The Protocol to the Australia–United States Tax Treaty: Part 1

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The Protocol to the tax Treaty between Australia and the United States that was signed in September 2001 represents a departure, in a number of significant respects, from the approach traditionally adopted by Australia in negotiating tax treaties. In particular, the Protocol reflects a greater emphasis on residence-based taxation as reflected in lower source country tax rates on certain dividend, interest and royalty flows. This approach was adopted against a backdrop of concern that Australia was becoming a “branch economy”, and the adoption of a zero rate of tax on dividends was especially important in this context as a lever to encourage corporates with significant United States earnings to retain their base in Australia. The increased focus on residence-based taxation has since received qualified endorsement from the Australian Government for future treaty negotiations. This article reviews the changes to the Australia–United States Treaty effected by the Protocol. Part 1 considers the changes to the residence, taxes covered, business profits, dividend and interest Articles, while Part 2, which is to appear in a coming issue of the Australian Tax Review, will consider the changes to the royalty, alienation of property, limitation on benefits and other income Articles.

INTRODUCTION

This article discusses the Protocol1 to the Convention Between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1983 (the US Treaty) which was signed by Australia and the United States on 27 September 2001. Legislation giving domestic effect to the Protocol was enacted in Australia in June 2002,2 and the United States Senate ratified the Protocol on 13 March 2003. Instruments of ratification were exchanged in May 2003,3 and the Protocol applies to dividends, interest and royalties paid on or after 1 July 2003. It also applies to Australian tax on other income and gains from the income year commencing 1 July 2004.4 The main Australian tax policy objectives in negotiating the Protocol were to reduce the United States withholding tax rate in relation to distribution of profits by United States subsidiaries and branches of Australian resident companies; and to protect Australia’s taxing rights in relation to capital gains derived by United States residents.5 The first of these objectives is realised in the new dividends Article (Art 10), which reduces the rate of dividend withholding tax to zero where dividends are paid to a listed parent company which owns at least 80% of the shares in the subsidiary and to 5% in

2 International Tax Agreements Amendment Act (No 1) 2002 (Cth).
3 The instruments of ratification were exchanged at 3:30 pm on 12 May 2003 Washington DC time: See Costello P, Press Release No 28, Entry into Force of the Protocol Amending the Australia and United States Double Tax Treaty (13 May 2003).
4 Article 13, the Protocol.
certain other cases. The second objective is realised in the amended alienation of property Article (Art 13) which provides that each Contracting State may tax capital gains in accordance with its domestic law.

Dividend withholding tax rates lower than the 15% traditionally agreed to in Australian tax treaties have also been negotiated by Australia in other recent treaties. In relation to dividends paid by Australian resident companies, those lower rates apply only to the extent that the dividends are franked. Given that Australia already unilaterally exempts franked dividends from dividend withholding tax, this approach is cost-free as far as the Australian revenue is concerned but potentially benefits Australian taxpayers by reducing non-creditable foreign dividend withholding taxes. By contrast, the Protocol is not cost-free for the Australian revenue because the lower dividend withholding tax rates apply to both franked and unfranked dividends. Furthermore, royalty and interest withholding tax revenue will be forgone as a consequence of the 5% royalty withholding tax rate and the exemption for interest paid to a financial institution.

As far as the United States is concerned, a zero rate of dividend taxation was agreed to for the first time in the Treaty it entered into with the United Kingdom in July 2001. Generally, the lowest rate of dividend taxation agreed to by the United States in its treaties is 5%. Australia unilaterally exempts franked dividends and certain dividends sourced from foreign income from withholding tax. So it is unlikely that the United States would have viewed the agreement by Australia to reduce its dividend withholding tax rate as a true quid pro quo for the reduced United States dividend tax rate. Also, as the United States typically agrees to a zero rate of source country tax on interest and royalties in its treaties, it was not sacrificing anything in agreeing to a zero rate on interest paid on financial institution lending, and a 5% rate on royalties, that it would not normally give up in a treaty context. Therefore, the key bargain reflected in the Protocol is the United States’s agreement to a zero rate of

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6 A 5% rate was agreed to in the Agreement Between Australia and the Czech Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1995 (Czech Republic Treaty); the Agreement Between Australia and Romania for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2001 (Romanian Treaty); the Agreement Between the Government of Australia and the Government of the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2000 (Russian Treaty); and in the Protocol to the Convention Between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1981 (Canadian Treaty). A 10% rate was agreed to in the Agreement Between the Government of Australia and the Government of the Argentine Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1999 (Argentinian Treaty) and in the Agreement Between the Argentine Republic and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 2000 (Mexican Treaty). Note that legislation is yet to be introduced into Parliament to give force to the Mexican Treaty.

7 Under Art 10 of the Mexican Treaty, for example, Australia agrees to a zero rate where the dividends are franked and are paid to a 10% or greater shareholder. Similarly, in Art 8 of the Protocol to the Canadian Treaty Australia agrees to a 5% rate on franked dividends paid to a 10% or greater shareholder.

8 Section 128B(3)(ga), Income Tax Assessment Act 1936 (Cth) (ITAA 1936).

9 In the circumstances in which the lower withholding tax rate applies in other Australian treaties the dividends are usually exempt from Australian income tax under s 23AJ of the ITAA 1936 because the treaty requires a shareholding of at least 10% in the company paying the dividends. Therefore, any reduction in foreign dividend withholding tax provides an immediate cash benefit to the Australian corporate shareholder.


