Bilateral treaties between Australia and the US, and Australia the UK, may provide some withholding tax relief to some Australians paying interest to US and UK financial institutions.

Tax treaty relief from Australian interest withholding tax for US or UK financial institutions

The new 'Interest' Article in the revised double tax treaties with the US and UK exempts payments of interest to some US and UK lenders from Australian interest withholding tax. However, it remains the case that where an Australian borrower undertakes a borrowing by way of an issue of debentures that satisfies the requirements of section 128F of the Tax Act, it will not be necessary to consider the treaties. Partner Diccon Loxton and Senior Associate Thomas McAuliffe report.

Since Australia entered into revised double tax treaties with the United States and the United Kingdom during the past two years, lenders resident in those countries and Australian borrowers alike have been tentatively considering the new 'Interest' Article in each of those treaties. That Article exempts payments of interest to some US and UK lenders from Australian interest withholding tax (IWHT). Some welcome guidance on this issue has been released by the Australian Taxation Office (ATO) in the form of a draft Taxation Ruling (TR 2004/D16). This Focus highlights certain aspects of the draft Ruling that you should be aware of, and discusses the practical implications for Australian borrowers.

Being a draft Ruling (for industry and professional comment), its contents may change before it is issued in final form. Comments on the draft Ruling can be made to the ATO by 15 October 2004.
The new ‘Interest’ Article

Under Article 11 of each of the double tax treaties between Australia and the US and the UK, Australia may not tax interest arising in Australia that is beneficially owned by a resident of the US or the UK if that interest is derived by a ‘financial institution’ that is unrelated to and dealing wholly independently with the payer. For the purposes of each treaty, ‘financial institution’ is defined to mean:

- 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.

In the draft Ruling, the ATO states that it will interpret this definition as comprising two distinct categories of financial institution, being:

- banks; and
- other enterprises substantially deriving their profits from 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.

Which entities will be accepted as ‘banks’?

According to the draft Ruling, the ATO will regard as banks entities that are residents of the US or the UK that:

- have been granted their principal licence to operate as a bank in either the US or the UK where they are resident respectively, as distinct from operating in either country as the holder of a foreign banking licence; and
- satisfy the capital adequacy requirements necessary to operate as a bank, as distinct from other categories of deposit-taking institutions, in either the US or the UK.

Where an entity satisfies these requirements, the ATO will accept that it is a ‘bank’ for the purposes of each treaty, in which case it will not need to satisfy the other elements of the ‘financial institution’ definition. Subsidiaries of banks, that do not themselves hold a banking licence, will not be regarded by the ATO as banks and will therefore need to satisfy the ‘other enterprises’ category of financial institution (see below).

Credit unions, building societies and saving and loans institutions that have lower capital adequacy requirements than those required of banks will not be regarded as banks by the ATO. However, those entities may still qualify as financial institutions for the purposes of the treaty where they satisfy the additional requirements applicable to ‘other enterprises’.

Other enterprises substantially deriving their profits from spread activities

Where an enterprise does not meet the ATO’s criteria for a bank, it may nevertheless qualify as a financial institution for the purposes of the treaties if it substantially derives 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.

Australia may not tax interest arising in Australia that is beneficially owned by a resident of the US or the UK if that interest is derived by a ‘financial institution’ that is unrelated to and dealing wholly independently with the payer.

This definition of financial institution comprises numerous elements, each of which is considered in some detail by the draft Ruling. Some of the issues identified by the draft Ruling include whether:

- the entity raises debt finance (as opposed to equity finance) in the financial markets;
- the entity raises funds directly in the financial markets;
- the entity takes deposits at interest, with the ATO taking the view that it must be an enterprise that is authorised under the regulatory regime of either the US or the UK, to take sums of money in the form of deposits at interest;
- the entity uses the funds deposited with it in carrying on a business of providing finance; and
- the entity’s ‘spread activities’ (ie raising debt finance in the financial markets, or taking deposits at interest, and using those funds in carrying on a business of providing finance) represents the main business activity of the entity. In this regard, the draft Ruling contains an example that is relevant to
investment banks. That example involves a company that, over a period of three years, derived 40 per cent of its gross profit from its spread activities, 30 per cent of its gross profit from advice work and 30 per cent of its gross profit from other business activities. The ATO concludes that, when compared to the company’s other separate activities over a reasonable time, its main business is from its spread activities; it does not matter that the spread activities do not constitute the majority of its overall profits.

The manner in which the ATO has dissected the definition of this category of financial institution, and the examples given in the draft Ruling, amplify the need to undertake a careful and detailed analysis of whether protection from IWHT will, in fact, be available under the new 'Interest' Article in each of the treaties.

For example:
- interest derived by a UK branch of a German bank would not be protected from IWHT under the Interest Article in the Australia/UK treaty as the German bank would not be a resident of the UK;
- a US insurance company that derives 60 per cent of its gross profits from insurance premiums and the remaining 40 per cent from carrying on spread activities will not be regarded as a financial institution by the ATO. This will apply even where it is a subsidiary of a bank; it will not itself be a bank if it does not hold a banking licence; and
- where the fund-raising activity is undertaken by a parent entity that then on-lends the funds raised by it to a subsidiary carrying on the business of providing finance, the ATO may not regard the subsidiary itself as having raised its own funds in the financial markets as required by the treaty.

Exceptions to the zero withholding rate for ‘financial institutions’

The draft Ruling also discusses the circumstances in which Australia will retain the right to tax interest arising in Australia because:
- the US or UK financial institution is related to, and not dealing wholly independently with, the Australian borrower;
- the interest is effectively connected with an Australian permanent establishment of the US or UK financial institution; or
- the interest is paid as part of an arrangement involving ‘back to back’ loans.

Risk allocation issues

It will be important for Australian borrowers to appreciate that they bear the primary risk associated with the non-payment of IWHT if it transpires that the US or UK lender is not, in fact, entitled to the zero withholding rate under the relevant treaty, even where there is no gross-up clause.

If an Australian borrower failed to withhold an amount of IWHT payable in respect of interest paid to a US or UK lender, the Australian borrower would be liable for the amount of tax that should have been withheld and remitted to the ATO, together with any late payment interest and, possibly, penalties. Any income tax deductions that the Australian borrower had claimed for the relevant interest expense would also be jeopardised.

Therefore, the losses an Australian borrower may sustain could be significant. In this regard, it is worth noting that many of the factors on which eligibility for treaty protection rests are matters that will be primarily, if not solely, within the knowledge and control of the lender. Accordingly, Australian borrowers from US or UK lenders who claim to be entitled to the zero withholding rate under the US or UK treaty should require:
- a warranty from the lender that it is entitled to the zero withholding rate under the relevant treaty, together with a representation that it will continue to be so entitled (subject to a change in law);
- an undertaking by the lender to notify the Australian borrower on a timely basis if it ceases to be entitled to the zero withholding rate; and
- an indemnity from the lender for any amounts payable by the Australian borrower to the ATO if that warranty or representation turns out to be incorrect, or if it breaches the undertaking.

Of course, where an Australian borrower undertakes a borrowing by way of an issue of debentures that satisfies the ‘public offer test’ and other requirements of the s128F exemption from IWHT, it will not be necessary for the parties to consider whether the US or UK lender is entitled to the zero withholding rate under the relevant treaty. That remains a safer option when available.
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