PRACTITIONER ARTICLES

[1570] New Australia/Israel tax treaty: good news, but where are your directors located?

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On 28 March 2019, Australia and Israel signed a new tax treaty (see 2019 WTB 13 [412]), *Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance* ("Israeli Convention"). The *Treasury Laws Amendment (International Tax Agreements) Act 2019* (the Act), implements the Israeli Convention for Australia and received assent on 28 November 2019: The Treasurer announced on 6 December 2019 that the Israeli Convention is now fully ratified: see para [1589] of this *Bulletin*.

In addition to the benefits of the Israeli Convention for cross-border investment and relations between Australia and Israel, it is important for Israeli and Australian residents to be aware of the impact of the Israeli Convention on them and their businesses. This article addresses 2 potentially negative outcomes under the Convention for companies operating in both jurisdictions:

- residents of Israel will be subject to an increased scope for Australian taxation than is currently the case, including Israeli directors of Australian companies; and
- the benefits of the Israeli Convention (such as lower withholding rates) may not be available for Israeli resident companies managed from Australia - ie, dual resident companies.

The passing of the Israeli Convention into Australian law also serves as a timely reminder that the above outcomes may also arise under other existing Australian treaties. Particularly, under Australian treaties affected by the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (MLI), dual resident companies may not be entitled to treaty benefits.

Date of effect

The Israeli Convention has now entered into force and will apply from 1 January 2020 for withholding taxes, 1 April 2020 for fringe benefits tax and 1 July 2020 for income tax.

Deemed source rule: casting a wider net

The Act includes a new set of domestic source rules for assessable income. One effect of these rules is that residents of Israel will be subject to an increased scope for Australian taxation after implementation of the Israeli Convention than is currently the case. This is because amounts that Australia *may* tax under the Israeli Convention are deemed to have an Australian source.

For example, director fees paid to an Israeli resident director of an Australian company who performs their role entirely in Israel would not *generally* be taxable in Australia (although it would depend on the exact facts). Under Article 15 of the Israeli Convention, Australia would have the right to tax the director fees so they would be deemed to have an Australian source. Although relief under the treaty should be available to prevent double taxation, the operation of the deemed source rule will add to the compliance burden of the affected directors and companies.

The problems with deemed source rules is not a new issue. All of Australia's comprehensive tax treaties include a deemed source rule, either in the treaty itself or in the *International Tax Agreements Act 1953*. The recent decision of the Full Fed-

eral Court in *Satyam Computer Services Limited v FCT* [2018] FCAFC 172 provided a practical example of the problem deemed source rules may create: see 2018 WTB 43 [1421].

In *Satyam Computer Services*, amounts paid by Australian consumers of IT services provided by the taxpayer's employees in India were covered by the definition of royalties in the *Agreement between the Government of Australia and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (**Indian Agreement**) (but not the Australian domestic definition).

Accordingly, notwithstanding that Australia would not otherwise have a right to tax the amounts because Australia could tax the amounts under the royalties article, they were deemed to have an Australian source and were therefore taxable in Australia. In March 2019 the High Court refused the taxpayer special leave to appeal the decision of the Full Court: see 2019 WTB 12 [388].

The Israeli Convention does not contain the same broad royalties definition that the Indian Agreement does. However, there are several treaty articles granting Australia taxing rights, which may give rise to similar issues.

While it may seem strange to include a rule under which residents of treaty countries are in a worse position than residents of non-treaty jurisdictions - that is the clear intention behind the source rule, which is confirmed in the Explanatory Memorandum (at para [2.7]).

Additionally, the inclusion of the deemed source rule directly in the ITAA 1997 as opposed to within the treaty itself (the usual preference) represents a shift in Australian treaty practice. The Explanatory Memorandum to the Act (at para [2.11]) suggests that this shift is intended to overcome the need to negotiate the inclusion of a non-OECD model provision in treaty negotiations. It is also interesting that the deemed source rule for the Israeli Convention (and future treaties) has been moved to an entirely new Division, ie Div 764 "Source Rules", which also includes a re-written Australian source rule. These changes may foreshadow the insertion of new statutory source rules or at least a new home for existing statutory source rules.

