
TREASURY LAWS AMENDMENT (INTERNATIONAL TAX AGREEMENTS)
BILL 2019

EXPOSURE DRAFT EXPLANATORY MATERIALS

Table of contents

Glossary..... 1

Chapter 1 The Australia-Israel Convention 3

Chapter 2 Australia’s deemed source rule 44

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>
Assessment Acts	The ITAA 1936 and ITAA 1997
BEPS	Base Erosion and Profit Shifting
Convention	<i>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</i>
FBT Act	<i>Fringe Benefits Tax Assessment Act 1986</i>
G20	<i>Group of 20</i>
Israel	The State of Israel
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
OECD	Organisation for Economic Cooperation and Development
OECD Model	OECD Model Tax Convention on Income and on Capital
OECD Model Commentary	OECD Model Convention Commentaries (contained in the OECD Model Tax Convention on Income and Capital Full Version (as it read on 21 November 2017))

Chapter 1

The Australia-Israel Convention

Outline of chapter

1.1 This Bill amends the Agreements Act 1953 to give force of law to the *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* (the Convention).

Context of amendments

1.2 The Convention was signed in Canberra, Australia, on 28 March 2019. It improves bilateral tax arrangements between Australia and Israel by alleviating double taxation of income. It also enables greater administrative cooperation in tax matters, including through information exchange, to help reduce tax evasion and avoidance.

1.3 Countries commonly seek to eliminate double taxation and, particularly since the Final Reports of the OECD/G20 *Base Erosion and Profit Shifting Project* in 2015, mitigate tax evasion and avoidance through tax treaties. In 2019, Australia had bilateral tax treaties in place with over 40 jurisdictions.

1.4 The Convention broadly follows the OECD Model. OECD members and many other countries use the OECD Model as the basis of bilateral conventions to eliminate double taxation. This helps to ensure a uniform approach to resolving the most common problems that arise in international taxation.

Double taxation

1.5 A key objective of the Convention is to alleviate the double taxation that results from the interaction of the Australian and Israeli tax systems. The OECD defines double taxation as the imposition of comparable taxes in two (or more) countries on the same taxpayer in respect of the same taxable income or capital.

1.6 Australia and Israel, like most countries, tax income on both a ‘source’ and ‘residence’ basis. For example, Australia usually taxes Australian residents on income from both domestic and foreign sources, and taxes non-residents on income from Australian sources.

1.7 Double taxation can occur when there is an overlap of source and/or residence taxing rights, such as when a person who is resident in one country derives income from another.

1.8 Under the Convention, Australia and Israel agree to restrict their respective taxing rights to alleviate double taxation. The Convention allocates taxing rights between Australia and Israel over different categories of income including business profits, dividends, interest, royalties and pensions. The Convention also provides for relief from double taxation where both countries have a right to tax the same income, and for the resolution of disputes where the two countries attempt to tax the same income.

Tax evasion and avoidance

1.9 Another key objective of the Convention is to prevent tax evasion and avoidance. This is made clear in the title and the preamble of the Convention which clarify that Australia and Israel do not intend the provisions of the Convention to create opportunities for tax evasion and avoidance.

1.10 As members of the Inclusive Framework on BEPs, Australia and Israel are committed to the implementation of the OECD/G20 BEPS Project. That project provides governments with solutions, designed to be implemented domestically and through treaty provisions, for closing the gaps in existing international tax rules that allow corporate profits to disappear or be artificially shifted to low/no tax environments. These solutions are outlined in the *Base Erosion and Profit Shifting 2015 Final Reports*.

1.11 The Convention adopts a range of the integrity provisions recommended by the BEPS Project. These are outlined in the table below.

<i>Australia-Israel Convention provisions</i>	<i>BEPS Project 2015 Final Reports</i>
Title	Action 6
Preamble	Action 6
Article 1 (Persons covered), paragraph 2	Action 2
Article 5 (Permanent establishment), paragraphs 5, 6, 7, 9, 10 and subparagraph 8(a)	Action 7
Article 7 (Business profits), paragraph 9	Action 14
Article 9 (Associated enterprises), paragraph 4	Action 14
Article 10 (Dividends), subparagraph 2(a)	Action 6
Article 13 (Alienation of property), paragraph 2	Action 6
Article 22 (Limitation on Benefits)	Action 6

<i>Australia-Israel Convention provisions</i>	<i>BEPS Project 2015 Final Reports</i>
Article 25 (Mutual agreement procedures), paragraphs 1, 2 and 3	Action 14

Summary of new law

1.12 This Bill amends the Agreements Act 1953 to give the Convention the force of law in Australia.

1.13 Key features of the Convention include:

- Reduced withholding tax rates to create a more favourable bilateral investment environment and also make it cheaper for Australian business to access foreign capital and technology;
- Rules to reduce potential double taxation, which can deter investment; and
- Providing greater tax certainty to taxpayers in both jurisdictions.

1.14 Importantly, the Convention also includes OECD/G20 BEPS treaty-related recommendations, in line with Australia’s ongoing commitment to tackling international tax avoidance practices.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
The Convention has the force of law in Australia.	Not applicable.

Detailed explanation of new law

1.15 These amendments list the ‘Israeli Convention’ as a current agreement that is given the force of law by the Agreements Act 1953. *[Schedule 1, item 2, subsection 5(1) (table item relating to Convention) of the Agreements Act 1953]*

1.16 The effect of this listing is that the provisions of the Convention are incorporated into the Assessment Acts and the FBT Act, and are prioritised over the other provisions of those Acts (other than Part IVA of the ITAA 1936) or any imposition Acts to the extent of any inconsistency (see sections 4 and 4AA of the Agreements Act 1953).

1.17 The amendments define the ‘Israeli Convention’ as the Convention, and its protocol, entered into between the Government of Australia and the Government of the State of the Israel on 28 March 2019 in Canberra. [*Schedule 1, item 1, subsection 3AAA(1) (definition of Israeli Convention) of the Agreements Act 1953*]

1.18 The Convention is based on the OECD Model. Consistent with the way that Australia negotiates its tax treaties, the OECD Model Commentary is directly relevant to the interpretation of the equivalent provisions of the Convention.¹

1.19 The following section provides an overview of the provisions of the Convention. As the OECD Model Commentary explain the provisions of the Convention that are identical to the equivalent provision in the OECD Model, the overview focusses on the departures from the OECD Model that were agreed to by Australia and Israel.

1.20 Where particular provisions of the Convention are not explained in the following section, it is because those provisions are aligned with the equivalent provision in the OECD Model and their operation is explained by the OECD Model Commentary.

The Australia-Israel Convention

Title and preamble

1.21 The title and the preamble are a general statement of the object and purpose of the Convention. The title and preamble provide that the Convention is for: the elimination of double taxation concerning taxes on income; and, the prevention of tax evasion and avoidance, including through the provisions of the treaty.

1.22 As the title and preamble form part of the context of the Convention, they serve an important role in interpreting the provisions of the Convention. This is consistent with the general rule of treaty interpretation in Article 31(1) of the Vienna Convention on the Law of Treaties, which provides that a ‘treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.’

¹ The OECD Model and the OECD Model Commentary can be accessed online at: <https://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-20745419.htm>; and <https://www.oecd.org/tax/treaties/model-tax-convention-on-income-and-on-capital-2017-full-version-g2g972ee-en.htm>

Article 1 – Persons covered

1.23 Article 1 establishes that the Convention applies to all ‘persons’ who are residents of one or both of Australia and Israel. [*Article 1, paragraph 1*]

1.24 ‘Persons’ is defined to include an individual, company and any other body of persons. [*Article 3, subparagraph 1(f)*]

1.25 Article 1 helps to ensure that the benefits of the Convention for income derived by or through entities that are wholly or partly fiscally transparent (for example, certain partnerships and trusts) are granted in appropriate cases, but only to the extent that the income is treated as the income of a resident of Australia or Israel under their respective domestic laws. [*Article 1, paragraph 2*]

1.26 In the case of Australia, entities that are treated as wholly or partly fiscally transparent for Australian tax purposes include partnerships which are subject to Division 5 of Part III of the ITAA 1936 (but not corporate limited partnerships that are subject to Division 5A of Part III), and trusts which are subject to Division 6 of Part III of the ITAA 1936 where the beneficiary of the trust is presently entitled to the income and assessable accordingly (but not a public trading trust subject to Division 6C of Part III).

1.27 The reference to ‘income’ in this Article has a wide meaning, and is to be read as including ‘profits or gains’. [*Protocol, paragraph 2*] Using the term in this way is intended to put beyond doubt that the various forms of income that may be taxable in Australia are within scope of this Article.

1.28 Paragraph 3 confirms the general principle that the Convention does not restrict in any way Australia or Israel’s right to tax their own residents, except where this is intended. [*Article 1, paragraph 3*]

1.29 The paragraph lists the Articles of the Convention that affect the taxation of a resident of Israel or Australia. To the extent there are any differences between the Articles listed in this paragraph and the corresponding paragraph in the OECD Model it is because the Article in the Convention does not affect the taxation of a resident.

Article 2 – Taxes covered

1.30 Article 2 specifies that taxes on income are covered by Convention. Article 2 also specifies the existing taxes to which the Convention particularly applies to. [*Article 2*]

1.31 In Israel, these taxes are: the income tax and company tax (including tax on capital gains); the tax on gains from the alienation of property according to the Real Estate Taxation Law; and the Petroleum Profits Taxation Law. [*Article 2, subparagraph 3(a)*]

1.32 In Australia, these taxes are: the income tax; resources rent tax; and the fringe benefits tax. *[Article 2, subparagraph 3(b)]*

1.33 The Convention also applies to any identical or substantially similar taxes that Australia or Israel may implement domestically in the future. The competent authorities of Australia and Israel (the (Australian and Israeli tax authorities) are required to notify each other of any significant changes to their taxation laws. *[Article 2, paragraph 4]*

1.34 Article 2 departs slightly from the OECD Model to reflect that in Australia and Israel taxes on income are collected at the federal level and not by political subdivisions or local authorities. *[Article 2, paragraph 1]*

Article 3 – General definitions

1.35 Article 3 provides definitions of and rules of interpretation for basic terms and key concepts that are used throughout the Convention that apply for all purposes. Certain other terms are defined in other articles of the Convention, such as ‘resident of a Contracting State’ (Article 4) and ‘Permanent Establishment’ (Article 5).

1.36 The term ‘Israel’ means the State of Israel, inclusive of its territorial sea and adjacent maritime areas. *[Article 3, subparagraph 1(a)]*

1.37 The definition of ‘Australia’ in the Convention follows the model set out in Australia’s other modern tax treaties. The definition excludes all external territories, but adds back certain external territories by further exception. The definition includes areas adjacent to Australia (and the relevant Territories) which are subject to a domestic law dealing with the exploration for and exploitation of natural resources of the exclusive economic zone, or the seabed and subsoil of the continental shelf. *[Article 3, subparagraph 1(b)]*

1.38 The terms ‘a Contracting State’ and ‘the other Contracting State’ mean Australia and Israel and are used interchangeably to refer to Australia and Israel, as the context requires. *[Article 3, subparagraph 1(c)]*

1.39 The definition of ‘company’ in the Convention means any body corporate or any entity which is treated as a company or a body corporate for tax purposes. *[Article 3, Subparagraph 1(d)]*

1.40 This definition is broadly consistent with the definition in the OECD Model, which refers to any entity that is treated as a body corporate for tax purposes. The definition is adapted to reflect that Australia’s income tax laws do not use the expression ‘body corporate’.

