New tax treaty with Germany: a model for Australia's future tax treaties

25 October 2016

In brief

On 20 October 2016, legislation to give effect to a new tax treaty between Australia and the Federal Republic of Germany, which was signed in Berlin on 12 November 2015, was enacted in Australia. Once the treaty has entered into force, it will replace the current treaty that has been in place since 1975.

The treaty is one of Australia's first '21st century' treaties that incorporate the Organisation for Economic Cooperation and Development (OECD)/G20 Base Erosion and Profit Shifting (BEPS) Project recommendations, demonstrating the Australian Government's commitment to tackling international tax avoidance practices.

In detail

The new tax treaty between Australia and Germany (the new treaty) modernises the existing tax treaty arrangements between the two countries to conform to international norms and standards, largely following the OECD's Model Tax Convention on Income and Capital. As it replaces one of the oldest tax treaties still in operation (the oldest being the Australia – Singapore tax treaty which has been in effect since 1969!), the new treaty is significantly different to the existing treaty, including updated definitions and concepts, reduced withholding tax rates in certain circumstances, and new arbitration rules.

The new treaty is likely to be effective from next year (1 January for German taxes and Australian withholding taxes, and 1 July for Australian income tax), although this timing will depend on Australia and Germany exchanging instruments of ratification on the completion of the necessary implementing domestic procedures.

As noted above, the new treaty is one of the first signed by Australia since the final recommendations from the OECD's BEPS projects were delivered in October 2015, and as such, incorporates various BEPS measures to address cross-border tax avoidance practices. The specific BEPS measures which have incorporated within the new treaty include:

Treaty provisions	***BEPS Action***
Title and Preamble	Action 6 - *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*
Article 1 (*Persons Covered*)	Action 2 - *Neutralising the Effects of Hybrid Mismatch Arrangements*
Article 5 (*Permanent Establishment*)	Action 7 - *Preventing the Artificial Avoidance of Permanent Establishment Status*
Article 7 (*Business Profits*)	Action 14 - *Making Dispute Resolution Mechanisms More Effective*
Article 9 (*Associated Enterprises*)	Action 14 - *Making Dispute Resolution Mechanisms More Effective*
Article 10 (*Dividends*)	Action 6 - *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*
Article 13 (*Alienation of Property*)	Action 6 - *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*
Article 23 (*Limitation of Benefits*)	Action 6 - *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*
Article 25 (*Mutual Agreement Procedure*)	Action 14 - *Making Dispute Resolution Mechanisms More Effective*

The new treaty provides an insight into the model likely to be adopted by the Australian Government for future treaty negotiations, and in a welcome move, the Government has provided significant guidance on the operation of the new treaty in a lengthy Explanatory Memorandum (EM) which accompanied the legislation when it was introduced into Parliament. It is understood that this was done in recognition of the fact that there is still minimal guidance available from the OECD on the operation of the new anti-BEPS provisions.

We have highlighted key aspects of the new treaty which give effect to the BEPS measures below.

Preventing treaty abuse and tax avoidance

At the outset, the new treaty includes the BEPS Action 6 recommended wording in the title and preamble of the treaty, making it clear that the purpose of the treaty is not merely to eliminate double taxation and prevent fiscal evasion, but to also address tax avoidance. Further integrity measures are provided in the new treaty to prevent the abuse of various treaty concessions such as:

- Adopting a six and twelve month holding period condition to access certain concessional dividend withholding tax rates (Article 10). This was also a recommendation from the BEPS Action 6 Report, intended to address potential treaty abuse cases where, for example, a company increases its holding shortly before the dividends are paid for the purpose of securing a lower withholding rate.
- In respect of the alienation of property, introducing a 365 day test period for determining whether shares or comparable interests derive more than 50 per cent of their value from immovable property located in Australia or Germany (Article 13). This is intended to address cases where assets are contributed to an entity shortly before the sale of the shares or other interests in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in either country. The introduction of Article 13 is a substantial change to the old treaty.

An important aspect of the new treaty aimed at preventing treaty abuse is the revised Limitation of Benefits article (Article 23). The Limitation of Benefits article is a common feature in most tax treaties, and is broadly intended to prevent access to treaty benefits to certain individuals and entities, usually to prevent inappropriate treaty benefits arising through treaty shopping. The updated treaty includes a new 'Principal Purpose Test' (PPT) in the Limitation of Benefits article as recommended in the BEPS Action 6 Report. The PPT will effectively deny treaty benefits if the principal purpose of a person is to take advantage of the treaty. As noted in the EM accompanying the Bill to give the new treaty the force of law in Australia, this article is "intended to ensure that the German agreement will apply for the purposes for which it was entered into, as opposed to arrangements whose principal objective is to secure a more favourable tax treatment."

The introduction of the PPT in the new treaty (and presumably in all future treaties negotiated by Australia) creates a new level of uncertainty for taxpayers seeking to rely on the treaty to secure certain tax outcomes given the scope and nature of the test. Some observations include:

- The test is highly dependent on the specific facts and circumstances of the particular transactions or arrangements, and there is a need to consider both direct and indirect transactions and arrangements to assess whether the principal purpose was to obtain a tax benefit under the treaty.
- The PPT threshold is lower than the 'sole or dominant purpose' test in Australia's general anti-avoidance rules, and will be satisfied if it can be reasonable to conclude that obtaining the benefit was one of the primary purposes of an arrangement or transaction that resulted in that benefit.
- The application of the PPT cannot be circumvented by asserting the arrangement or transaction was entered into to avoid the domestic law of a country and that the obtaining of a treaty benefit was merely an additional outcome of the arrangement. Evidence will need to be weighed up objectively to determine if it is reasonable to conclude that an arrangement or transaction was entered in to obtain a tax benefit under the treaty.