11 The United States’s treaty negotiating position is expressed in Art 10(2), United States Model Income Tax Convention 1996 (the US Model Convention): http://www.irs.gov/pub/irs-ty/asm061.pdf viewed 22 May 2003. Art 10(2) of the US Model Convention provides for a 5% rate if the beneficial owner of the dividends is a company that owns directly at least 10% of the voting stock of the company paying the dividends.

12 Articles 11 and 12, US Model Convention.
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tax on dividends paid to Australian parent companies in exchange for the Australian agreement to exempt interest paid to financial institutions and to tax royalties at a reduced 5% rate.

In the National Interest Analysis in relation to the Protocol, the net annual cost of the Protocol to the Australian revenue was estimated at $190 million.13 When the Protocol was considered by the Joint Standing Committee on Treaties, Australian Taxation Office (ATO) officials were asked to explain and quantify the benefits of Australia offsetting that revenue loss.14 When the officials were unable to provide this explanation, the Committee declined to support binding treaty action and recommended that the ATO and Treasury develop a methodology for quantifying the benefits of treaties to Australia.15 This prompted a letter from the Secretary to the Treasury to the Joint Standing Committee that outlined an analysis of the comparative net benefits of the Protocol.16 Attachment B to the Treasury letter calculates the net national benefit to Australia as being $70 million for the 2004/2005 financial year. This amount was calculated by netting off the gross revenue cost of $275 million, flowing from the reduction of withholding tax on dividends, interest and royalties, against the business cost savings of $260 million and $85 million of protected revenue that might not otherwise be collected if Australia’s right to tax capital gains of United States residents was not confirmed in the Protocol.17

The business cost reductions that were taken into account consist of reduced United States withholding tax on dividends and royalties of $145 million, and lower borrowing and licensing costs of $115 million flowing from reduced withholding tax gross up obligations on interest and royalties paid by Australian residents. These numbers are based on a “static analysis” that the Treasury letter explains does not attempt to trace through the consequences of the Protocol for investment levels, access to technology, cost of capital and economic growth, and cost of employment.18 Following receipt of the Treasury letter, the Joint Standing Committee resolved to recommend binding treaty action on the Protocol.19

The reduction in United States dividend withholding tax does not flow through at the company level to additional tax collections in Australia. This is because the dividends that enjoy the lower rates are exempt from tax in Australia in the circumstances in which the rate reduction is provided.20 Additional revenue may be collected in Australia through the allowance of a lower level of foreign tax credits in relation to United States interest and royalty withholding tax. However, the level of United States interest withholding tax that is to be forgone is not estimated in the Treasury letter and the level of forgone United States royalty withholding tax is estimated at only $5 million. Therefore, on the basis of the assumptions in the Treasury letter, there will be a transfer from the Australian revenue to the United States revenue as the reductions in Australian withholding tax translate to a lower level of foreign tax credit claims in the United States. The offsetting effect in relation to United States withholding tax is of a much lower order because of the dividend exemption

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13 ATO Treaties Unit, National Interest Analysis, n 5, at [30].
17 The $275 million gross revenue cost consists of reductions in the collection of dividend withholding tax of $45 million, interest withholding tax of $90 million and royalty withholding tax of $140 million. The business cost reductions of $260 million flow from reduced obligations to pay withholding tax gross up amounts of $45 million in respect of interest and $70 million in respect of royalties, $140 million from the reduction in United States dividend withholding tax and $5 million from reduced United States royalty withholding tax.
18 Treasury letter, n 16, Attachment B.
19 Australia, House of Representatives, Debates (26 June 2002) p 4469.
20 Section 23AJ, ITAA 1936. Additional tax may be collected at the individual shareholder level; however, this is not clear because in many circumstances the shareholder in the Australian company will be resident outside Australia and in many cases repatriated dividends may be used for reinvestment purposes.
at the corporate level and the lower level of reduced Australian foreign tax credit claims flowing from the reduction in United States interest and royalty withholding tax.\(^{21}\)

The tax policy justification for this outcome appears to be that it is acceptable for Australia to suffer a net revenue loss under a treaty as long as the treaty results in a net overall benefit to Australia. This is a significant change from the traditional approach in Australian tax treaties whereby the emphasis has rested with protecting the Australian tax base in respect of income derived from Australian sources. The government has recently accepted a recommendation of the Board of Taxation that Australia move towards a more residence-based tax treaty policy of the type reflected in the Protocol.\(^{22}\) This focus is likely to be reflected in the Treaty currently being negotiated with the United Kingdom and, in some cases, in revisions to treaties under which Australia has an obligation to renegotiate withholding tax rates as a consequence of the lower rates agreed to in the Protocol.\(^{23}\)

Under those provisions, if Australia agrees in any treaty to limit its rate of taxation on dividends, interest or royalties paid to a resident of the treaty partner state to a rate lower than that in the particular treaty, it will enter into negotiations to review the relevant provisions “in order to provide the same treatment” for the treaty partner.\(^{24}\) It is likely that these clauses will be viewed by Australia as imposing simply an obligation to negotiate, and not as imposing an obligation to agree to the lower rates. However, given the importance placed in the negotiation of the Protocol on preserving Australia’s right to tax capital gains, it is likely that Australia will use the opportunity of renegotiating treaties with “most favoured nation” clauses to secure agreement to Australia taxing capital gains.\(^{25}\)

This should be an important consideration, in particular, in relation to the Netherlands and Switzerland Treaties\(^{26}\) given that those countries are often used as a location for holding companies in relation to investments by foreigners into Australia.