1.41 The term ‘competent authority’ means the Commissioner of Taxation for Australia and the Minister of Finance for Israel, and their authorised representatives. *[Article 3, subparagraph 1(e)]*

1.42 The term ‘enterprise’ applies to the carrying on of any business. *[Article 3, subparagraph 1(f)]*

1.43 The term ‘business’ includes the performance of professional services and of other activities of an independent character. *[Article 3, subparagraph 1(k)]*

1.44 Consistent with the OECD Model, these definitions read together clarify that, under the Convention, business activities are considered to constitute an enterprise, regardless of the meaning of that term under domestic law.

1.45 The terms ‘enterprise of a Contracting State’ and ‘enterprise of the other Contracting State’ mean an enterprise carried on by a resident of Australia and Israel, and are used interchangeably to refer to Australia and Israel, as the context requires. *[Article 3, subparagraph 1(g)]*

1.46 The term ‘international traffic’ means any transport by a ship or aircraft, except when that transport is between points in a Contracting State, and the enterprise that operates the ship or aircraft is from the other Contracting State. *[Article 3, subparagraph 1(h)]*

1.47 This definition is used to preserve the right of a Contracting State to tax transportation that occurs domestically, even when it is carried out by an enterprise of the other State. The definition follows the alternative formulation to the standard OECD model that is provided for in paragraph 6.3 of the 2017 OECD Model Commentary on the definition.

1.48 The term ‘national’ means any individual possessing the nationality or citizenship of a Contracting State, and any legal person, company, partnership or association in accordance with a Contracting State’s domestic laws. *[Article 3, subparagraph 1(i)]*

1.49 The terms ‘person’ includes an individual, a company and any other body of persons. *[Article 3, subparagraph 1(j)]*

1.50 The term ‘tax’ means Australian tax or Israeli tax as the context requires, but excludes any penalty or interest imposed under Australia and Israel’s domestic laws. *[Article 3, subparagraph 1(l)]*

1.51 The taxes covered by the Convention are stipulated in Article 2 (Taxes Covered). The specific exclusion for penalties and interest is not contained in the OECD Model, but is a standard feature of Australia’s tax treaties. The exclusion reflects that penalties and interest are not treated as a tax under Australia’s income tax laws. As such, the Convention does not restrict the Commissioner of Taxation’s ability to levy penalties or interest where Australia has a right to tax, and Australia is not required to provide relief under the Convention for penalty or interest charges.

1.52 The term ‘recognised pension fund’ of a Contracting State extends the OECD Model definition to ensure that it applies appropriately to Australian superannuation funds. *[Article 3, subparagraph 1(m)]*

1.53 The changes ensure that Australian superannuation funds are covered by the definition, irrespective of the requirement that an entity or arrangement of a State be treated as a separate legal entity under the taxation laws of the State. This addition resolves the issue identified in paragraph 10.6 of the OECD Model Commentary on the definition, which recognises that in some States, a pension fund might not constitute a separate legal person.

1.54 The definition of recognised pension fund in the Convention also expands on the condition in subparagraph 1(m)(ii), which covers entities or arrangements that are established and operated exclusively to invest funds for entities or arrangements that provide retirement benefits. The extension covers the investment of a life insurance company's funds, to the extent those funds support retirement income products provided by the life insurance company. This extension reflects the fact that Australia's superannuation system also extends to life insurance companies.

1.55 A term not defined in the Convention has the same meaning that it has under the domestic law of the Contracting State applying the Convention. The definition of a relevant term under a Contracting State's taxation law has precedence over its meaning under other domestic laws.
[Article 3, paragraph 2]

Article 4 – Resident

1.56 Article 4 does not differ substantively from the corresponding Article in the OECD Model.

1.57 The Article provides a basic rule that defines the term 'resident' for the purposes of the Convention as any person who is liable to tax as a resident of Australia or Israel, or is liable to tax by reason of domicile, place of management, place of incorporation or any criterion of a similar nature. *[Article 4, paragraph 1]*

1.58 The Convention applies on the basis that a person is a resident of either Australia or Israel.

1.59 Article 4 contains a series of tie-breaker rules for determining the country of residence for an individual who is a resident of both Australian and of Israel under the basic residence rule.
[Article 4, paragraph 2]

1.60 The tie-breaker rules are based on the equivalent provision in the OECD Model. Consistent with the OECD Model, the rules apply hierarchically (for example, the second tie-breaker rule only applies if an individual's residence cannot be determined under the first rule). The final tie-breaker rule provides that the competent authorities of Australia and Israel shall endeavour to resolve the individual's residence by mutual agreement. *[Article 4, subparagraph 2(d)]*

1.61 The requirement to endeavour to determine an individual's residence by mutual agreement is a departure from the equivalent provision in the OECD model, which obliges the competent authorities to settle the question of residency.

1.62 Article 4 also contains a tie-breaker rule for persons other than individuals that are residents of both Australia and Israel under the basic residence rule. This rule provides that the competent authorities of Australia and Israel shall endeavour to determine by mutual agreement, which country the person is a resident of for the purposes of the Convention. In reaching such agreement, the competent authorities must consider the person's place of effective management, place of incorporation or constitution and any other relevant factors. If the competent authorities cannot agree on such persons' residence status, the dual-resident will not be considered a resident of either Australia or Israel for the purposes of the Convention, and will not be able to enjoy the benefits of the Convention. *[Article 4, paragraph 3]*

1.63 This tie-breaker rule is based on the equivalent provision in the OECD Model. However, in contrast to the OECD Model, the competent authorities are not authorised to agree to extend the benefits of the Convention to a person where they cannot agree on a person's residence status. This departure is aligned with Australia's position in respect of Article 4 of the *Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting*.

1.64 Although the Convention may deem certain dual-residents to not be Australian residents for the purposes of the Convention (either because they are treated as a resident of Israel, or residents of neither Australia nor Israel), such persons remain a resident for the purposes of Australian domestic tax law. This is because the residence rule in the Convention does not affect the characterisation of a person's residence under Australia's domestic law. Accordingly, such a person remains liable for taxation in Australia as a resident, insofar as is permitted under the Convention.

Article 5 – Permanent establishment

1.65 Article 5 introduces the concept of 'permanent establishment', which is used to determine the rights of a Contracting State to tax the profits of an enterprise of the other Contracting State. This concept is central to the operation of Articles 7 (Business profits), 10 (Dividends), 11 (Interest), 12 (Royalties), 13 (Alienation of property), 14 (Income from employment), 21 (Other income) and 24 (Non-discrimination).

1.66 Article 5 applies the primary definition of 'permanent establishment' in the OECD Model. The definition applies for the purposes of the Convention and provides that a 'permanent establishment'

is a fixed place of business through which an enterprise conducts its business. *[Article 5, paragraph 1]*

1.67 Article 5 also includes a non-exhaustive list of examples of places of business that constitute permanent establishments under paragraph 1. This list is based on the OECD Model but contains two variations. *[Article 5, paragraph 2]*

1.68 First, it expands the OECD Model example concerning a mine, an oil or gas well, a quarry or any other place of extraction of natural resources to include places of ‘exploration’ and ‘exploitation’ as permanent establishments under paragraph 1. *[Article 5, subparagraph 2(f)]*

1.69 This expansion reflects Israel’s reservation outlined in paragraph 198 of the OECD Model Commentary on Article 5. Its inclusion is also consistent with paragraph 48 of the OECD Commentary on Article 5.

1.70 Second, consistent with the majority of Australia’s other modern tax treaties, ‘permanent establishment’ is explicitly applied to agricultural, pastoral or forestry property. *[Article 5, subparagraph 2(g)]*

1.71 This reflects Australia’s policy to retain taxing rights over the use of Australian land for primary production activities.

1.72 Consistent with the OECD Model, Article 5 further holds that a building site or a construction or installation project constitutes a permanent establishment. However, the Convention reduces the OECD Model’s 12 month threshold for a site or project to be considered a permanent establishment to nine months. *[Article 5, paragraph 3]*

1.73 The truncation of the 12 month threshold to nine months further bolsters Australia’s source-based taxation rights concerning its natural resources.

1.74 Article 5 deems three additional activities as permanent establishments, in line with Australia’s reservations on Article 5 of the OECD Model Commentary. *[Article 5, paragraph 4]*

1.75 First, Article 5 deems supervisory or consultancy activities connected to a building site or construction or installation project (exceeding 183 days in any 12 month period) to be a permanent establishment. *[Article 5, subparagraph 4(a)]*

1.76 This is consistent with Australia’s reservation to Article 5, set out in paragraph 202 of the OECD Model Commentary for Article 5.

1.77 Second, Article 5 deems natural resource activities exceeding 90 days in any 12 month period to be a permanent establishment. *[Article 5, subparagraph 4(b)]*

1.78 This provision preserves Australia's ability to tax profits arising from activities connected to Australian natural resources and is consistent with Australia's reservation to paragraph 1 of Article 5 of the OECD Model, as noted in paragraph 188 of the OECD Model Commentary. The rule establishes a duration test expressed as a period or periods exceeding, in aggregate, 90 days in and 12 month period.

1.79 Finally, Article 5 provides that the operation of substantial equipment for a period exceeding 183 days in any 12 month period is a permanent establishment. *[Article 5, subparagraph 4(c)]*

1.80 Australia sought the inclusion of this provision to cover situations where income is derived from the use of such equipment in Australia by an Israeli enterprise, and vice versa.

1.81 In this subparagraph, the term 'operates' means the active use of substantial equipment by a foreign enterprise in a Contracting State. *[Article 5, subparagraph 4(c)]*

1.82 The threshold of 'substantial' equipment is determined on the relevant facts and circumstances of each individual case. *[Article 5, subparagraph 4(c)]*

1.83 Article 5 further sets out rules for aggregating the time spent on particular projects by closely related enterprises for the purpose of paragraphs 3 and 4. *[Article 5, paragraph 5]*

1.84 These provisions prevent enterprises from circumventing the permanent establishment time thresholds by splitting.

1.85 These provisions are consistent with paragraph 52 of the OECD Model Commentary for Article 5, which notes that the time threshold has been the subject of some abuse, and that although contract splitting activities may fall within the scope of anti-avoidance rules, "...some States may nevertheless wish to deal expressly with such abuses".

1.86 Article 5 also contains a list of preparatory or auxiliary activities that are exceptions to the general definition of permanent establishment in paragraph 1 of Article 5. These exceptions are subject to an anti-fragmentation rule that applies where business operations are split between locations *[Article 5, paragraphs 6 and 7]*

1.87 These exceptions are consistent with the equivalent provision in the OECD Model.

1.88 Article 5 also deems a permanent establishment to exist where a person, other than an independent agent, acts on behalf of an enterprise, even though the enterprise may not have a fixed place of business (within the meaning of paragraphs 1 and 2) in a Contracting State, under stipulated conditions. *[Article 5, paragraph 8]*

1.89 The conditions set out in the Convention are consistent with those of the OECD Model, with the exception of subparagraph 8(b) which extends the Article to cover situations where a person acts on behalf of another in the manufacturing or processing of goods or merchandise.

[Article 5, subparagraph 8(b)]

1.90 This variation prevents an enterprise that undertakes manufacturing or processing activities in a country through an intermediary from avoiding tax in that country. Its inclusion reflects Australia's reservation to Article 5 of the OECD Model outlined at paragraph 188 of the OECD Model Commentary on Article 5. This reflects Australia's policy to retain taxing rights over profits from manufacturing or processing activities conducted in Australia on behalf of others, particularly in relation to mineral resources.

1.91 Paragraph 12 is an Australian specialty and there is no equivalent in the OECD Model. It provides that the principles set out in Article 5 apply when determining whether a permanent establishment exists in a third country, or a third country enterprise has a permanent establishment in Australia or Israel. This is particularly the case when applying the source rules in Articles 11(7) (Interest) and 12(5) (Royalties).