Guidance and examples regarding the operation of the PPT from the BEPS Action 6 report will be useful in understanding and applying the new Limitation of Benefits article. It is worth noting, however, that concerns were raised with the OECD during the consultation process regarding the adequacy of examples in the BEPS Action 6 report, which does not offer taxpayers much in the way of assurance that treaty benefits will be available in many common commercial transactions.

Addressing hybrid mismatch arrangements

The new treaty attempts to address hybrid mismatches arising through the use of fiscally transparent entities by incorporating recommendations from the BEPS Action 2 Report. Specifically, the new treaty includes a new provision which ensures the benefits of the tax treaty are not granted where neither country treats the income of a fiscally transparency entity as the income of one of its residents under the domestic law. The new provision gives effect to the principles of the 1999 OECD report on The Application of the OECD Model Tax Convention to Partnerships.

Strengthening the 'Permanent Establishment' article

The concept of 'permanent establishment' has been reworked in the new treaty to incorporate recommendations from the BEPS Action 7 Report. The key changes include:

- A new anti-avoidance provision to prevent the misuse of Article 5 (Permanent Establishment) and Article 7 (Business profits) through the practice of contract splitting. This anti-avoidance provision broadly requires a taxpayer to consider any connected activities carried on by other,

- closely related entities during different time periods for the purposes of determining whether the time limitations included in the definition of 'permanent establishment' have been exceeded.
- Restricting the types of activities that would have otherwise have been an excepted from the definition of 'permanent establishment' to activities that only have a 'preparatory or auxiliary' character.
- An anti-fragmentation rule to prevent a multinational enterprise avoiding having a permanent establishment by fragmenting its operating business into several small operations to meet the 'preparatory or auxiliary' character exception.
- Changes in relation to dependent and independent agents to ensure that certain agency arrangements cannot be used to avoid permanent establishment.

Arbitration mechanism to resolve disputes

The new treaty also includes an enhanced mechanism for the resolution of disputes, picking up the best practice recommendations from the BEPS Action 14 Report, which aim to strengthen the effectiveness and efficiency of the mutual agreement procedures. The mutual agreement procedures refer to the mechanism through which the competent authorities (i.e. tax authorities) of the contracting states to a tax treaty resolve disputes regarding the interpretation or application of a treaty on a mutually-agreed basis. Of note, the updated treaty now provides that any unresolved disputes can be referred to independent arbitration. The arbitration mechanism, however, is not available for disputes involving the PPT in the Limitation of Benefits article or the domestic anti-avoidance rules of either country.

Other key features

The table below provides a comparison of the withholding tax rates under the current treaty and the new treaty.

Item	***Current rate***	***Revised rate***
Dividends		
Intercorporate dividends where 80% or more of the voting power of the paying company is directly held for a minimum of 12 months (subject to certain conditions)	15%	0%
Intercorporate dividends where 10% or more of the voting power of the paying company is directly held for a minimum of 6 months	15%	5%
All other cases	15%	15%
Interest		
Sovereign investment and other central bank functions	0%	0%
Unrelated financial institutions dealing wholly independently with each other (subject to certain conditions)	10%	0%
All other cases	10%	10%
Royalties		
All cases (note, the definition of royalties has been revised in the new treaty and now includes payments for the right to use spectrum licenses as well as for forbearance, and excludes the right to use industrial, commercial or scientific equipment)	10%	5%

Other key features of the new treaty include:

- A ten year time limit will generally apply for making adjustments to profits attributable to a permanent establishment under the business profits article (Article 7), except in cases of fraud,

willful default or negligence or if an audit have commenced within the ten year time period. The ten year time limit also applies to transfer pricing adjustments between associated enterprises (Article 9), with the taxation authorities required to make appropriate compensatory adjustments to ensure that any transfer pricing adjustment does not result in double taxation of the same profits in the hands of two associated enterprises.

- As noted above, treaty benefits will be available for income derived through fiscally transparent entities but only to the extent that the income is treated as the income of a resident of Australia or Germany under domestic law. Treaty benefits will, however, generally be available for German sourced income received by an Australian managed investment trust (MIT). This is achieved by broadly treating certain collective investment vehicles (including Australian MITs) as resident individuals for the purposes of applying the treaty, but only to the extent that residents beneficially own the interests in the collective investment vehicle (and in certain circumstances this requirement can be disregarded).
- The tax authorities of Australia and Germany will be authorised to exchange taxpayer information in respect of all taxes imposed in either country. The information obtained may be used for purposes other than for the assessment, collection and enforcement of taxation laws if permitted under the law of either country. Strict rules will govern the protection of personal information exchanged in relation to individuals.

The takeaway

The new treaty provides an important update to modernise the current tax arrangements between Australia and Germany to reflect current international standards and norms. Whilst the implementation of the new treaty will have immediate impacts for Australian and German cross-border transactions once in effect, it also may ultimately have broader implications for all cross-border transactions as it provides an insight into the design of Australia's future tax treaties incorporating the OECD's BEPS measures going forward.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

Christian Holle, Sydney
+61 (2) 8266 5697
christian.holle@pwc.com

© 2016 PricewaterhouseCoopers. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers a partnership formed in Australia, which is a member firm of PricewaterhouseCoopers International Limited, each member firm of which is a separate legal entity. This publication is a general summary. It is not legal or tax advice. Readers should not act on the basis of this publication before obtaining professional advice. PricewaterhouseCoopers is not licensed to provide financial product advice under the Corporations Act 2001 (Cth). Taxation is only one of the matters that you need to consider when making a decision on a financial product. You should consider taking advice from the holder of an Australian Financial Services License before making a decision on a financial product.

Liability limited by a scheme approved under Professional Standards Legislation.