Dual resident companies beware

It is important to note that the tie-breaker in the Israeli Convention for entities who are not individuals (eg companies) is aligned with Australia's MLI position (in Article 4). That is, the operation of the normal "place of effective management" tie-breaker is subject to the agreement of the competent authorities.

Article 4(3) of the Israeli Convention provides:

Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which the person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. ***In the absence of such agreement, such person shall not be considered to be a resident of either Contracting State for the purposes of enjoying benefits under this Convention.*** [Emphasis added.]

Accordingly, in the case of dual resident companies, ***no treaty benefits*** will be available until such time as the competent authorities agree on the location of residency.

Given the Commissioner's new position on corporate residency following *Bywater Investments Ltd v FCT; Hua Wang Bank Berhad v FCT* (2016) 260 CLR 169, as set out in *Taxation Ruling* TR 2018/5 and *Practical Compliance Guideline* PCG 2018/9, there is now a greater likelihood of dual resident companies. For example, the participation of an Australian based director in board decisions (from Australia) of an Israeli incorporated company would likely result in both Australia and Israel seeking to tax the company as a resident.

Accordingly, it will be important to be aware of the risk of dual residency for Israeli incorporated companies that have central management and control in Australia and that relief from double taxation and reduced withholding rates under the Israeli Convention may not be available.

As noted, the position in Art 4(3) is consistent with Australia's position under the MLI. Therefore, the passage of the Israeli Convention into Australian law also serves as a timely reminder of the implications of dual residency under Australian treaties affected by the MLI. The MLI is currently operational for many of Australia's key trading partners, such as the UK, New Zealand, Japan and France. Note that a similar outcome arises under the *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income as amended by the 2001 Protocol*, which is not covered by the MLI.

Approach by Revenue authorities regarding NZ treaty

Importantly, in respect of the *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* (the **NZ Convention**), the Australian Taxation Office and the NZ Internal Revenue Department have agreed a compliance approach to the residency article which allows corporate taxpayers to self-determine their residency under the "place of effective management" test under certain very limited circumstances (see ATO document QC 59062). This approach effectively reverts to the pre-MLI position for the NZ Convention but there are a number of threshold requirements that must be met before the compliance approach can be relied upon, so these should be carefully considered by taxpayers. It is unclear whether such an approach will be taken with other tax authorities.

TAX PRACTICE UPDATE

[1571] ATO views on *Harding* residency case

The ATO has released a Decision Impact Statement (DIS) on the Full Federal Court decision in *Harding v FCT* [2019] FCAFC 29, reported at 2019 WTB 9 [286]. The Full Federal Court found that the taxpayer had a permanent place of abode in Bahrain, even though he lived in temporary accommodation, and therefore allowed his appeal against a decision that he was a resident of Australia under s 6(1) of the ITAA 1936. The High Court refused the Commissioner special leave to appeal.

ATO view

The Commissioner said he accepts that, in the particular circumstances of Mr Harding, described by the first instance judge as 'unusual', rare and extraordinary, "it was reasonable to conclude that Mr Harding's presence in Australia during the 2011 income year did not amount to residing in Australia under the ordinary concepts test". The Commissioner considers the case "stands for no higher proposition than that Mr Harding, when his circumstances were examined, was found not to reside in Australia".

Regarding the domicile test, the Commissioner said he will apply the Full Federal Court's construction and, in determining whether he is satisfied that a person's permanent place of abode is outside Australia, will consider whether the person has:

- definitely abandoned residence in Australia, and
- commenced living permanently in a specific country overseas.

In deciding whether the person's permanent place of abode is outside Australia, the Commissioner said he will consider the facts and circumstances surrounding the person's departure from Australia, their arrangements in relation to the overseas country and nature of their presence there.