[Article 5, paragraph 12]

Article 6 – Income from immovable property

1.92 Consistent with the OECD Model, Article 6 states that 'immovable property' is defined in accordance with the laws of the country in which it is located. Immovable property includes, for example, leases and other interests in or over land, livestock and equipment used in agriculture and forestry. The Convention adds to this definition to clarify that the right to explore or mine for mineral, oil or gas deposits or other natural resources are also immovable property, and that these rights and interests are located in the country where the exploration or mining may take place. *[Article 6, paragraphs 2 and 3]*

1.93 These provisions enhance Australia's ability to tax income generated by Israeli residents from mining interests and rights located in Australia.

1.94 Article 6 further establishes that income generated by a resident of one state from immovable property located in the other state may be taxed in that other state. *[Article 6, paragraph 1]*

1.95 This includes income from the direct use, leasing of, or use in any other form, of immovable property, as well as income from the immovable property of an enterprise. *[Article 6, paragraph 4 and 5]*

1.96 Some of Australia's tax treaties exclude profits of an enterprise from agriculture or forestry from the operation of this Article. Such profits are generally dealt with under Article 7 (Business Profits) of Australia's

tax treaties. Under this Convention, the allocation of taxing rights over such profits is determined by Article 6. Accordingly, profits from the relevant activities may be taxed in Australia where the immoveable property is situated in Australia, irrespective of whether the enterprise has a permanent establishment in Australia.

1.97 In the case of agriculture and forestry activities, an enterprise would in any event generally have a permanent establishment in the country in which the property is situated.

Article 7 – Business profits

1.98 Article 7 provides for the taxation of business profits. The Article is based on the OECD Model text of Article 7 and its Commentary as they read before 22 July 2010. This approach is consistent with Australia’s reservation to Article 7 of the OECD Model outlined in paragraph 99 of the OECD Commentary on Article 7.

1.99 The Article provides that the business profits of a resident of one country may only be taxed in the other country if those profits are attributable to the carrying on of a business through a permanent establishment, as defined in Article 5 (Permanent Establishment), in that other country. *[Article 7, paragraph 1]*

1.100 The profits of a permanent establishment are to be determined for the purposes of this Article on the basis of arm’s length dealings. *[Article 7, paragraph 2 and 3]*

1.101 The Convention modifies a number of the standard OECD Model provisions to clarify the way the arm’s length principle is to be applied. These provisions are consistent with corresponding provisions in Australia’s other tax treaties, and with internationally accepted concepts more generally.

1.102 The Convention supplements the standard OECD Model reference in paragraph 2 of Article 7 to a permanent establishment ‘dealing wholly independently with the enterprise of which it is a permanent establishment’, so that it also includes a reference to ‘other enterprises with which it deals’. *[Article 7, paragraph 2]*

1.103 This addition recognises that the permanent establishment of an enterprise also has dealings with other enterprises, and ensures that in working out the profits that are attributable to the permanent establishment, those dealings must also be on an arm’s length basis.

1.104 The Convention also supplements the standard reference in paragraph 3 of Article 7 to the expenses of an enterprise that must be allowed as deductions. In addition to being expenses incurred for the purposes of the permanent establishment, the expenses must be ones that would be deductible if the permanent establishment were an independent entity which paid those deductions. *[Article 7, paragraph 2]*

1.105 The Convention contains an additional rule that preserves the operation of any domestic rules that Australia or Israel have for determining the tax liability of a person, provided that such laws are applied consistently with the principles of Article 7. *[Article 7, paragraph 4]*

1.106 This provision is a standard feature of Australia's tax treaties, and puts beyond doubt that domestic rules that apply the arm's length principle can be relied upon to determine a person's tax liability.

1.107 The Protocol to the Convention also clarifies that the reference to 'income' in paragraph 6 of Article 7 has a wide meaning, and includes profits and gains. *[Protocol, paragraph 2]*

1.108 Article 7 also contains a provision that excludes profits from any form of an insurance business from the application of Article 7. *[Article 7, paragraph 7]*

1.109 This exclusion means that Australia and Israel retain the right to tax the income of non-resident insurers and re-insurers under their respective domestic laws. The provision is consistent with Australia's reservation to Article 7 of the OECD Model, and preserves the application of Division 15 of Part III of the ITAA 1936 (Insurance with non-residents).

1.110 Article 7 contains a further rule to ensure that the Article applies appropriately to business profits that a resident of Australia or Israel derives through one or more interposed trust estates. This rule specifies that such a resident is deemed to have carried on the business of the trust through a permanent establishment located in the other country. *[Article 7, paragraph 8]*

1.111 This provision is consistent with Australia's reservation to Article 7 of the OECD Model, and ensures that Article 7 does not prevent Australia from taxing the beneficiary of a trust estate on the basis that the trustee, rather than the beneficiary, is the entity that has a permanent establishment in Australia.

1.112 In the course of negotiations, Australia and Israel agreed that this provision was designed to ensure that Australia could continue to tax the beneficiaries of a trust estate. It was also agreed that the provision did not restrict Israel's ability to continue to tax a trust according to its laws (for example, the provision does not infer that the trust no longer carries on a business or that it does not have a permanent establishment). *[Protocol, paragraph 3]*

1.113 Article 7 also provides a general seven year limit on the time that Australia and Israel can adjust the profits that are attributable to a permanent establishment. The seven year limit applies from the end of the taxable period in which the profits would have been attributable to the permanent establishment. The limit does not apply on a finding of fraud, gross negligence or wilful default, or where an audit has commenced in

relation to the profits of the enterprise within a period of 10 years from the end of the taxable year in which the profits would have been attributable to the permanent establishment *[Article 7, paragraph 9]*

1.114 This provision is based on the wording recommended in paragraph 39 of the BEPS Action 14 2015 Final Report as an alternative provision for inclusion in the OECD Model Commentary on Article 7 of the OECD Model. The seven year period is broadly consistent with the general limitation period that applies for transfer pricing adjustments in respect of permanent establishments under Subdivision 815-C of the ITAA 1997.

Article 8 – Shipping and air transport

1.115 Article 8 provides that profits from international shipping or air transport are taxable only in the country of residence of the operator. *[Article 8, paragraph 1]*

1.116 Notwithstanding the general rule in paragraph 1, Article 8 also stipulates that profits from international shipping or air transport activities, including from leased containers used in such activities, may be taxed in the other country where the transport and offloading occurs within that other country. *[Article 8, paragraphs 2 and 4]*

1.117 This approach to the coverage of the profits from domestic sea and air transportation, which gives effect to source-country taxing rights over internal traffic, is endorsed in OECD Model Commentary.

1.118 The provisions of Article 8 also apply to profits from the participation in a pool, joint business or an international operating agency. *[Article 8, paragraph 3]*

Article 9 – Associated enterprises

1.119 Article 9 deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies under common control) on other than arm's length terms.

1.120 This Article would 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.

1.121 Paragraphs 1 and 3 of the Convention's Article 9 are paragraphs 1 and 2 respectively of the OECD Model. Amendments to the wording reflect Australia's consistent treaty practice. *[Article 9, paragraphs 1 and 3]*

1.122 The term 'might be expected to operate' in paragraph 1 is included to broadly conform to Australia's treaty practice and allows

adjustments where it is not possible to determine the conditions that ‘would have been made or occurred’ between the associated enterprises.

1.123 These wording variations address Australia’s concerns that the appropriate benchmark for determining the conditions that exist, or are made or imposed, between associated enterprises should have regard to whether those dealings between the enterprises occurred on a truly independent basis. [*Protocol, paragraph 4*]

1.124 Paragraph 2 is a departure from the OECD Model. IT preserves the application of Australia’s domestic transfer pricing rules. This is consistent with Australia’s reservation to the OECD Model’s Article 9 in the OECD Model Commentary. [*Article 9, paragraph 2*]

1.125 Paragraph 4 is an Australian specialty that imposes a seven year application limitation to initiate transfer pricing adjustments, unless there is fraud, gross negligence or wilful default. [*Article 9, paragraph 4*]

Article 10 – Dividends

1.126 Article 10 allocates taxing rights over dividends paid between Australia and Israel.

1.127 The Article follows the standard OECD Model approach of generally permitting source based taxation of a dividends paid by a resident company of one country to a resident of the other country. [*Article 10, paragraph 1*]

1.128 The Article also provides that:

- certain cross-border intercorporate dividends are subject to a maximum 5 per cent rate of tax in the source country;
- dividends beneficially owned by a Government or a recognised pension fund (derived from complying superannuation activities) are not taxable in the source country;
- a maximum 15 per cent rate of tax in the source country may be applied on all other dividends, and to distributions from Israeli Real Estate Investment Trusts (REIT);
- 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 extraterritorial application by either country of taxing rights over dividend income is not permitted.

Definition of ‘dividend’

1.129 The term ‘dividend’ is defined in the Article as:

- income from shares or other rights, not being debt-claims, participating in profits; and
- other amounts that are subject to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident for the purposes of its tax.

[Article 10, paragraph 5]

1.130 This definition is based on the equivalent provision in the OECD Model, but contains three key variations.

1.131 First, the definition does not refer to ‘jouissance’ shares or rights, as the term is not used in Australia or Israel’s domestic tax laws.

1.132 Second, the definition uses the term ‘other amounts’ instead of ‘income from other corporate rights’. This removes any doubt as to whether the definition can be applied to certain deemed dividends that might not be characterised as ‘income’ (such as bonus shares and certain capital distributions), as well as to distributions from certain non-corporate entities (such as deemed dividends received from trusts).

1.133 Finally, the reference to ‘for the purposes of its tax’ in respect of the residence of the company making a distribution is intended to ensure that the domestic law characterisation of a company as a resident of a country is retained, even where the general residence tie-breaker rule would ordinarily prevent the company from being the resident of that country for the purposes of the treaty. This rule ensures that the correct tax laws are used to define the meaning of ‘dividend’ when applying the dual-resident company rule in paragraph 8 of Article 10.

1.134 The Protocol to the Convention also specifies that the term ‘dividend’ does not include ‘distributions by an Israeli REIT’. *[Protocol, subparagraph 5(b)]*

1.135 This reflects that distributions by Israeli REITs are specifically dealt with in the Article.

Maximum rates of withholding tax

1.136 The Article sets the standard maximum rates of taxation for the country in which a dividend is sourced. These rates are 5 per cent for certain intercorporate dividends, and 15 per cent for other dividends, and are based on the standard approach in the OECD Model. *[Article 10, paragraph 2]*

1.137 For the 5 per cent rate for intercorporate dividends to apply, the beneficial owner of the dividends must be a company that directly holds at least 10 per cent of the voting power in the company paying the dividends throughout a 365 day period that includes the day that the dividends are paid. *[Article 10, subparagraph 2(a)]*

1.138 This holding period requirement differs from the holding period requirements that are included in some of Australia's existing tax treaties, which generally require the holding period to be satisfied at the time the dividend is declared. In contrast, the holding period in Article 10 of the Convention can be for any 365 day period that includes the day of the payment of the dividends. Thus, under paragraph (2)(a) of Article 10, the holding period may straddle the dividend payment date. This approach is consistent with the approach in the OECD Model.

1.139 However, in contrast to the OECD Model, Article 10 of the Convention uses a minimum of 10 per cent voting power in a company (instead of 25 per cent of the capital) as the threshold for determining when the intra-corporate dividend rate applies. The focus on voting power is Australia's consistent treaty practice, and has previously been endorsed by the OECD (see, for example, paragraph 15 of the Commentary to Article 10 of the 2008 OECD Model).

1.140 Consistent with Australia's reservation to paragraph 2 of Article 10 of the OECD Model, the Convention does not contain a provision authorising the competent authorities of Australia or Israel to settle, by mutual agreement, the mode of application of the limits in paragraph 2.

