or if a person has become a resident of a Contracting State, to take advantage of the provisions of the Convention by means of such creation, assignment or residence.

This is, in effect, a general LOB provision, though one driven by “purpose” rather than by more observable criteria such as ownership structure, listing on a stock exchange, the conduct of an active trade or business, or the leakage of income offshore.

The 2003 treaty with Russia also contains a LOB article, though it is more nuanced than the provision quoted above. It has clearly been drafted to deny treaty benefits to companies that enjoy clandestine tax preferences. Article 23 applies where under the laws or administrative practices of a Contracting State, such income or profits are preferentially taxed and, in relation thereto, information is accorded confidential treatment beyond the usual or general protection of information accorded for tax purposes.

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46 Ibid., at section 99A.

47 Convention Between Australia and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol, signed at Sydney on July 30, 2013, at protocol clause 1.

The denial of treaty benefits is limited to entities engaged in particular industries—
banking; shipping; financing and insurance; Internet activities; headquarters compa-

dies; coordination centres; group financing and administrative support; “activities
which give rise to passive income, such as dividends, interest and royalties”; and
“activities the performance of which do not require substantial presence in the State
of source.”49 This LOB article does not depend on findings about purpose.

Purpose-Based Exclusions

Australia has an apparent affection for purpose-based LOB provisions. The general
denial of benefits contained in the protocol to the Swiss treaty discussed above is
one example. A second approach, which is very common, denies access to the lim-
itations on source country taxation in articles 10, 11, and 12. Article 10(9) of the
New Zealand treaty, which is typical, provides as follows:

No relief shall be available under this Article if it is the main purpose or one of the
main purposes of any person concerned with an assignment of the dividends, or with
the creation or assignment of the shares or other rights in respect of which the dividend
is paid, or the establishment, acquisition or maintenance of the company that is the
beneficial owner of the dividends and the conduct of its operations, to take advantage
of this Article. In any case where a Contracting State intends to apply this paragraph,
the competent authority of that State shall consult with the competent authority of the
other Contracting State.50

Articles 11(9) and 12(7) of the New Zealand treaty are phrased in similar terms. The
requirement for a state to consult with the competent authority of the other
state prior to denying treaty benefits is a feature of this way of drafting a denial of
benefits.

Another example appears in article 4(5) of the 1990 treaty with China. It pro-
vides as follows:

If a company has become a resident of a Contracting State for the principal purpose
of enjoying benefits under this Agreement, that company shall not be entitled to any of
the benefits of Articles 10, 11 and 12.51

Although the article operates on the basis of the definition of “resident,” its effects
are limited to denying access to articles 10, 11, and 12. The company remains a
resident for the purposes of other articles.

49 Ibid.

50 Ibid., at article 10(9).

51 Agreement Between the Government of Australia and the Government of the People's Republic
of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with
respect to Taxes on Income, signed at Canberra on November 17, 1988, at article 4(5).
Anti-Back-to-Back Provision in the Interest Article

Australia’s treaty practice also includes a specific prohibition on treaty benefits in circumstances where conduit financing is involved. Australia’s recent treaties eliminate all source country tax when interest is paid to “a financial institution which is unrelated to and dealing wholly independently with the payer,” but a specific limitation is added to prevent exploitation. For example, article 11(4) of the New Zealand treaty provides as follows:

Notwithstanding paragraph 3, interest referred to in subparagraph (b) of that paragraph may be taxed in the State in which it arises at a rate not exceeding 10 per cent of the gross amount of the interest if . . .

(b) it is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.53

The clause is a mixture of an apparently objective criterion (a “back-to-back loan” or an arrangement that is “economically equivalent” to a back-to-back loan) and a purpose-based test (an arrangement that is intended to have a particular effect).

These modifications to the OECD model convention now represent a common constellation of provisions in Australia’s recent tax treaties. It seems that Australia adopts both purpose-based rules (to protect the dividends, interest, and royalties articles) and structural rules (to protect the exemption for interest earned by financial institutions). Australia appears to have no appetite for the widespread use of a general LOB article based on the kinds of observable characteristics (set out earlier) seen in the US provision—ownership structure, listing on a stock exchange, the conduct of an active trade or business, or the leakage of income offshore.

Applying the Australian GAAR

Australia’s GAAR is a potential weapon available to be used to combat treaty shopping. Bilateral income tax treaties are given effect in Australian domestic law by the International Tax Agreements Act 1953. Section 5 of that statute provides that a tax treaty “has the force of law according to its tenor” from the date of its entry into force, and section 4(2) gives the treaty superiority over domestic law by providing that the treaty will “have effect notwithstanding anything inconsistent . . . contained in the Assessment Act.” The superiority of the treaty is, qualified, however. Section 4(2) provides that the superiorit of the treaty does not extend to superiority over Australia’s domestic GAAR.54 This provision might appear at odds with Australia’s

52 For example, the New Zealand treaty, supra note 39, at article 11(3)(b).
53 Ibid., at article 11(4)(b).
54 Under the International Tax Agreements Act 1953 (Cth), at section 4AA(2), the superiority of the treaty is also deferred to another anti-avoidance rule in Australia’s fringe benefits tax legislation.
obligations under international law to honour its treaty obligations, but its existence is probably tacitly accepted because it has been in the legislation since the introduction of Australia’s revised GAAR in 1981 and is presumably the kind of provision that the commentary to the OECD model allows.