The Protocol was negotiated against a backdrop of concern that Australia could become a branch office economy as a consequence of Australian-based companies with significant foreign earnings migrating to more hospitable fiscal climes, and as more Australian companies were acquired by foreign-based groups.\(^{27}\) Credence was given to the possibility of companies migrating from Australia by the decision of James Hardie Industries Limited (James Hardie) in 2001 to effectively migrate to the Netherlands through a scheme of arrangement under which shareholders in the Australian listed company exchanged their James Hardie shares for shares in the Netherlands holding company.\(^{28}\) In its 2001 Federal Election platform, the Liberal Party committed to a reform of Australia’s international tax rules with a view, in particular, to identifying “those arrangements that impact on the decisions of

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21 The Australian revenue gives up $275 million of withholding tax and this translates into a gain to the United States revenue of that amount through lower claims by United States residents for foreign tax credits. The Australian revenue potentially gains $85 million of capital gains tax, and this could translate into a loss to the United States revenue of an equivalent amount through increased foreign tax credit claims. Finally, the United States revenue loses $5 million of royalty withholding tax and this potentially translates into a gain to the Australian revenue through lower foreign tax credit claims. The net outcome is a transfer from the Australian revenue to the United States revenue of $185 million.

22 Costello P, Press Release No 32, Review of International Taxation Arrangements (13 May 2003), Attachment E.

23 Australia’s tax treaties with Austria, Finland, France, Italy, Korea, the Netherlands, Norway and Switzerland all contain “most favoured nation” clauses of this type.

24 Clause 6(b), Protocol to the Agreement Between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1976.

25 The importance, from a tax treaty policy perspective, of preserving Australia’s right to tax capital gains was recently emphasised by the government’s rejection of the Board of Taxation’s recommendation to exempt treaty negotiation capital gains derived by non-residents in connection with disposals of non-portfolio shareholdings in Australian resident companies: See Costello, n 22.

26 Agreement between Australia and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1976 (Netherlands Treaty) and Agreement Between Australia and Switzerland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1981 (Swiss Treaty).

27 See, for example, Rennie P, “Expatriate Hardie Gives Others Itchy Feet”, Business Review Weekly: (3 August 2001) p 36 where the possibility of AMP, CSR, Lend Lease, National Australia Bank, Amcor, Boral, Fosters Group and Southcorp either migrating from Australia, or entering into dual listed company structures under which control shifted offshore, was discussed.

companies to remain in Australia or locate in other countries”.

The migration of companies to more tax friendly jurisdictions has also recently been a political issue in the United States, and this led to the introduction of a number of Bills into the United States House of Representatives that were designed to remove the tax advantages flowing from a corporate migration. In an Australian context, a survey by the Productivity Commission published in early 2002 indicates that there were not significant numbers of Australian firms considering moving their headquarters offshore, and of those firms which were considering migration it was found that improved access to world markets was the principal motivating factor. Therefore, the concern that Australian companies would migrate to other jurisdictions appears to have been over-emphasised. Be that as it may, the concern has usefully concentrated government attention on the appropriate focus of Australia’s tax treaty policy.

RESIDENCE

Article 1 of the Protocol amended Art 1(3) of the US Treaty to permit the United States to tax certain former “long-term residents” without regard to the terms of the US Treaty. Subject to the limitations in Art 1(4), Art 1(3) permits the Contracting States to tax their residents and citizens as if the US Treaty had not entered into force. In relation to United States taxation of United States source income, Art 1(3) provides that a former citizen whose loss of citizenship had as one of its purposes the avoidance of tax, is treated as a citizen for this purpose for a period of 10 years. This reflects domestic United States tax law which continues to tax former United States citizens on certain United States source income for a period of 10 years after they cease to be a citizen if the loss of citizenship improved access to world markets was the principal motivating factor. Therefore, the concern that Australian companies would migrate to other jurisdictions appears to have been over-emphasised. Be that as it may, the concern has usefully concentrated government attention on the appropriate focus of Australia’s tax treaty policy.

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30. Liberal Party, n 29, p 17. The important feature of the Protocol in this context was the source country exemption under the new Art 10 for dividends paid to 80% shareholders. This removed the incentive for Australian companies to migrate to other jurisdictions which had agreed to dividend withholding tax rates of lower than 15% in their tax treaties with the United States. This did not prevent James Hardie from migrating because after tax earnings could still be enhanced for shareholders in jurisdictions which had agreed to dividend withholding tax rates of lower than 15% in their tax treaties with the United States.
31. The Treasurer’s approval was required under s 25 of the Foreign Acquisitions and Takeovers Act 1975 (Cth).
34. Productivity Commission, Offshore Investment by Australian Firms: Survey Evidence (AusInfo, Canberra, 2002). Of the 200 firms that responded to the survey, four firms had moved headquarter operations from Australia and another four were considering such a move. Further, the question asked of respondents was whether they had shifted, or were considering shifting “key headquarter functions” – defined as the chief executive officer and corporate support units – from Australia. Thus, respondents who were contemplating shifting headquarters, or who had already made such a shift, were not necessarily contemplating a fully blown migration of the type undertaken by James Hardie.

(2003) 32 AT Rev 135
has as one of its principal purposes the avoidance of United States tax. The amendment to Art 1(3) extends this treatment to former long-term residents. This follows amendments in 1996 to the rule dealing with former United States citizens that functioned to extend the rule’s operation to long-term residents. There is no definition in the US Treaty of “long-term resident”, but the United States Treasury Technical Explanation to the Protocol indicates that it is intended to have its United States domestic law meaning as an individual other than a citizen who was a permanent resident of the United States in at least eight of the last 15 years, excluding any years in which the person was treated as a resident of another country for the purposes of a tax treaty that the United States has with that other country. Therefore, if a former long-term resident of the United States became resident in Australia in circumstances in which the United States anti-avoidance rule applied, the United States could continue to tax United States source income without regard to the US Treaty, subject only to the limitations in Art 1(4). For example, if the individual derived United States source dividends or interest, those amounts would be taxed at the United States domestic rate of 30%, rather than at the lower US Treaty rate.