Israeli Real Estate Investment Trusts

1.141 Article 10 of the Convention makes specific provision for Israeli REITs. These provisions provide distributions from Israeli REITs to Australian residents with treatment equivalent to that which applies to general dividend payments (that is, a maximum rate of taxation of 15 per cent by Israel). *[Article 10, paragraph 3]*

1.142 For the purposes of Article 10, an 'Israeli REIT' is defined in the Protocol to the Convention as a 'Real Estate Investment Fund' according to Article 64A2 of the Israeli Income Tax Ordinance. *[Protocol, subparagraph 5(a)]*

Exemption for Governments and recognised pension funds

1.143 Article 10 of the Convention also provides an exemption from source country taxation for certain dividends that are beneficially owned by a government, or recognised pension fund, of Australia or Israel.

1.144 Dividends which are beneficially owned by Australia or Israel, or one of their political subdivisions or local authorities (including a government investment fund), are not taxable in the source country if they hold no more than 10 per cent of the voting power in the company paying the dividends. *[Article 10, subparagraph 4(a)]*

1.145 The 10 per cent threshold ensures that the exemption only applies where the beneficial owner of the dividends holds a portfolio

interest in the company paying the dividends, and is consistent with Australia's long-standing practice in respect of sovereign immunity.

1.146 The exemption also applies to the central banks of Australia and Israel (the Reserve Bank of Australia and the Bank of Israel, respectively), and to the recognised pension funds of Australia and Israel. [*Article 10, subparagraphs 4(b) to (d)*]

1.147 The Protocol to the Convention also clarifies that dividends are regarded as being derived by Australia or Israel (or one of their political subdivisions, local authorities or government investment funds) if the dividends are derived from the investment of monies that are and will remain public funds. [*Protocol, paragraph 6*]

1.148 The requirement that the invested monies (for example, the monies that were used to acquire shares in respect of which the dividends are paid) remain public monies ensures that the benefits of the exemption do not flow to individuals acting in a private capacity.

1.149 The exemption for recognised pension funds of Israel applies to a fund of Israel whose income is exempt from tax in Israel. The exemption for recognised pensions funds of Israel also extends to residents of Israel that derive the dividends in respect of a pension plan that has been approved as a Provident Fund under the Control of Financial Services Act (Provident Funds) 2005. Consistent for the requirements of Israeli pension funds, the dividends derived in respect of a Provident Fund must not be taxed in Israel. [*Article 10, subparagraph 4(d)*]

1.150 The exemption for recognised pension funds of Australia applies where the fund derives dividends from the carrying on of complying superannuation activities. The exemption also applies to another resident of Australia that carries on such activities. This extension recognises that Australia's superannuation system extends to other entities, such as life insurance companies. [*Article 10, subparagraph 4(c)*]

1.151 The exemption for dividends beneficially owned by Australian pension funds does not require the dividends to be exempt from tax in Australia. This approach reflects that Australian superannuation funds have concessional tax arrangements (which can include tax exemptions), but not full tax exemptions in all cases.

Dividends effectively treated as business profits

1.152 Paragraphs 1, 2, 3 and 4 of Article 10 do not apply to dividends that are effectively connected with a permanent establishment of the beneficial owner of the dividends that is located in the country where the dividends are sourced. The taxation of such dividends is instead dealt with by Article 7 (Business Profits). [*Article 10, paragraph 6*]

1.153 This exception is based on the OECD Model, but adapted so that it also applies to Israeli REITS.

Extra-territorial taxation precluded

1.154 Article 10 limits the extra-territorial application, by either Australia or Israel, of taxing rights over dividend income. Broadly, a country is precluded from taxing dividends paid by a company that is a resident solely of the other country, unless:

- The person that derives the dividends is a resident of the first country; or
- The shareholding that gives rise to the dividends is effectively connected with a permanent establishment in the first country.

[Article 10, paragraph 7]

1.155 This provision ensures that source country taxation does not extend to the distribution of profits, which may already be taxed in accordance with the provisions of the Convention, to the company's shareholders that are unconnected to the source country. The provision is based on the OECD Model but contains two deviations.

1.156 First, the provision is adapted so that it also applies to distributions made by Israeli REITS.

1.157 Second, the reference to dividends being 'beneficially owned' by a resident replaces the standard OECD approach that requires the dividends to be 'paid' to a resident. This approach ensures that the limitation applies appropriately where the recipient of the dividend payments is not the beneficial owner.

1.158 The Protocol to the Convention also clarifies the understanding that was reached in negotiations on paragraph 7, that the reference to the beneficial owner of the dividends does not oblige Australia or Israel to provide a benefit under the convention for taxation by the other country of dividends that are not paid, but are beneficially owned, by a resident of that other country. *[Protocol, subparagraph 5(c)]*

Tie-breaker preservation rule

1.159 The limitation on extra-territorial taxation does not apply to dividends that are paid by a dual-resident company that is deemed to be a resident only of Australia or Israel because of the residency tie-breaker rule in Article 4 (Resident). Where such dividends are beneficially owned by a resident of the country to which the dual-resident company's residency was allocated under the treaty, Article 10 applies as though the dual-resident company was a resident of the other country. *[Article 10, paragraph 8]*

1.160 The effect of this rule is that the country of source can continue to tax dividends paid by a dual-resident company whose residency is allocated to the other country. Australia's consistent treaty practice is to

include this provision to prevent dual-resident companies being established in Australia to allow untaxed Australian profits to be paid to shareholders resident in a treaty partner country or a third country, without any Australian tax at either the company or shareholder level.

Article 11 – Interest

1.161 Article 11 allocates taxing rights over interest paid between Australia and Israel.

1.162 The Article follows the standard OECD Model approach of generally permitting source based taxation of interest paid between residents of each country. *[Article 11, paragraph 2]*

1.163 The Article also provides that:

- interest derived by financial institutions and recognised pension funds is subject to a maximum 5 per cent rate of tax in the source country;
- interest derived by a Government is generally exempt from tax in the source country;
- a maximum 10 per cent rate of tax in the source country may be applied to other interest payments;
- interest paid in respect of a debt-claim that is effectively connected with a permanent establishment are to be dealt with under Article 7 (Business Profits);
- interest is generally deemed to arise in the payer’s country of residence; and
- the concessional arrangements for interest only apply to the amount that would be expected to be paid under arm’s length dealing between independent parties.

Definition of ‘interest’

1.164 The term ‘interest’ is defined in the Article as:

- income from debt-claims of every kind (whether or not secured by a mortgage and whether or not carrying a right to participate in the debtor’s profits);
- income from government securities;
- income from bonds and debentures; and
- income which is subjected to the same taxation treatment as income from money lent by the law of the source country.

[Article 11, paragraph 5]

1.165 This definition is based on the equivalent provision in the OECD Model but extends that definition to include income that is subjected to the ‘same taxation treatment as income from money lent’ by the law of the source country. This extension ensures that income that is effectively treated as interest under a State’s domestic law is dealt with by Article 11, and is consistent with Australia’s reservation to Article 11 of the OECD Model outlined in paragraph 45 of the OECD Model Commentary on Article 11.

Maximum rates of withholding tax

1.166 The Article sets the standard maximum rates of taxation for the country in which interest arises. These rates are 5 per cent of the gross amount of interest derived by a financial institution or recognised pension fund, and 10 per cent of the gross amount of interest in other cases.

[Article 11, paragraph 2]

5 per cent rate for financial institutions

1.167 A maximum 5 per cent rate of source country taxation applies to the gross amount of interest derived by a financial institution, which is unrelated to and deals wholly independently with the payer, provided the financial institution is a resident of the other country and is the beneficial owner of the interest.

1.168 The reduced rate recognises that the general 10 per cent source country tax rate on gross interest can be excessive given the cost of their funds.

1.169 For the purposes of this Article, 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 a business of providing finance. *[Article 10, subparagraph 2(a)]*

1.170 The Protocol to the Convention clarifies that the term ‘financial institution’ does not include an insurance company, a ‘lending fund’, a corporate treasury or a member of a group that performs the financing services of the group. *[Protocol, paragraph 7]*

1.171 The term ‘lending fund’ refers to an entity that is formed by investors and has the primary purpose of making investments through interest bearing loans. *[Protocol, paragraph 7]*

1.172 This clarification was included at Israel’s request. In the course of negotiations, Israel advised that they had not previously agreed to a concessional rate for financial institutions, and requested that the Convention make it clear that the concessional rate did not apply to entities that were established primarily using private funds.

1.173 Such funds would not ordinarily fall within the definition of ‘financial institution’, which requires debt to be financed through the financial markets or from deposits. However, the specific reference to a lending fund puts this position beyond doubt.

1.174 The reduced rate for financial institutions is not available for interest paid as part of an arrangement involving back-to-back loans, or arrangements that are economically equivalent and intended to have a similar effect. *[Article 10, subparagraph 2(a)]*

1.175 The restriction for such arrangements is directed at preventing related party and other debt from being structured through financial institutions to gain access to the concessional rate under the Convention. The restriction applies to any interest paid on the component of a loan that is considered to be back-to-back. In such cases, the general 10 per cent rate limit applies.

1.176 An example of a back-to-back arrangement is a transaction or series of transactions structured in such a way that:

- an Israeli financial institution receives or is credited with an item of interest arising in Australia; and
- the financial institution pays or credits, directly or indirectly, all or substantially all of that interest (at any time or in any form, including commensurate benefits) to another person who, if it received the interest directly from Australia, would not be entitled to similar benefits with respect to that interest.

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

5 per cent rate for recognised pension funds

1.178 Consistent with the exemption from dividend withholding tax in Article 10 (Dividends), the 5 per cent rate for recognised pension funds of Israel applies to a fund of Israel whose income is exempt from tax in Israel. The reduced rate for recognised pensions funds of Israel also extends to residents of Israel that derive the interest in respect of a pension plan that has been approved as a Provident Fund under Israel’s Control of Financial Services Act (Provident Funds) 2005. Consistent with the requirements of Israeli pension funds, the interest derived in respect of a Provident Fund must not be taxed in Israel. *[Article 11, subparagraph 2(b)(ii)]*

1.179 Similarly, the reduced rate of withholding for recognised pension funds of Australia applies where the fund derives interest from the carrying on of complying superannuation activities. The reduced rate also applies to another resident of Australia that carries on such activities. This extension recognises that Australia’s superannuation system extends

to other entities, such as life insurance companies. *[Article 11, subparagraph 2(b)(i)]*

1.180 The reduced rate of withholding for interest derived by Australian pension funds does not require the interest to be exempt from tax in Australia. This approach reflects that Australian superannuation funds have concessional tax arrangements (which can include tax exemptions), but not full tax exemptions in all cases.

1.181 The reduced rate does not apply to a recognised pension fund, or to another that can access the reduced rate, where the beneficial owner of the interest is able to control or influence the key decision-making of the issuer of the debt-claim. *[Article 11, paragraph 4]*

1.182 This restriction ensures that the reduced rate is only applicable where the beneficial owner of the interest is an arm's length lender who does not play an active role in the management or operation of the entity paying the interest. This reflects that the reduced rate is intended to apply to 'passive' investments by the lender, which exclude debt arrangements that convey special rights or obligations, or that are entered into where the lender plays an active role in the other entity because of some other arrangement (such as a substantial shareholding).