**THE SECOND STRING TO THE BOW**

Although Australia has mechanisms in its treaties and in domestic law aimed at preventing treaty abuse, a more interesting strategy for managing treaty shopping emerges from the general domestic tax policy settings that Australia has chosen to implement. As I noted above, so far as Australian residents are concerned, treaties play a minor role in determining their Australian tax liability. The same is true for many non-residents—their Australian tax liabilities are also governed largely by Australian domestic law, applied indifferently to investors from treaty and non-treaty countries alike. Treaties do not often deliver large tax reductions to non-residents. This may be a curious position internationally, but it is undoubtedly the case that non-residents from treaty and non-treaty countries will often end up in the same position because our domestic policy settings are already at a level that is at least as generous as the treaty provisions.

The irrelevance of treaties in determining non-residents’ Australian tax liabilities can be seen in a number of places. For example, Australian domestic law does not impose tax on dividends paid to non-residents if the dividend is paid from the taxed profits of an Australian company.

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55 The reference to the current version of Australia’s GAAR was added by Income Tax Laws Amendment Act (no. 2) 1981, at section 13.

56 Organisation for Economic and Co-operation and Development, Model Tax Convention on Income and on Capital: Condensed Version (Paris: OECD, July 2010), commentary on article 1, at paragraphs 7 et seq. and 21 et seq. See also Public Discussion Draft: BEPS Action 6, supra note 7, at paragraph 57 et seq.

57 Non-portfolio dividends from foreign subsidiaries are exempt from Australian tax whether or not the subsidiary is resident in a treaty country: Income Tax Assessment Act 1936 (Cth) section 23AJ. Gains made on the sale of shares in foreign operating subsidiaries are also exempt from Australian tax whether or not the subsidiary is resident in a treaty country: Income Tax Assessment Act 1997 (Cth), division 768-G. Australia’s controlled foreign corporation (CFC) rules do not differentiate between good and bad countries or types of income on the basis of whether or not the CFC is resident in a treaty country: Income Tax Assessment Act 1936 (Cth), part X, division 7. The extent of the attributable income of a CFC depends on whether the CFC is resident in a listed country or an unlisted country. There are only 7 listed countries—Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States. The rest of the world, including the remaining 37 treaties countries, are all viewed as being alike for CFC purposes: Income Tax Regulations 1936, schedule 10. Other types of foreign-source income that have been taxed at source will typically enjoy a foreign tax credit under Australian domestic law: Income Tax Assessment Act 1997 (Cth), division 770. There is no serious suggestion that the credit provided under article 23 of Australia’s treaties is likely to be more generous than that provided under domestic law.

paid to non-residents even from the untaxed profits of an Australian company, if those profits were earned offshore.59 Thus, although a treaty might allow Australia to tax dividends at 5, 10, or 15 percent, domestic law does not claim it. The same is true if non-residents sell shares in an Australian company. If the non-resident makes a gain that Australian law regards as a capital gain, Australian domestic law will rarely claim tax.60 Indeed, when this rule was announced in May 2005, the justification for the rule was deliberately to align the domestic law with the result that would be reached if a treaty applied.61

The domestic rule has interesting consequences for one of Australia’s treaty curiosities. Article 13 of Australia’s treaties with the United States and the United Kingdom preserves the source country’s right to tax “capital gains in accordance with domestic law” for all residual capital gains. The text departs from article 13(5) of the OECD model convention (which allocates the right to tax residual capital gains exclusively to the residence state) and was drafted at a time when the ATO was very insistent on retaining the right to tax non-residents on gains made on Australian assets. It also departs from the text of some of Australia’s other recent treaties, such as those with South Africa, Japan, and France, all of which give the residence country the right to tax residual capital gains. The irony is that, having ensured that domestic law could operate without restraint on residual capital gains, the domestic law was changed so that it now rarely claims tax on residual capital gains.