TAXES COVERED

Article 2 of the Protocol amended Art 2 of the US Treaty to include, within the Australian taxes covered by the US Treaty, the tax on capital gains and the resource rent tax. In relation to capital gains, Art 9 of the Protocol also amended Art 13 of the US Treaty (Alienation of Property), to provide that “each Contracting State may tax capital gains in accordance with the provisions of its domestic law”. Therefore, if a United States resident derives a capital gain that is subject to tax under Australia’s capital gains tax provisions, Australia’s ability to tax that gain is preserved by the amended Art 13 and the United States is required to provide a foreign tax credit for that tax. While the resources rent tax is now also a tax covered, Art 12 of the Protocol amended the tax credit Article of the US Treaty to exclude that tax from being considered by virtue of the US Treaty to be an income tax for United States foreign tax credit purposes. Therefore, while the US Treaty would potentially limit the way in which the resources rent tax would apply to United States residents, it would not apply to require the United States to allow a foreign tax credit for that tax. The availability of such credits will be determined under United States domestic law.

FISCALLY TRANSPARENT ENTITIES

Article 4 of the Protocol amended the business profits Article of the US Treaty by inserting a new provision that deals with business profits derived through fiscally transparent entities. The new Art 7(9) of the US Treaty applies where a resident of one of the Contracting States is beneficially entitled directly or through one or more fiscally transparent entities to a share of the business profits of an enterprise carried on in the other State by the entity or by the trustee of a trust estate, and the

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35 Section 877, Internal Revenue Code 1986 (US) (IRC). For this purpose, income or gains on the sale of stock or debt issued by a United States corporation and certain income or gains in respect of interests in controlled foreign companies are deemed to have a United States source: s 877(d), IRC.
36 Section 877(e), IRC inserted by Public Law 104-191 (subs 511(a)-(d) and (f)(1)), Health Insurance Portability and Accountability Act 1996).
38 The 30% rate would apply under s 871(a), IRC.
40 Article 12 of the Protocol amended Art 22(1) of the US Treaty to provide that for the purposes of applying United States foreign tax credit rules in relation to income tax paid to Australia, the taxes referred to in Art 2(1)(b)(ii), US Treaty are considered to be income taxes. Article 2(1)(b)(i) as amended by the Protocol refers to the Australian income tax and the tax on capital gains. The resources rent tax is separately referred to in Art 2(1)(b)(iii) as a tax covered by the US Treaty. However, as that subparagraph is not referred to in the amended Art 22(1) it is not treated as an income tax for United States foreign tax credit purposes by virtue of that Article.
fiscally transparent entity or the trustee has a permanent establishment in the other State. In these circumstances, the enterprise carried on by the fiscally transparent entity or trustee is deemed to be a business carried on by the resident through a permanent establishment in that other State and the resident’s share of the business profits is attributed to that permanent establishment.

Prior to its amendment by the Protocol, the US Treaty did not contain a provision equivalent to Art 7(9), but similar provisions are contained in all tax treaties entered into by Australia after 1984. For treaties entered into before 1985, including the US Treaty, s 3(11) of the International Tax Agreements Act 1953 (Cth) (ITAA 1953) applies to ensure that business profits derived by trustees through Australian permanent establishments can be taxed to beneficiaries presently entitled to those profits. However, that section has only a one-sided operation in relation to income derived through United States permanent establishments, while Art 7(9) will also apply to income derived through United States permanent establishments. Also, Art 7(9) will apply both to trusts and to fiscally transparent entities.

The concept of a “fiscally transparent entity” is not defined in the Protocol. The rule in Art 3(2) of the US Treaty that undefined terms have the meaning that applies under the domestic tax law of the country applying the treaty would not be relevant from an Australian perspective because “fiscally transparent entity” is not defined in Australian domestic tax law. From Art 7(9) itself the reference to a resident of a State being beneficially entitled to income derived by a fiscally transparent entity indicates that an entity is fiscally transparent for Art 7(9) purposes where its profits are treated for tax purposes as profits of a person other than the entity. The Explanatory Memorandum states at [2.11] that the expression has been used to encompass any entity that may be taxed on a “look-through” basis. In the United States, the concept is given fuller expression in regulations under s 894 of the IRC. Under those regulations, an entity is treated as fiscally transparent under the laws of its jurisdiction in relation to an item of income to the extent that the laws of that jurisdiction require the interest holder in the entity to take into account on a current basis its share of the item of income paid to the entity, whether or not that item is distributed, and the character and source of the item of income in the hands of the interest holder is determined as if that item was realised directly from the source from which it was realised by the entity.

For Australian tax purposes, general partnerships are fiscally transparent while limited partnerships are taxed as companies and would therefore be treated as non-transparent. Trusts are not strictly fiscally transparent – because in some circumstances trust income may be taxed to the trustee and losses are quarantined at the trust level – but are in any event specifically covered by

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41 The old Art 16(3) of the US Treaty contained a provision dealing with income derived by a trustee which was treated as income of a resident of one of the Contracting States. However, it applied only where the trustee derived the income in connection with a scheme a principal purpose of which was to obtain a benefit under the US Treaty. This provision was targeted at “treaty shopping” and was therefore contained in the limitation on benefits Article (Art 16). Article 7(9) is not concerned with “treaty shopping”, but rather with ensuring that the business profits derived through trusts and transparent entities can be taxed in the source State if the profits are attributable to a permanent establishment of the trustee or entity in that State.