Exemption for Governments

1.183 Article 11 of the Convention also provides an exemption for interest that arises in either Australia or in Israel, and that is beneficially owned by the other country or one of their political subdivisions or a local authority (including a government investment fund). *[Article 11, paragraph 3]*

1.184 The exemption also applies to interest that is beneficially owned by the central banks of Australia and Israel (the Reserve Bank of Australia and the Bank of Israel, respectively). *[Article 11, paragraph 3]*

1.185 Consistent with the restriction on the concessional rate that applies to recognised pension funds, the exemption from source based taxation does not apply where the beneficial owner of the interest is able to control or influence the key decision-making of the issuer of the debt-claim. *[Article 11, paragraph 4]*

1.186 This restriction is consistent with the scope of Australia's domestic sovereign immunity rules, which are limited to the passive investments.

1.187 The Protocol to the Convention also clarifies that interest is regarded as being derived by Australia or Israel (or one of their political subdivisions, local authorities or government investment funds) if the interest is derived from the investment of monies that are and will remain public funds. *[Protocol, paragraph 6]*

1.188 The requirement that the invested monies (for example, the monies lent to the borrower under a loan arrangement) remain public monies ensures that the benefits of the exemption do not flow to individuals acting in a private capacity.

Interest effectively treated as business profits

1.189 Paragraphs 1, 2, 3, and 4 of Article 11 does not apply to interest that is effectively connected with a permanent establishment of the beneficial owner of the interest that is located in the country where the interest arises. The taxation of such interest is instead dealt with by Article 7 (Business Profits). *[Article 11, paragraph 6]*

1.190 This exception is consistent with the OECD Model.

Deemed source of interest

1.191 Article 11 contains a rule that generally deems interest to arise in the country in which the payer is a resident. *[Article 11, paragraph 7]*

1.192 This deeming rule is based on the equivalent provision in the OECD Model.

1.193 However, the provision in the Convention contains an additional rule that deems interest to arise in the country that a dual-resident payer is deemed to be *not* a resident of because of paragraphs 2 or 3 of Article 4 (Resident). This rule only applies where the interest is allowed as a deduction for the payer in that country against income that is also derived in that country. *[Article 11, paragraph 7]*

1.194 This extension is consistent with Australia's long-standing treaty practice of retaining source based taxing rates over certain interest paid by dual-residents whose residency is allocated to another country because of the residency tie-breaker rules in Article 4 (Resident). The provision follows a different formulation to that generally used in Australia's tax treaties as it refers to instances where the payer of the interest receives a deduction for the payment against their other Australian income. The provision does not apply where the payer does not receive an offsetting deduction for the payment.

1.195 Neither of the above deemed source rules apply to interest payments that are an expense of a person that is incurred in carrying on a business through a permanent establishment. In such cases, the interest is deemed to arise in the country in which the permanent establishment is situated. *[Article 11, paragraph 7]*

1.196 This provision is based on the equivalent provision in the OECD Model. However, in contrast to the OECD Model, the provision in the Convention is not limited to permanent establishments that are located in the Contracting States (that is, Australia or Israel). As such, interest can be

deemed to arise in a third country where it is connected to a permanent establishment of the payer in such a country.

Related persons

1.197 Article 11 contains a general safeguard against payments of excessive interest where a special relationship exists between the parties to a loan transaction (or between those parties and some other person). In such cases, the beneficial treatment provided by Article 11 is limited to the amount of interest that would have been expected to have been agreed to if the parties to the loan arrangements were dealing at arm's length. Any excess part of the interest continues to be taxable according to the domestic laws of Australia and Israel and the other provisions of the Convention. *[Article 11, paragraph 8]*

1.198 This provision is based on the equivalent provision in the OECD Model. The provision contains a minor departure clarifying that the 'beneficial owner' referred to in the OECD Model is the owner of the interest. This clarification does not affect the substantive operation of the provision.

Article 12 – Royalties

1.199 Article 12 allocates taxing rights over royalties paid or credited between Australia and Israel.

1.200 In contrast to the OECD Model, which allocates taxing rights over royalties on an exclusive residency basis, Article 12 of the Convention also permits source based taxation of royalties that arise in Australia or in Israel. *[Article 12, paragraphs 1 and 2]*

1.201 The Article provides that:

- royalties that arise in Australia or Israel and that are beneficially owned by a resident of the other country may be subject to a maximum 5 per cent rate of tax in the country in which they arise;
- royalties that are effectively connected with a permanent establishment of the beneficial owner are to be dealt with under Article 7 (Business Profits);
- royalties are generally deemed to arise in the payer's country of residence; and
- the concessional arrangements for royalties only apply to the amount that would be expected to be paid or credited under arm's length dealing between independent parties.

Definition of 'royalty'

1.202 The definition of 'royalty' in the Article expands on the equivalent definition in the OECD Model.

1.203 These extensions generally ensure that the definition in the Convention is aligned with the definition in Australia's domestic income tax law. As a result of these changes, the definition in Article 12 to the Convention is structured differently to that in the OECD Model.

1.204 In contrast to the OECD Model, which refers to payments that are received as consideration, the definition in the Convention expands on the reference to payments so that the definition applies to 'payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration'. [Article 12, paragraph 3]

1.205 The definition of royalty in the Convention includes payments or credits made as consideration for:

- the use of, or right to use, intellectual property, as well as the supply of any assistance that is ancillary and subsidiary to such use;
- the supply of scientific, technical, industrial or commercial knowledge or information, as well as the supply of any assistance that is ancillary and subsidiary to such use;
- the use of, or right to use, motion picture films, or any tapes or discs, or any other means of reproduction or transmission;
- the use of, or right to use, radiofrequency spectrum;
- the use of, or right to use, industrial, commercial or scientific equipment; or
- not supplying or granting another person any property or right that is covered by the definition.

[Article 12, paragraph 3]

1.206 In contrast to the part of the definition in OECD Model that refers to 'information concerning industrial, commercial or scientific experience', the definition of royalty in the Convention refers to the supply of such information or knowledge. [Article 12, subparagraph 3(b)]

1.207 This expanded reference ensures that the definition covers the full range of technical know-how that may be supplied as a royalty.

1.208 In contrast to the part of the definition in OECD Model that includes a general reference to 'artistic work... including cinematograph films', the definition in the Convention refers specifically to 'motion picture films and films or audio or video tapes or disks, or other means of image or sound reproduction or transmission for use in connection with television, radio or other broadcasting'. [Article 12, subparagraph 3(d)]

1.209 This expanded reference is included to ensure that this part of the definition is capable of being applied in the context of modern technological developments. This approach reflects Australia's consistent treaty practice. However, in practical terms, the general reference to 'artistic work' in the OECD Model is likely to include each of the specific extensions in this part of the definition.

1.210 The definition of royalty in the Convention also applies to payments or credits made for the use of, or right to use, the radio frequency spectrum specified in a spectrum licence. *[Article 12, subparagraph 3(e)]*

1.211 This provision is not included in the OECD Model. The provision commonly included in Australia's tax treaties and is aimed to preserve Australia's ability to tax payments (or credits) that arise in Australia for the use in Australia of any part of the radio frequency spectrum specified in an Australian spectrum licence. The extension also ensures that the definition of royalty in the Convention is aligned with Australia's domestic definition.

1.212 Article 12 also 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. *[Article 12, subparagraph 3(g)]*

1.213 This provision is not included in the OECD Model, and ensures that such payments are subject to tax as a royalty payment under the terms of this Article.

1.214 The Protocol to the Convention also clarifies that the term 'royalties' does not include payments or credits made as consideration for the use of any equipment used in the transport of goods or merchandise if such use is directly connected or ancillary to the operation of ships or aircraft in international traffic. In such cases, the provisions of paragraph 4 of Article 8 (Shipping and Air Transport) of the Convention apply. *[Protocol, paragraph 8]*

Royalties effectively treated as business profits

1.215 Article 12 does not apply to a royalty that is effectively connected with a permanent establishment of the beneficial owner of the royalty that is located in the country in which the royalty arises. The taxation of such royalties is instead dealt with by Article 7 (Business Profits). *[Article 12, paragraph 4]*

1.216 This exception is consistent with the OECD Model, but adapted to reflect that the definition of 'royalty' in the Convention also includes amounts that are 'credited'.

Deemed source of royalties

1.217 Article 12 contains a rule that generally deems royalties to arise in the country in which the payer is a resident. *[Article 12, paragraph 5]*

1.218 While there is no equivalent provision in Article 12 of the OECD Model, this deeming rule follows the provision that is included in Article 11 (Interest) of the Convention, which is based on the deeming rule for Article 11 (Interest) of the OECD Model.

1.219 The provision contains an additional rule that deems a royalty to arise in the country that a dual-resident payer is deemed to be *not* a resident of because of paragraphs 2 or 3 of Article 4 (Resident). This rule only applies where the royalty is allowed as a deduction for the payer in that country against income that is also derived in that country. *[Article 12, paragraph 5]*

1.220 This extension is consistent with Australia's long-standing treaty practice of retaining source based taxing rates over certain royalties paid by dual-residents whose residency is allocated to another country because of the residency tie-breaker rules in Article 4 (Resident). The provision follows a different formulation to that generally used in Australia's tax treaties as it refers to instances where the payer of the royalty receives a deduction for the payment against their other Australian income. The provision does not apply where the payer does not receive an offsetting deduction for the payment.

1.221 Neither of the above deemed source rules apply to royalties payments that are an expense of a person that is incurred in carrying on a business through a permanent establishment. In such cases, the royalty is deemed to arise in the country in which the permanent establishment is situated. *[Article 12, paragraph 5]*

1.222 As with the deeming rule for interest in Article 11 (Interest), royalties can be deemed to arise in a third country where they are connected to a permanent establishment of the payer in such a country.

Related persons

1.223 Article 12 contains a general safeguard against payments or credits of excessive royalties where a special relationship exists between the parties to a transaction (or between those parties and some other person). In such cases, the beneficial treatment provided by Article 12 is limited to the amount of royalties that would have been expected to have been agreed to if the parties to the arrangements were dealing at arm's length. Any excess part of the royalty continues to be taxable according to the domestic laws of Australia and Israel and the other provisions of the Convention. *[Article 12, paragraph 6]*

1.224 This provision is based on the equivalent provision in the OECD Model. The provision contains minor departures clarifying that the 'beneficial owner' referred to in the OECD Model is the owner of the royalty. The provision is also modified to reflect that the definition of royalty in the Convention extends to amounts that are credited. These modifications do not affect the substantive operation of the provision.

Article 13 – Alienation of property

1.225 Article 13 allocates taxing rights over income arising from the alienation of immovable property and moveable property. Paragraphs 1 to 4 of Article 13 align the equivalent provisions in the OECD Model.

1.226 The reference to ‘income’ in this Article has a wide meaning, and is to be read as including ‘profits or gains’. [*Protocol, paragraph 2*]

1.227 Using the term in this way is intended to put beyond doubt that a gain from the alienation of property, which in Australia may be income or a profit under ordinary concepts, is to be taxed in accordance with this Article.

1.228 Article 13 permits source based taxation of income from the alienation of immovable property by the country in which the property situated. [*Article 13, paragraph 1*]

1.229 The Article also permits source country taxation of income from the alienation of any shares or comparable interests (for example, in a partnership or trust) by a country. The provision only applies where, at any time during the 365 days preceding the alienation, more than half of the value of such interests related to immovable property located in that country. [*Article 13, paragraph 2*]

1.230 This rule is designed to deal with arrangements involving the effective alienation of incorporated immovable property, or like arrangements. It ensures that capital or revenue gains on disposal of a foreign resident’s interests in certain assets are taxable by Australia. Such treatment applies whether the immovable property is held directly or indirectly through a chain of interposed entities. The rule refers to ‘any shares’, whereas the OECD Model simply refers to ‘shares’. This expanded reference is intended to make it clear that the provision has the broadest possible application.