A similar alignment occurs for much cross-border interest. Australian domestic law imposes tax at a rate of 10 percent on interest paid to non-residents, but mainly if they are associates of the Australian borrower62—that is, most interest paid to unrelated non-residents is not liable to tax.63 Article 11 of Australia’s treaties typically provides for 10 percent tax on interest, and consequently no reduction in tax is to be gained by shopping into or between treaties.64

60 Ibid., at division 768-G. Capital gains made by non-residents on the sale of shares in an Australian company will be liable to tax only if (1) the vendor holds 10 percent or more of the company’s shares and (2) 50 percent or more of the value of the assets of the company is represented by land in Australia.
62 Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974 (Cth), at section 7(b).
63 Income Tax Assessment Act 1936 (Cth), at section 128F.
64 One potential exception is the exclusion of all residence-based tax on interest paid to non-resident financial institutions under article 11 of Australia’s recent treaties. It is worth noting, however, that the domestic-law exception can often be triggered in this situation as well. The main situation in which Australian domestic law retains a tax claim (that is, where the interest is paid to a related entity) also rarely qualifies for the treaty exception.
This alignment of domestic law with treaty outcomes is not universal—the discussion above paints it in very broad strokes—but it occurs often and for situations that are commercially important. Thus, any non-resident that sets up an Australian subsidiary that pays dividends and interest to its non-resident owner is not likely to be advantaged by making that investment through a treaty country or by changing treaties. Similarly, when the non-resident sells the Australian subsidiary, it is not likely to be advantaged by selling while a resident of a treaty country.

There are certainly areas where discrepancies survive. For example, Australian domestic law claims tax at 30 percent on dividends paid from the untaxed profits of an Australian company, but Australia's recent treaties can reduce this amount to zero if the dividend is paid to a foreign parent. Similarly, domestic law claims tax at the rate of 30 percent on royalties paid to non-residents, but Australia's modern treaties typically reduce that rate to 15 percent or less and overturn the domestic-law treatment of equipment rentals as royalties, assigning them instead to the business profits article. Non-residents that earn significant amounts of income that Australian domestic law regards as sourced in Australia, but that can do so without maintaining a permanent establishment in Australia (e-commerce businesses are the obvious example) are immune from Australian tax if they reside in a treaty country but liable to tax if they don't.

I do not suggest that the alignment of domestic policy settings with treaty outcomes was done with treaties and the problem of treaty shopping in mind, although in the case of the jurisdictional claims of the capital gains tax the legislative history shows that this was a factor. For dividends and interest, the more likely explanation is that the policy settings are regarded as appropriate as a matter of domestic tax policy. While Australia has for much of its modern existence been a capital-importing country, investment flows have become more mature over time, and Australia is now both a capital importer and a capital exporter. In consequence, Australia's 2003 review of international taxation arrangements moved Australia's tax policy settings away from a preoccupation with maintaining source-based taxation and toward greater residence-based taxation.

One outcome of that change has been a gradual and unilateral reduction in source-based taxes. This reduction has happened because it is regarded as being in Australia's national interest. It has not been thought necessary—or even sensible—to wait until another country is ready to negotiate a treaty in order to implement reductions that Australia regards as appropriate.

65 Supra note 62, at section 7(a).
66 See, for example, the New Zealand treaty, supra note 39, at article 10(3).
67 Supra note 62, at section 7(c).
68 Australia's 2003 report on international taxation arrangements recommended “a move towards a more residence-based treaty policy in substitution for based on the source taxation of income.” See supra note 27, at recommendation 3.5.
This position may seem odd to countries that regard treaties as instruments for securing advantages for their residents that invest offshore. Australia does not promise a reciprocal rate reduction, and so at negotiations it appears to have very little to bargain with if it is trying to secure reductions from the other party. This appearance has not passed unnoticed, but the explanatory memorandum that accompanied the 2005 amendments, which wound back the domestic law on capital gains, argued that making the change in domestic law would actually make treaty negotiation easier and more successful:

By bringing Australia more in line with international practice, this will relieve the pressure to compromise other aspects of Australia’s preferred tax treaty practice. This will result in more favourable tax treaty outcomes for Australia.69

Whether or not that statement is correct, if one believes that lower taxes at source are in the national interest, then waiting until another party is ready to reciprocate would be foolish. And perhaps the treaty negotiators believe that the other party, by insisting on retaining its high withholding rates, will eventually discover that it is harming itself and also decide, unilaterally, to make a similar change.

As I noted above, though these policy settings may have been chosen for entirely self-interested reasons and without much regard to their effects on tax treaties, they may explain why Australia has been uninterested in pursuing treaty shopping. Because treaties often deliver to non-residents little that domestic law does not already offer, no benefits arise from treaty shopping in many common situations. Indeed, one could go further: it is not farfetched to argue that Australia should encourage non-residents to access Australia’s treaties inappropriately. Such a strategy might just prove to be valuable to Australia’s national interest. The current debate about the evils of treaty shopping focuses entirely on its impacts on the distributive rules, which usually operate to reduce the source country’s taxing powers. But treaties also include important administrative provisions, especially provisions dealing with the exchange of information and perhaps assistance in the collection of tax. A non-resident that seeks to access one of Australia’s tax treaties inappropriately may find that it has secured no tax relief beyond what domestic law already allowed, but it has certainly exposed itself to exchange of information and possibly to the collection of Australian taxes. This benefit from treaty shopping should not be ignored in the current efforts to stifle the practice.

69 Supra note 61.