42 See, for example, Art 5(c), Russian Treaty.

43 Section 3(11) appears to have been enacted in response to an argument raised in an article published in 1984 which suggested that protection could be available under treaty business profits Articles for business profits derived by trust beneficiaries: See Sharp JR, “Tindal, and all that …” (1984) 18 Tax in Aust 1038.

44 Section 894 requires that the IRC is to be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer. The regulations under that section deal, among other things, with the way in which treaties are to apply to fiscally transparent entities, and potentially limit treaty benefits in relation to income flowing through such entities.


46 Under s 92, ITAA 1936, the net income and losses of a general partnership are treated as assessable income and losses of the partners on the basis of their interests in the partnership.

47 Pt III, Div 5A, ITAA 1936. An exception from non-transparent treatment has recently been provided for venture capital limited partnerships: See s 94D(2), ITAA 1936 which prevents these partnerships from being “corporate limited partnerships” thereby ensuring that they cannot be taxed on a basis that is similar to companies under ss 94H-94Y of the ITAA 1936.
Under the new Australian tax consolidation regime, subsidiary members of consolidated groups will be fiscally transparent because they will be treated for tax purposes as a division of the group’s head entity. However, this should have no practical significance for Art 7(9) purposes because if a subsidiary member of the Australian group carries on business in the United States through a permanent establishment, it is likely that the United States would treat that subsidiary as the relevant entity for treaty purposes.

For United States federal income tax purposes, the classification of entities is determined under ss 301.7701-1 to 301.7701-4 of the Treasury Regulations. Under those Regulations, a business entity organised under a United States federal or state statute is treated as a corporation if the statute describes or refers to the entity as incorporated or as a corporation, body corporate or body politic. The Treasury Regulations contain a list of entities established under foreign law that are treated as corporations for United States tax purposes. The list includes Australian public limited companies but not proprietary limited companies. For entities that are not corporations under these rules, entity classification elections can be made.

In the absence of an entity classification election, United States domestic entities other than corporations are classified as partnerships if they have two or more members, or are disregarded as separate entities if they have a single owner. Foreign entities which are not deemed by the Treasury Regulations to be corporations for United States tax purposes are treated as partnerships if they have two or more members and at least one does not have limited liability. They are treated as an association, and therefore as a corporation, if all members have limited liability; and they are disregarded if they have a single owner who does not have limited liability. These classifications are displaced if an entity classification election is made. An entity with at least two members can elect to be treated as an association, and therefore as a corporation, or as a partnership. An entity with a single member can elect to be treated as an association or to be disregarded.

These rules provide scope for entities to be characterised differently for Australian and United States tax purposes. For example, an Australian proprietary company in respect of which a disregarded entity election has been made under the Treasury Regulations would be treated as a company for Australian purposes but as a branch of its shareholder for United States purposes. Similarly, a United States limited liability company (LLC) or limited partnership would be treated as a company for Australian tax purposes but would ordinarily be classified as a partnership for United States tax purposes. From an Australian perspective, this mismatch has created problems under its controlled foreign companies tax legislation because LLCs are not subject to United States tax on

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48 The net income of a trust estate is taxed to the trustee under s 99 or s 99A of the ITAA 1936 to the extent that no beneficiary of the trust is presently entitled to the income of the trust estate.
50 Section 301.7701-2(b)(1), Treasury Regulations. Joint stock companies or associations organised under a State statute, insurance companies, State chartered business entities conducting banking activities, business entities wholly owned by a State or political subdivision thereof and entities taxable as a corporation under the IRC are also treated as corporations: s 301.7701-2(b)(3)-(7), Treasury Regulations.
51 Section 301.7701-2(b)(8), Treasury Regulations.
52 Section 301.7701-3(b)(1), Treasury Regulations.
53 Section 301.7701-3(b)(2), Treasury Regulations.
54 Section 301.7701-3(a), Treasury Regulations.
56 Sections 94H – 94Y, ITAA 1936 modify the income tax legislation to ensure that corporate limited partnerships are taxed on the same basis as companies. Limited liability companies established under United States State law have a separate legal existence from their members, and can sue or be sued in their own name. Consequently, LLCs are “bodies” within the terms of the definition of “company” in s 6, ITAA 1936 and are companies for Australian tax purposes. The ATO shares this view: See National Tax Liaison Group, Application of Foreign Source Income Measures to United States Limited Liability Companies (December 1998), and ATO Interpretative Decision ID 2003/246 (19 March 2003).
57 While limited partnerships and limited liability companies could elect to be classified as corporations for United States tax purposes, in practice they are generally classified as partnerships: Blessing P, Income Tax Treaties of the United States (Warren, Gorham & Lamont, 1996) at [2.01(3)(b)(vi)].
their worldwide income and therefore are not resident in the United States for the purposes of that legislation.58 Legislation addressing this issue was introduced into Federal Parliament on 26 June 2003 in *Taxation Laws Amendment Bill (No 7) 2003* (Cth) (TLAB7). Under the proposed legislation, LLCs and limited partnerships which are controlled foreign companies for the purposes of Pt X of the ITAA 1936 will be treated as partnerships for taxation purposes.59 Where investments in LLCs are subject to the foreign investment fund measures, investors may elect partnership treatment under proposed s 485AA of the ITAA 1936. Such an election will not apply to foreign investors in the LLC. Therefore, even after the legislation has been enacted, scope for different entity classification will arise, for example where there are no Australian resident investors in the LLC, so that it is not a controlled foreign company and the partnership election cannot be made because the foreign investment fund rules do not apply.