1.231 Article 13 permits source country taxation by a country of income from the alienation of moveable property that forms part of the business property of a permanent establishment located in that country. [*Article 13, paragraph 3*]

1.232 The Article also assigns exclusive residence based taxation for income that an enterprise that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or from movable property related to their operation. [*Article 13, paragraph 4*]

1.233 This provision aligns with the equivalent provision in the OECD Model. However, as noted above in respect of Article 3 (General Definitions), the definition of ‘international traffic’ used in this Convention is based on the alternative formulation provided in the OECD Model Commentary.

1.234 Article 13 contains a ‘sweep up’ rule that generally assigns exclusive taxing rights over an enterprise’s gains from the alienation of property that is not otherwise dealt with in the Article to the enterprise’s country of residence. *[Article 13, paragraph 5]*

1.235 This aspect of the sweep-up rule is based on the equivalent provision in the OECD Model. However, in contrast to the other provisions in Article 13 of the Convention, the sweep-up rule refers specifically to ‘gains’. This means that the broad reference to ‘income’ in Article 13 is not relevant to the sweep-up rule, which applies to a more limited class of ‘gains’. As such, any income or profits that are not also gains are dealt with as business profits under Article 7 (Business Profits), or as ‘other income’ under Article 21 (Other Income).

1.236 The sweep-up rule in the Convention also contains an exception that applies where the alienator of the property is not the beneficial owner of the gains. In such cases, the gains from the alienation of property may also be taxed in the country in which the property is situated. *[Article 13, paragraph 5]*

1.237 This exception is not contained in the OECD Model. It ensures that source country taxation can apply to gains that are made by a fiscally transparent entity such as a trust.

1.238 The Protocol also clarifies that the general allocation of taxation to a residence country does not restrict Australia or Israel’s ability to tax income, profits or gains that a person is treated as having derived up to the time of a change in residency. *[Protocol, paragraph 9]*

1.239 This ensures that Australia and Israel can tax their former residents on unrealised income, profits or gains that accrued up to the time they changed residency.

1.240 In addition, Article 13 does not affect Australia or Israel’s right to tax income from the alienation of property derived by a person who ceases to be a resident of their country in certain circumstances. This rule applies to a person that was a resident at any time during the year of income in which the property was alienated, or had been a resident at any times during the five preceding years. *[Article 13, paragraph 6]*

1.241 This provision preserves the operation of ‘exit taxes’ that are applied to a person who ceases to be a resident of Australia or Israel. However, the five year limit means that any exit taxes that apply after a person ceases to be a resident (for example, because they have deferred effect) cannot be applied after the time limit expires. In such cases, any income from the alienation of an asset that would otherwise be subject to an exit tax in the former country of residency is taxable in the new country of residency (subject to the other provisions of the Article).

Article 14 – Income from employment

1.242 Article 14 provides that income from employment (that is, salaries, wages and similar remuneration) earned by an individual may only be taxed in their state of residence. *[Article 14, paragraph 1]*

1.243 However, if the individual’s employment occurs in the other state, then their salary, wages or similar remuneration may be taxed in that state, subject to certain conditions and exceptions (or example in respect of short-term visits, employment on a ship or aircraft and fringe benefits). *[Article 14, paragraphs 1 to 4]*

1.244 Article 14 additionally allocates taxing rights of fringe benefits. The effect is that fringe benefits can only be taxed in the state that has been allocated the right, under the Convention, to tax income from the employment to which the fringe benefit relates. *[Article 14, paragraph 5]*

1.245 Article 14 expressly defers to the provisions of Articles 15 (Directors’ Fees), 17 (Pensions), 18 (Government Service) and 19 (Professors, Teachers and Researchers) that also concern salaries, wages and similar remuneration. *[Article 14, paragraph 1]*

Article 15 – Directors’ fees

1.246 Article 15 provides that the directors’ fees and other similar payments earned by a resident of one state may be taxed in the country of residence of the company receiving the directorship services. *[Article 15]*

Article 16 – Artistes and sportspersons

1.247 Article 16 provides that income earned by a resident of one state as an artiste (that is, an entertainer) or sportsperson in the other state, may be taxed in that other state. *[Article 16, paragraph 1]*

1.248 If income from an entertainer or sportsperson’s performance accrues to another person, it may be taxed in the state where the performance takes place, notwithstanding Articles 7 (Business Profits) and 14 (Income from Employment). *[Article 16, paragraph 2]*

1.249 However, the income of visiting entertainers and sportspersons is taxable only in the individual’s country of residence if the visit is supported wholly or mainly by public funds of the individual’s country of residence. *[Article 16, paragraph 3]*

1.250 This will foster publicly-funded artistic and sporting visits between Australia and Israel.

Article 17 – Pensions

1.251 Article 17 provides that pensions and other similar periodic remuneration may only be taxed in the recipient’s country of residence,

subject to the provisions of Article 18 (Government Service). [*Article 17, paragraph 1*]

1.252 However, if certain lump sum pension payments and other similar remuneration arise in the source state and are paid to a resident of the other state, the source state may tax the payment. Source state taxation only applies where the payment is made from a recognised pension fund, is made under a retirement benefit scheme, or in consequence of retirement, invalidity, disability or death, or by way of compensation for injuries. [*Article 17, paragraph 2*]

1.253 The Protocol to the Convention explains that the term ‘retirement benefit scheme’ means an arrangement that an individual participates in to secure retirement benefits. The Protocol also provides examples of such schemes in Australia, all of which are effectively treated as part of Australia’s superannuation. [*Protocol, paragraph 10*]

Article 18 – Government service

1.254 Article 18 provides that income (that is, salaries, wages and other similar remuneration) paid to an individual by a state for the individual’s government service are only taxable in that state. However, such income is taxable only in the other state, if the individual who earns the income is a resident of that state, provided they did not become a resident solely to render the services, or they are a national of that country. [*Article 18, paragraph 1*]

1.255 Government pensions and other similar remuneration are taxable only in the source country unless the person is both a resident and a national of the other country, in which case the pension is taxable only in the residence country. [*Article 18, paragraph 2*]

1.256 The Protocol to the Convention also clarifies that the term ‘pensions and other similar remuneration’ includes both periodic payments and lump sum payments. [*Protocol, paragraph 11*]

Article 19 – Professors, teachers and researchers

1.257 Article 19 was included at Israel’s request. It exempts from tax remuneration for teaching or research received by a professor, teacher or researcher who is resident of one state while they are teaching or engaging in research at an educational institution in the other state. This tax exemption applies for a period of two years or less. [*Article 19, paragraph 1*]

1.258 However, this exemption only applies to remuneration for research if it is undertaken in the public interest. [*Article 19, paragraph 2*]

Article 20 – Students

1.259 Article 20 provides that payments received from abroad by visiting students and business apprentices where those payments are made

for the purposes of their maintenance, education or training will not be taxed. *[Article 20]*

1.260 Payments received by visiting students or business apprentices from employment are covered by other Articles.

Article 21 – Other income

1.261 Article 21 provides for the taxation of any form of income that is not dealt with by the earlier Articles of the Convention.

1.262 Any such income that is beneficially owned by a resident of Australia or Israel is taxable only in that country, unless the income arises in the other country. Where the income arises in the other country, that country may also tax the income. *[Article 21, paragraph 1]*

1.263 This approach differs from that provided in the OECD Model, which allocates exclusive taxing rights on the basis of residency. The departure is consistent with Australia's reservation to the OECD Model.

1.264 Where income may be taxed in both countries in accordance with this Article, the country of residence of the beneficial owner of the income is obliged by Article 23 (Relief from Double Taxation) to provide double taxation relief.

1.265 The reference to income that is 'beneficially owned' by a resident is a further departure from the equivalent provision in the OECD Model. This departure clarifies that residence of the beneficial owner is relevant, rather than the residence of the recipient (to the extent they are different).

1.266 Article 21 also provides an exemption to the general rule for income from a right or property that is effectively connected to a permanent establishment. In such cases, Article 7 applies to allocate the taxing right of that other income to the country in which the permanent establishment is situated. *[Article 21, paragraph 2]*

1.267 This provision is based on the equivalent provision in the OECD Model, but is adapted to reflect that paragraph 1 refers to a resident who is the 'beneficial owner' of the income.

1.268 Article 21 contains a general safeguard against amounts of income that are excessive because of a special relationship that exists between the parties to a transaction (or between those parties and some other person). In such cases, Article 21 only applies to the amount if the income that would have been expected to have agreed to between the parties to the arrangements had they been dealing at arm's length. Any excess amount continues to be taxable according to the domestic laws of Australia and Israel and the other provisions of the Convention. *[Article 21, paragraph 3]*

1.269 This provision is not contained in Article 21 (Other Income) of the OECD Model but is based on the provisions in the OECD Model that are contained in Articles 11 (Interest) and 12 (Royalties).

Article 22 – Limitation on benefits

1.270 Article 22 ensures that the benefits of the Convention are denied where one of the principal purposes of an arrangement or transaction that has been entered into is to obtain a benefit under the Convention. The Article provides that treaty benefits under the Convention are not be granted for an item of income, if it can be reasonably concluded that the obtaining of the benefit was one of the principal purposes of an arrangement or transaction that resulted in that benefit, unless it is established that the granting of that benefit is in accordance with the object and purpose of the relevant provisions of the Convention. *[Article 22]*

1.271 The Article adopts the wording of the Principal Purpose Test in the OECD Model and is intended to ensure that the Convention should apply in accordance with the purposes for which it was entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services and movements of capital and persons, as opposed to arrangements whose principal objective is to secure a more favourable tax treatment.

Article 23 – Relief from double taxation

1.272 Article 23 provides the rules to reduce double taxation. Under the Convention Australia and Israel agree to restrict their respective taxing rights to avoid double taxation. The Convention broadly follows the OECD Model for the alleviation of double taxation with the Convention adopting the credit method of relief from double taxation. Under this method the residence country is required to give credit against its tax for the tax of the source.

1.273 Israel provides for relief from double taxation by allowing a deduction against its own tax for Australian tax paid under the law of Australia and in accordance with the Convention on income derived by a resident of Israel from sources in Australia. The deduction shall not exceed the related income. *[Article 23, paragraph 1]*

1.274 Australia provides for relief from double taxation by allowing a credit against its own tax for Israeli tax paid under the law of Israel and in accordance with the Convention on income derived by a resident of Australia from sources in Israel. *[Article 23, paragraph 2]*

1.275 This is primarily achieved through Australia's domestic tax provisions that provide for tax credits, such as the foreign income tax offset rules in Division 770 of the ITAA 1997. Australia also provides exemption for certain amounts of income which means that there is no Australian tax Australia from having to provide a credit against Australian tax (for example, certain branch profits are exempt under

section 23AH of the ITAA 1936 and certain non-portfolio dividend distributions are exempt under Subdivision 768-A of the ITAA 1997).

1.276 Profits, income and gains owned by a resident of Australia or Israel which may be taxed in the other country in accordance with the terms of the Convention are deemed for the purposes of the article to arise from sources in that other country. *[Article 23, paragraph 3]*

Article 24 – Non-discrimination

1.277 Article 24 provides the rules to prevent tax discrimination. Article 24 implements the provisions of the OECD Model with some departures.

Discrimination based on nationality

1.278 Under the Convention, Australia and Israel agree that nationals of one country shall not be treated less favourably than nationals of the other country in the same circumstances. That is, the treatment in respect of taxation or any connected requirement cannot be other or more burdensome than for a national of the other country. This principle applies to both the taxation itself and any requirement connected with such taxation. *[Article 24, paragraph 1]*

Non-residents of Australia and Israel

1.279 The Convention departs from the OECD Model in excluding the final sentence of paragraph 1 of Article 24 (Non-discrimination) of the OECD Model, which states that Article 24 applies to persons who are neither resident of Australia nor Israel. Consequently, residents of third countries are not able to seek the benefits of this provision.

Non-discrimination and permanent establishments

1.280 Paragraph 2 forbids a country from levying tax less favourably on permanent establishments of the other country than on the country's own enterprises carrying on the same activities. This applies to all residents of a treaty country, irrespective of their nationality, who have a permanent establishment in the other country. *[Article 24, paragraph 2]*

1.281 The Article should not be construed as obliging a country to provide residents of the other country any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. *[Article 24, paragraph 3]*

Deductions for payments to foreign residents

1.282 The two countries must allow the same deductions for interest, royalties and other disbursements paid to residents of the other country as they do for payments to their own residents. However, the two countries are allowed to reallocate profits between associated enterprises on an arm's-length basis in accordance with paragraph 1 of Article 9

(Associated Enterprises), and to limit deductions in accordance with paragraph 8 of Article 11 (Interest) and paragraph 6 of Article 12 (Royalties). The Convention departs from the OECD Model in excluding the deductibility of debts owed to a resident of the other country. That is, for the purpose of determining the taxable capital for the application of Israel's capital taxes, debts owed by an Israeli enterprise to an Australian resident is not deductible under the same conditions as if they were owed to an Israeli resident. **[Article 24, paragraph 4]**

Enterprises owned or controlled abroad

1.283 Paragraph 5 forbids a country from giving 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 Israeli residents may not be given other or more burdensome treatment than similar locally owned or controlled Australian companies. **[Article 24, paragraph 5]**

Taxes to which this Article applies

1.284 Paragraph 6 departs from the OECD Model so that instead of applying to taxes of every kind and description, the Article applies only to those taxes covered by Article 2 (Taxes Covered) of the Convention. **[Article 24, paragraph 6]**

Article 25 – Mutual agreement procedure

1.285 Article 25 provides for a procedure for resolving difficulties and disputes arising from the application of the Convention. It provides for the 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 the Convention. **[Article 25, paragraphs 1 and 2]**

1.286 The Protocol to the Convention also notes that Australia and Israel agree that their respective competent authorities will implement a notification process for cases that are presented to them by a person under paragraph 1 of Article 25. This process is to be used when the competent authority to which a case is presented does not consider the person's objection to be justified. **[Protocol, paragraph 12]**

1.287 Article 25 also obliges the competent authorities of the two countries to endeavour to resolve by mutual agreement any difficulties or doubts that arise regarding the interpretation or application of the treaty. The competent authorities may also consult together for the elimination of double taxation in cases not provided for in the Convention. **[Article 25, paragraph 3]**

1.288 The competent authorities are permitted to communicate directly with each other without having to go through diplomatic channels. This

may be done by electronic means (for example, email or web conferencing), letter, telephone, direct meetings or any other convenient means. *[Article 25, paragraph 4]*

Article 26 – Exchange of information

1.289 Article 26 obliges the competent authorities to exchange information as is foreseeably relevant for carrying out the provisions of the Convention or to the administration or enforcement of domestic laws concerning the taxes covered by the Convention. The information is not restricted to persons covered under the treaty and may therefore cover persons who are not residents of either Australia or Israel. However, the information is restricted to taxes covered by the Convention. *[Article 26, paragraph 1]*

1.290 Article 26 departs from the OECD Model in that the competent authorities can only request and obtain information concerning taxes covered by the Convention. This means that taxes not covered by the Convention under the general rules of Article 2 (Taxes Covered) are not within the scope of the article. *[Article 26, paragraph 1]*

1.291 It is intended that the Article extend to any identical or substantially similar taxes which are subsequently imposed by either country in addition to, or in place of these taxes. *[Article 2, paragraph 4]*

1.292 Article 26 provides the purposes for which the exchanged information may be used and the persons to whom it may be disclosed, and limitations on the exchange of information, in a manner which is consistent with the approach taken in the OECD Model. *[Article 26, paragraphs 2 and 3]*

1.293 When requested, a country is required to obtain and supply information using its domestic information gathering powers even though the country may not require the information for its own tax 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 26, paragraph 4]*

1.294 Paragraph 5 ensures that the limitations to information exchange contained in paragraph 3 cannot be used to prevent the supply of information solely because the information is held by a bank, other financial institution, a nominee or a person acting in an agency or a fiduciary capacity, or because it relates to ownership interests in a person. *[Article 26, paragraph 5]*

Article 27 – Members of diplomatic missions and consular posts

1.295 Article 27 provides that the provisions of the Convention do not result in members of diplomatic missions and consular posts receiving less favourable treatment than that to which they are entitled to in accordance

with the general rules of international law or under the provisions of special agreements. *[Article 27]*

1.296 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 28 – Protocol

1.297 Article 28 provides that the Protocol to the Convention is an integral part of the Convention. *[Article 28]*

1.298 This Article incorporates the provisions of the Protocol into the Convention. The Protocol is explained in further detail below. Particular provisions of the Protocol are also referenced throughout this explanatory memorandum where those provisions are relevant to a specific Article.

Article 29 – Entry into force

1.299 Article 29 provides for the entry into force of the Convention. Australia and Israel shall notify each other in writing, through the diplomatic channels, that the country has completed their domestic requirements for the entry into force of the Convention. The Convention enters into force on the date of the last notification. *[Article 29]*

1.300 In Australia, enactment of the legislation giving the force of law in Australia to the Convention, is the necessary prerequisite to the exchange of diplomatic notes taking place.

Date of application for Australian taxes

Withholding tax

1.301 The provisions of the Convention apply in Australia in respect of withholding tax on income that is derived by a resident of Israel, in relation to income derived on or after 1 January next following the date on which the Convention enters into force. *[Article 29, subparagraph a(i)]*

Fringe benefits tax

1.302 The Convention applies in Australia in respect of fringe benefits tax in relation to fringe benefits provided on or after 1 April next following the date on which the Convention enters into force. *[Article 29, subparagraph a(ii)]*

Other Australian taxes

1.303 The Convention applies to other Australian taxes concerning income, profits, or gains of any year of income beginning on or after 1 July next following the date on which the Convention enters into force. *[Article 29, subparagraph a(iii)]*

Date of application of Israeli taxes

Withholding tax

1.304 The Convention applies in Israel to tax withheld at source concerning amounts paid on or after the first day of January of the calendar year following the year in which the Convention entered into force. *[Article 29, subparagraph b(i)]*

Other Israeli taxes

1.305 The Convention applies to other Israeli taxes levied for periods beginning on or after the first day of January for the calendar year following the year in which the Convention enters into force. *[Article 29, subparagraph b(ii)]*

Article 30 – Termination

1.306 Article 30 provides that the Convention continues in effect indefinitely. However, either country may terminate the Convention by giving notice of termination at least six months before the end of any calendar year beginning after the expiration of five years from the date of the Convention's entry into force. Termination is by written notice through the diplomatic channels. *[Article 30]*

Cessation date for Australian taxes

Withholding tax

1.307 In the event of termination the Convention will cease to apply in Australia in respect of withholding tax in relation to income that is derived by a resident of Israel on or after 1 January next following the date on which the notice of termination is given. *[Article 30, subparagraph (a)(i)]*

Fringe benefits tax

1.308 In the event of termination the Convention will cease to apply in Australia in respect of fringe benefits tax in relation to fringe benefits provided on or after 1 April next following the date on which the notice of termination is given. *[Article 30, subparagraph (a)(ii)]*

Other Australian taxes

1.309 In the event of termination, the Convention will cease to apply to other Australian taxes in relation to income, profits or gains of any year of income beginning on or after 1 July next following the date on which the notice of termination is given. *[Article 30, subparagraph (a)(iii)]*

Cessation date for Israeli taxes

Withholding tax

1.310 In event of termination, the Convention will cease to apply to tax withheld at source in relation to amounts paid on or after 1 January of

the calendar year following the year in which the notice of termination is given. *[Article 30, subparagraph (b)(i)]*

Other Israeli taxes

1.311 In the event of termination, the Convention will cease to apply to other Israeli taxes levied for periods beginning on or after the first day of January of the calendar year following the year in which the notice of termination is given. *[Article 30, subparagraph b(ii)]*

Protocol

1.312 The Protocol is an integral part of the Convention because of Article 28. The Protocol sets out a number of positions that were agreed to in the course of negotiations.

1.313 The Protocol provides that nothing in the Convention prevents the application of Australia or Israel's domestic laws that are designed to prevent the avoidance or evasion of taxes. *[Protocol, paragraph 1]*

1.314 The Protocol includes a number of examples of types of laws that are designed for this purpose. However, the Protocol is not limited to the listed examples as it applies to anti-avoidance laws more generally.

1.315 The types of laws that are listed in the Protocol include:

- thin capitalisation and dividend stripping rules;
- transfer pricing rules;
- controlled foreign company and transferor trust rules;
- foreign occupational company rules; and
- Australia and Israel's general anti-avoidance rules.

1.316 The Protocol also notes that a number of departures from the OECD Model were included in the Convention to conform to Australia or Israel's consistent treaty practice. *[Protocol, paragraphs 13 and 14]*

1.317 Other issues covered by the Protocol that are relevant to specific Articles are explained above in the context of those Articles.

Application

1.318 The amendments commence on the day after they receive the Royal Assent. However, the Convention itself must first enter into force before it can take effect. For entry into force, Australia and Israel must exchange instruments of ratification on the completion of their domestic implementation procedures.

Chapter 2

Australia's deemed source rule

Outline of chapter

2.1 This Bill introduces a domestic source of income rule to ensure that Australia can exercise its taxing rights under the *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* (the Convention) and future international tax agreements.

2.2 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

2.3 It has been Australia's preferred practice to negotiate the inclusion of a source of income ('source') rule in its tax treaties – see for example Article 22 of the New Zealand Convention ([2010] ATS 10), Article 22 of the Canadian Convention ([1981] ATS 14) and Article 22 of the Chilean Convention ([2013] ATS 7).

2.4 These source rules overcome a decision of the High Court in 1965 (*Federal Commissioner of Taxation v Mitchum*), where the Court held that Australia could not tax certain income even when the treaty allocated the taxing right to Australia, because the income was not 'sourced' in Australia.

2.5 In general terms, Australia's treaty based source rules address this issue by providing that income, profits or gains that are permitted to be taxed by Australia under the relevant treaty are taken to be sourced in Australia for the purposes of Australia's domestic tax rules. The treaty based source rules are given the force of law by section 5 of the Agreements Act 1953, and apply for the purposes of the Assessment Acts. The treaty rules prevail in the event of any inconsistency with a provision of the Assessment Acts, other than the general anti-avoidance rule in Part IVA of the ITAA 1936 (see section 4 of the Agreements Act 1953).

2.6 A specific source rule was not included in the Convention. Where a source rule is not included in the text of a particular tax treaty, Australia's consistent practice has been to instead legislate an equivalent source rule for the treaty in the Agreements Act 1953 – see for example section 11S of the Agreements Act 1953, which applies in respect of the Chinese Convention. As with the treaty based source rules, these source

rules also apply for the purposes of the Assessment Acts and prevail in the event of any inconsistency with a provision of those Acts, other than Part IVA of the ITAA 1936.

2.7 The treaty specific source rules enable Australia to exercise the taxing rights allocated to it under a treaty. These source rules can have the effect of assigning an Australian source to income that would otherwise not be treated as being sourced in Australia. As foreign residents are generally taxed on their Australian sourced income, the treaty specific source rules can trigger a tax liability for a foreign resident that would not otherwise exist.

2.8 The definition of Australian source is located in subsection 995-1(1). This definition was introduced when the ITAA 1997 was first enacted. The definition refers to amounts of ordinary or statutory income that are derived from sources in Australia for the purposes of the ITAA 1936.