The Organisation for Economic and Cooperative Development (OECD) considered the tax treaty implications of partnerships being characterised differently in different countries in its 1999 report on partnerships60 and the *OECD Model Convention with respect to taxes on income and on capital* (OECD Model Convention). That report highlighted a number of problems arising in relation to the application of tax treaties to partnerships, and a number of changes were made to the commentaries to the OECD Model Convention following recommendations made in the report. One of the changes deals with the situation where a partnership is treated as fiscally transparent in the country in which the partners reside but is treated as a separate entity under the tax law of the country from which the income is derived. In these circumstances, the commentaries state that because the income of the partnership flows through to the partners under the State of residence’s domestic law, the partners are the relevant taxpayers and should be entitled to claim treaty benefits even though the source State treats the partnership as a separate entity.61 In the context of the US Treaty, this situation could arise if an LLC formed under United States State law derived Australian sourced income. For Australian tax purposes the company would be treated as a separate taxable entity, whereas for United States tax purposes it is likely that the company would be treated as a partnership if it had more than one member.62 It is instructive to consider how the US Treaty would apply in this context.

Subject to the limitation on benefits Article (Art 16) of the US Treaty applies to persons who are resident in either or both Australia and the United States.63 A person is resident in the United States if the person is a United States corporation or any other person resident in the United States for the purpose of its tax.64 A partnership is treated as resident in the United States to the extent that its income is subject to United States tax as income of a United States resident either in the “hands” of the partnership or in the “hands” of the partners.65 There is a technical curiosity in this provision in that the rule deeming a partnership to be United States resident is a proviso to a rule that any person other than a corporation who is resident in the United States under its domestic tax law is resident there for treaty purposes. As there is no concept of a “resident partnership” under United States tax

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58 Section 332, ITAA 1936.
59 The new measures are contained in Sch 10, item 15 of the TLAB7. Under proposed s 830-15, an LLC will be a “foreign hybrid company” if it is a controlled foreign company under Pt X of the ITAA 1936 and is treated as a partnership or as a disregarded entity for United States tax purposes. Foreign hybrid companies are to be treated as partnerships under proposed subdiv 830-B. Under proposed s 830-10 foreign limited partnerships which are controlled foreign companies under Pt X are treated as “foreign hybrid limited partnerships” if foreign tax is imposed on the partners rather than on the partnership. Foreign hybrid limited partnerships are precluded from being corporate limited partnerships by proposed s 94D of the ITAA 1936 and therefore are subject to the normal tax rules governing partnerships.
62 Under the measures dealing with hybrid entities contained in Sch 10, TLAB7 the LLC would not be treated as a partnership if it was not a controlled foreign company under Pt X of the ITAA 1936: See item 10, proposed s 830-15(1). Therefore, for the purposes of the example in this article, it is assumed that all members of the LLC are resident outside Australia and that the LLC is not a Pt X controlled foreign company.
63 Art 1(1), US Treaty.
64 Art 4(1)(b), US Treaty.
law, the proviso would not appear to have any application. However, clearly it was intended that partnerships could be treated as United States tax residents and therefore it seems that the proviso is not a true proviso at all but rather a separate substantive rule.

A difficult question which arises in relation to the application of the “United States resident” definition to partnerships is, which country’s law applies in determining whether an entity is a partnership? If it is Australian law, an LLC would not be a partnership under current law and would not otherwise qualify under the US Treaty as a United States resident. If United States law applies, an LLC taxed as a partnership in the United States would be a United States resident in relation to income that is taxed to United States resident members. As the question of whether a person is resident in the United States is determined according to United States law, it should follow that the characterization of the entity whose residence is being tested would be determined in accordance with United States law. This would also be consistent with the underlying objective of providing treaty benefits to residents of the United States since, in substance, the income would be derived by such persons in the circumstances described. Having determined that the LLC is a resident of the United States, Australia would then treat it as a taxpayer resident in the United States for the purposes of the US Treaty.

If it is not permissible to apply United States characterisation rules in determining whether an LLC is a partnership for the purposes of the residence Article, the other possibility would be to adopt the approach set out in para [8.4] of the commentary to Art 4 of the OECD Model Convention. Under that approach, if the members of the LLC are United States residents, they would be treated as the relevant taxpayers for the purposes of the US Treaty and would be entitled to benefits under the US Treaty. Again, this would be consistent with the objective of providing treaty benefits to United States residents who derive Australian source income. The new limitation on benefits Article (Art 16) would then be applied to ensure that treaty benefits have not been inappropriately extended to residents of third countries. This issue is not resolved under the foreign hybrid measures contained in Sch 10 of the TLAB. Those measures only treat an LLC as a partnership for tax purposes if it is a controlled foreign company under Pt X of the ITAA 1936. Therefore, it is still necessary to consider the treaty status of LLCs which are not so deemed to be partnerships.

If the LLC is treated as a United States resident partnership for the purposes of the US Treaty and Australia treats the company as the relevant taxpayer, Art 7(9) would have no application because Australia would apply its law in determining whether the company was fiscally transparent. Therefore, the fiscal transparency of the company for United States tax purposes would qualify the company as a United States resident under Art 4(1)(b)(i) of the US Treaty, but would not result in the company being fiscally transparent for Australian purposes. Australia would tax the company, but

66 Blessing, n 57 at [2.01(3)(b)(vi)]. The concept of a “domestic partnership” is used, for example, to source certain categories of income and to impose a withholding tax obligation on disposals of United States real property interests by domestic partnerships to the extent that the gain is attributable to a foreign partner: See ss 861(a)(1)(B)(ii), 861(a)(3)(C)(ii) and 1445(o)(1), IRC. However, the expression is not used in the same sense as “resident” or “domestic corporation” to identify taxpayers whose worldwide income is subject to United States tax.