Summary of new law

2.9 This Bill amends the ITAA 1997 to introduce a new deemed source of income rule that ensures Australia can exercise its taxing rights under the Convention and future international tax agreements. The Bill does not affect existing Conventions (all of which already have specified source rules either in the relevant Convention itself or the Agreements Act 1953).

2.10 The new deemed source rule enables Australia to exercise the taxing rights allocated to it under the Convention and any future international agreements. The effect of the deemed source rule is consistent with the specific source rules that apply for each of Australia's existing tax treaties, and ensures there is a consistent approach for all future treaties.

2.11 This approach means that Australia will no longer need to secure agreement to include its specific source rule in the course of negotiating a tax treaty, or legislate a specific rule where such agreement cannot be secured. This is appropriate, as the characterisation of source (and other matters that go to establishing a tax liability) are ultimately a matter for the domestic laws of each Contracting State.

2.12 Consistent with this principle (that source is ultimately a domestic matter), the general source rule is located in a new Division of the ITAA 1997 (Division 764). Although the location of the provision is different to the other treaty specific source rules (which are in the Agreements Act 1953), the deemed source rule is given the same priority as those treaty rules. This ensures a consistent approach to source in

respect of Australia’s tax treaties, irrespective of the treaty source rule that applies.

2.13 To facilitate the inclusion of the deemed source rule in the new Division 764, the amendments also re-write the existing definition of ‘Australian source’. These changes improve the structure of the definition by clarifying the various ways in which Australian source is determined under the ITAA 1997 and ITAA 1936.

Comparison of key features of new law and current law

<i>New law</i>	<i>Current law</i>
A general source rule ensures that income that Australia is permitted to tax under an international agreement is deemed to be sourced in Australia. This rule applies to the Convention and any future international agreements.	Treaty specific source rules have previously been either included in the relevant bilateral tax treaty, or implemented unilaterally through the Agreements Act 1953.

Detailed explanation of new law

Deemed source rule for international agreements

2.14 The amendments introduce a deemed source rule that applies in respect of the Convention and any future international agreements.

2.15 This rule provides that that ‘income, profits or gains’ derived by a person are taken to be derived from an Australian source if:

- the person is a resident of a foreign country or foreign territory for the purposes of an international tax agreement; and
- the effect of the agreement is that the income, profits or gains may be taxed in Australia.

[Schedule 1, item 3, subsection 764-10(1)]

2.16 The deemed source rule only applies to international tax agreements that were made on or after 28 March 2019, which is the day the Convention was signed. *[Schedule 1, item 3, subsection 764-10(2)]*

2.17 This ensures that the source rule will apply to the Convention and any new agreements entered into, but does not apply to any existing agreements. In the event that it is not appropriate for the deemed source rule to apply to a future agreement, the effect of the deemed source rule

can be limited at the time that the legislation implementing the agreement is enacted.

2.18 The effect of this rule in determining when an amount is sourced in Australia is consistent with the existing source rules contained in Australia's tax treaties, and the treaty specific rules in the Agreements Act 1953. To ensure this consistency, the deemed source rule is formulated in a way that closely aligns with those existing rules. However, the rule has been necessarily adapted to ensure that it can be applied to international agreements generally (in contrast to the specific rules that apply to a single treaty).

2.19 In broad terms, the deemed source rule treats an amount of a foreign resident's income, profit, or gains as being sourced in Australia where Australia is allocated a right to tax the amount under an international tax agreement.

2.20 The reference to an 'international tax agreement' means an agreement that is given the force of law by the Agreements Act (as per section 5 of that Act). This term 'international tax agreement' extends to agreements that are not double tax treaties, the deemed source rule is also capable of applying to such agreements. However, for this to occur, the agreement must also allocate Australia taxing rights in respect of the income of a foreign resident.

2.21 The phrase 'income, profits or gains' draws directly from the concepts that are used in Australia's tax treaties (which are based on the OECD Model). Treating such amounts as having as being derived from a source in Australia is relevant for determining whether the amount is sourced in Australia under the re-written definition of Australian source. Such an amount will be Australian sourced to the extent that it is also ordinary or statutory income.

2.22 The residency requirement ensures that the deemed source rule does not apply to persons who are an Australian resident for the purposes of the relevant agreement. This is appropriate because although Australian residents are generally taxed on their worldwide income, some provisions (including tax exemptions) are based on a resident having foreign sourced income. For example, section 23AG of the ITAA 1936 provides a tax exemption to Australian residents for certain foreign income derived from foreign services.

2.23 The reference to a person being a resident of a 'foreign country' is applicable to any international tax agreement that Australia has with another country. The term 'foreign country' takes on its meaning from section 2B of the *Acts Interpretation Act 1901*. The reference to a person being a resident of a 'foreign territory' is applicable to any international tax agreement that Australia has with a territory, rather than a country. Under Australia's existing agreement of this kind, a person's residence is

defined in respect of such territories. The term ‘foreign’ is used to distinguish a territory that is a counter-party to an agreement from Australia’s external territories.

2.24 In contrast to the existing treaty specific source rules, which refer to particular Articles in the relevant treaty, the deemed source rule refers to the treaty in its entirety. Despite this difference in approach, the actual scope of the deemed source rule is the same. This is because the Articles that are *not* specified in the specific treaty rules do not allocate taxing rights. As a result, the more general reference in the new deemed source rule does not have any operation in respect of these types of provisions. For example, Articles 1 to 5 in most of Australia’s existing tax treaties cover the scope of the treaty and its various definitions. These rules do not allocate taxing rights between Australia and the other country. Because of this, there is no basis for triggering the deemed source rule in respect of these Articles. Adopting a more general reference to the treaty is preferable for a general rule of this kind because the Articles contained in individual international tax agreement, and their numbering, differs from agreement to agreement.

2.25 Consistent with the way that the existing treaty related source rules apply, this rule takes priority over any other rule that determines source in the ITAA 1997 or ITAA 1936, other than the general anti-avoidance rule in Part IVA of the ITAA 1936. [*Schedule 1, item 3, subsection 764-5(3) and subsection 764-10(3)*]

2.26 In practice, the only source rules in the Assessment Acts that could be inconsistent with the deemed source rule are those that treat an amount as *not* being from an Australian source.

2.27 The existing treaty related source rules are given priority over the provisions of the Assessment Acts (other than Part IVA of the ITAA 1936) and any Act imposing tax because of subsection 4(2) of the Agreements Act. The rules are also given priority over any provisions of the *Fringe Benefits Tax Assessment Act 1986* because of subsection 4AA(2) of the Agreements Act.

2.28 In contrast to the priority rules in the Agreements Act (which apply to that Act generally), the priority rules for the deemed source rule do not refer to the imposition acts or the *Fringe Benefits Tax Assessment Act 1986*. This does not result in a difference in scope because those Acts do not have any provisions that refer to an amount being Australian sourced (while an imposition Act may ultimately impose tax on an amount of income that is Australian sourced, the assessment of such tax is determined under the Assessment Acts).

2.29 The deemed source rule is, however, subject to the specific rule in subsection 3AA(2) of the Agreements Act. That provision disregards the specific treaty based source rules for the purposes of working out the

source of certain income from funds management activities. Consistent with this approach, the deemed source rule only applies for the purposes of working out the source of income that is covered by that provision when the other treaty related rules also apply. *[Schedule 1, item 6, subsection 3AA(2) of the Agreements Act 1953]*

Division 764 – Source rules

2.30 The amendments create a new Division (Division 764) to facilitate the introduction of the new deemed source rule for international agreements. This Division is used to determine whether income is from an Australian source. *[Schedule 1, item 3, Division 764]*

2.31 It is expected that, over time, any new provisions that have general application in respect of source would be included in this Division (including any existing provisions that are re-written as part of some other process).

2.32 As part of this process, the existing definition of ‘Australian source’ in the ITAA 1997 is re-written and incorporated into the new Division. The re-written definition sets out the methodology for determining when an amount of ordinary or statutory income is Australian sourced under the ITAA 1997.

2.33 These changes do not alter the meaning or scope of the existing definition of Australian source. Similarly, the changes do not disturb or disrupt any provision that includes an amount of income in assessable income on a basis other than source (such as paragraph 6-10(5)(b)).

2.34 The re-written definition clarifies that to be Australian sourced, an amount of ordinary or statutory income must be either:

- from a source in Australia; or
- be treated being derived from, attributable to, or otherwise have a source in Australia (however described) by another provision of ‘this Act’.

[Schedule 1, item 3, subsection 764-5(1)]

2.35 The reference to an amount being ‘from a source in Australia’ relates to the ordinary meaning of Australian source, and ensures that existing concepts and common law principles for determining source continue to apply. This is consistent with the scope of the previous definition. Although that definition referred to amounts being derived from an Australian source for the purposes of the ITAA 1936, the meaning of that concept within the ITAA 1936 has always been determined having regard to established principles and jurisprudence about source.

2.36 The re-written definition also makes it clear that the ordinary meaning of source can be extended through any specific statutory provisions that deem or treat an amount as Australian sourced. This element of the definition uses examples of an amount being ‘derived’ or ‘attributable’ to a source in Australia, but does not require a provision to have a particular formulation. This reflects that source is described in different ways across the Assessment Acts.

2.37 Examples of specific statutory provisions that have this effect are subsections 6B(2A), 6C(1A), 6CA(2), 6CA(3) and 26E(1) of the ITAA 1936. The new deemed source rule (explained above) is another example of a provision that has this effect.

2.38 The re-written definition also provides that amounts of ordinary or statutory income are *not* from an Australian source if a provision of ‘this Act’ states that it is derived from, attributable to, or otherwise has a source other than an Australian source (however described). [*Schedule 1, item 3, subsection 764-5(2)*]

2.39 This element of the definition clarifies that, irrespective of whether an amount is Australian sourced according to ordinary concepts, certain provisions specifically treat amounts as not being sourced in Australia. Consistent with the element of the definition related to provisions that treat amounts as Australian sourced, this element of the definition uses examples of an amount being ‘derived’ or ‘attributable’ to a source other than an Australian source, but does not require a provision to have a particular formulation. Again, this reflects that source is described in different ways across the Assessment Acts.

2.40 Examples of specific statutory provisions that have this effect are subsections 83A-25(2), 83A-110(2) and 276-820(7), items 8 and 9 in the table in subsection 230-310(4).

2.41 The references to the provisions of ‘this Act’ in the definition include any provisions of the ITAA 1997, ITAA 1936 and certain provision of the *Taxation Administration Act 1953* (see the definition of ‘this Act’ in subsection 995-1(1)).

2.42 The amendments also amend the existing definition of ‘Australian source’ in subsection 995-1(1) to reflect that the meaning is now provided for in the new provision in Division 764. [*Schedule 1, item 4, subsection 995-1(1) (definition of Australian Source)*]

Technical correction to the Agreements Act 1953

2.43 The amendments also correct an incorrect cross-reference in section 3AA to the specific source rule that applies in respect of the earlier agreement with Germany. [*Schedule 1, item 5, paragraph 3AA(2)(c) of the Agreements Act 1953*]

2.44 A specific source rule was included in the Agreements Act 1953 in respect of the previous agreement with Germany. This rule was re-written to preserve its operation when the German Convention was renegotiated in 2015 and given force of law in 2016. However, the reference to this rule in section 3AA was not updated to reflect its new location. The amendments correct this cross-reference to ensure that it refers to the updated source rule.

Application

2.45 While amendments described in this Chapter generally apply from the time that they commence, the deemed source rule applies in respect of any international tax agreements that are made on or after 28 March 2019. While this includes the Convention, as noted above, the Convention will only take effect after it enters into force.