67 It would not be necessary to make this argument if the “resident” definition had been amended to include a provision based on Art 4(1)(d), US Model Convention. Under that provision, income derived through an entity which is fiscally transparent under Australian law would be treated as resident income of a resident in the sense that it is taxed to United States residents. The ATO accepts that changes to the Commentaries should be applied in interpreting treaties concluded before the changes were effected: See Taxation Ruling TR 2001/13 at [108]. However, the Ruling states that changes will not be applied to earlier treaties if the substance of the OECD Model Convention has changed or if an interpretation has been substantively altered. It may be that para [8.4] would be viewed as a substantive change to the Commentaries.

68 Paragraph [8.4] of the commentary on Art 4 of the OECD Model Convention was inserted into the Commentaries in 2000. The ATO accepts that changes to the Commentaries should be applied in interpreting treaties concluded before the changes were effected: See Taxation Ruling TR 2001/13 at [108]. However, the Ruling states that changes will not be applied to earlier treaties if the substance of the OECD Model Convention has changed or if an interpretation has been substantively altered. It may be that para [8.4] would be viewed as a substantive change to the Commentaries.

69 Schedule 10, item 15, proposed s 830-15(1), TLAB. If an LLC is treated as a partnership under these new measures and the LLC derives Australian source income, no question will arise in relation to the application of the US Treaty to that income to the extent it is allocated to Australian shareholders because that income would be viewed as Australian source income derived by an Australian resident.
would recognise that the company would be entitled to treaty benefits. Alternatively, if Australia regarded the members of the LLC as the relevant taxpayers by applying para [8.4] of the commentary on Art 4 of the OECD Model Convention, it would effectively be treating the company as fiscally transparent for Australian tax purposes. Consequently, Art 7(9) could apply in these circumstances to attribute the company’s Australian permanent establishment to its members, thereby ensuring that the members could not claim treaty protection on the basis that their business profits were not attributable to an Australian permanent establishment. The former approach would be more consistent with Australian domestic law because it does not require taxpayer status to be attributed to entities that are not considered to be taxpayers for Australian purposes.

As discussed earlier, Australian proprietary companies are disregarded for United States tax purposes if the appropriate election is made under the entity classification rules. For Australian tax purposes, such a company would be treated as an Australian resident and it would not be permissible in this case to have regard to characterisation of the company by the United States as fiscally transparent and treat the shareholders as the relevant taxpayers for Australian tax purposes. Consequently, Australia would not need to rely on Art 7(9) to ensure that it could tax business profits derived by the Australian company.

In the situation where a United States LLC has Australian resident members and derives United States source income, it would not be possible under current law to make the argument advanced above that for US Treaty purposes the LLC is a partnership resident in Australia under Art 4(1)(a)(iv). This is because for Australian tax purposes the LLC would be treated as a company and the income of the company would not be taxed as income of a resident of Australia. United States domestic law also removes any prospect of the United States providing treaty benefits under such a structure where the income derived by the company is taxed in the United States on a gross basis under s 871(a) or s 881(a) of the IRC. In these circumstances, treaty benefits would be denied under Regulations issued under s 894(a)(2) of the IRC. Those Regulations provide that income derived by an entity, wherever organised, which is fiscally transparent under the laws of the United States or any other jurisdiction are only eligible for a reduction in tax under a treaty if the income is derived by a resident of the applicable treaty jurisdiction. The relevant resident for this purpose can be the entity or persons with interests in the entity. However, an entity qualifies as a resident of an applicable treaty jurisdiction only if it is not fiscally transparent under the laws of its jurisdiction. A limited liability United States company would ordinarily be fiscally transparent under United States tax law and would therefore not satisfy this requirement.

Considering, then, whether treaty benefits would be available by focusing on the members of the LLC, an item of income paid to an entity is considered to be derived by an interest holder in an entity if the interest holder is not fiscally transparent in its jurisdiction and the entity is considered to be fiscally transparent under the laws of the interest holder’s jurisdiction. Therefore, if Australia regarded the LLC as fiscally transparent, the United States would allow treaty benefits in relation to dividends, interest or royalties derived by the company. However, as Australia would under current law not regard the company as fiscally transparent, treaty benefits would not be available in the United States. This position should in many cases change once the hybrid entity measures in
TLAB7 have been enacted. If the LLC is a controlled foreign company under Pt X of the ITAA 1936 it will be taxed as a partnership in Australia and therefore should be fiscally transparent for the purposes of the United States Regulations.77 If the LLC is not a controlled foreign company, individual investors may choose partnership treatment. The LLC should be fiscally transparent for the purposes of the United States Regulations for investors who choose partnership treatment, but not for those who do not make such a choice.

It may be thought that the Regulations under s 894(a)(2) of the IRC could apply where an Australian resident member of an Australian consolidated group derives United States source dividends, interest or royalties because the subsidiary will effectively be fiscally transparent. However, the Regulations provide that an item of income paid directly to a type of entity specifically identified in a treaty as a resident of a treaty jurisdiction is to be treated as derived by a resident of that jurisdiction.78 The subsidiary in this example would be Australian resident for the purposes of the US Treaty, and therefore the income would be treated as derived by a resident of Australia under the Regulations and treaty benefits would not be denied.79

The principle underlying the s 894(a)(2) Regulations is that a reduction in source country taxation "is predicated on the mutual understanding that the treaty partner is asserting tax jurisdiction over the income".80 Therefore, if an entity like an LLC is not fiscally transparent in the country in which its members are resident, treaty benefits are denied under the Regulations in relation to income taxed on a gross basis in the United States on the assumption that the company’s income is not currently taxed to the members. The s 894(a)(2) Regulations have not been extended to business profits taxed on a net basis.81 Therefore, Australian resident members of an entity treated as fiscally transparent for United States purposes but as non-transparent for Australian tax purposes could claim treaty benefits if the income derived through the entity was not connected with a United States permanent establishment. Of course if the income was connected with a United States permanent establishment, the United States, if required, could rely on Art 7(9) to ensure that an Australian resident member could not claim protection on the basis that the permanent establishment belongs to the entity and not the member.

As discussed above, Art 7(9) is intended to ensure that source country taxation rights in relation to business profits are preserved where such profits flow through a fiscally transparent entity. It would not have any taxation implications from a residence country perspective. In the deferential rules, such as controlled foreign company provisions, does not satisfy this requirement. Therefore, an LLC would not be fiscally transparent for a member resident in Australia because there would be no current inclusion of income under general principles and any current inclusion under the controlled foreign company provisions of Pt X of the ITAA 1936 must be disregarded. In United States Treasury Decision TD 8889, which provides the United States Treasury’s explanation of the s 894 Regulations, it is explained that the nature of an inclusion under controlled foreign company (CFC) provisions is that of a deemed distribution of after-tax profits of the CFC while the principle underlying the Regulations is that treaty benefits should be available where fiscal transparency has the same effect as if the member realised the income directly: See United States Treasury Decision Part IV.E, TD 8889, http://www.legalbitsstream.com viewed 7 July 2003. Similarly, in United States Treasury Decision: TD 8722, which provides the United States Treasury’s explanation of the proposed s 894 Regulations which preceded the final Regulations, it was explained that treaty benefits would not be provided where the residence country taxed distributions from the entity considered fiscally transparent in the source country, but did not directly tax the entity’s income to its members as it was earned. See United States Treasury Decision TD 8722, at [3] under “Application of principle to regular hybrid entity” at http://www.legalbitsstream.com viewed 7 July 2003. The concern in this context is that a distribution could have a different character than the income derived by the fiscally transparent entity and could be taxed more favourably in the residence country than a direct derivation of the underlying income derived by the entity. The same concern presumably underlies the position that attribution under CFC provisions is not sufficient to satisfy fiscal transparency in the residence country.

77 The LLC would be a foreign hybrid company under proposed s 830-15 of the TLAB7 and would therefore be treated as a partnership under proposed subdiv 830-B.
78 Section 1.894-1(d)(1), Treasury Regulations.
79 The subsidiary would be resident in Australia for the purposes of Art 4(1)(a)(i), US Treaty.
81 In United States Treasury Decision TD 8889 under “I. General” the Treasury indicates that additional Regulations may be published addressing the availability of treaty benefits in relation to business profits derived through fiscally transparent entities. At the date of writing, no such Regulations had been issued.
above example of an Australian member of an LLC, Art 7(9) would not trigger the operation of s 23AH of the ITAA 1936. This is due to the fact that, while the member would be treated as having a United States permanent establishment for s 23AH purposes, there is nothing in s 23AH which states that the deemed conduct of a business in the United States for US Treaty purposes results in the member also being deemed to be carrying on such a business for s 23AH purposes. Consequently, the US Treaty would not convert the dividends derived by the member from the company into exempt s 23AH business profits. In any event, this would not be significant if the LLC were a controlled foreign company for Australian tax purposes because any business profits attributable to a United States permanent establishment would be exempt from tax by attribution. Such business profits would also be exempt from tax on distribution if they were attributable to a United States permanent establishment and the distribution was a non-portfolio dividend for the purposes of s 23AJ.

DIVIDENDS

Rate of dividend withholding tax

Article 6 of the Protocol inserted a new Art 10 into the US Treaty which provides for three rates of tax in relation to dividends. First, Art 10(2)(a) limits the tax on dividends to “5% of the gross amount of the dividends, [where] the person beneficially entitled to those dividends is a company which holds directly at least 10% of the voting power in the company paying the dividends”. Second, Art 10(3) provides that dividends are not subject to tax in the State in which the paying company is resident if the dividends are paid to a company resident in the other State, and if certain requirements as to ownership and stock exchange listing are satisfied. Finally, if neither the 5% nor zero rate applies, then the dividend tax rate is capped by Art 10(2)(b) at 15% of the gross dividend. Therefore, in broad terms the treaty rate for dividends paid to individuals and to companies in respect of portfolio shareholdings will be 15%, while for other dividends paid to companies the rate will be either 5% or zero.

The technical requirements for achieving the zero treaty rate are that the dividends must be paid by a company resident in one State to a company resident in the other; the shareholding company must have owned shares representing 80% or more of the voting power of the dividend-paying company for a 12 month period ending on the date the dividend is declared; and the shareholder must either be a qualified person under Art 16(2)(c) of the Treaty or entitled to the benefit of the Treaty under Art 16(5). These requirements mirror those in Art 10, UK–US Treaty for attaining the zero dividend tax rate in relation to dividends under that Treaty.

62 For s 23AH purposes, treaty concepts of permanent establishment are applied by virtue of the definition of “permanent establishment” in s 23AH(12).
63 Under the foreign hybrid measures in the TLAB the LLC could be treated as a partnership in which case s 23AH(6) could apply to treat the Australian shareholder’s portion of the LLC’s income as exempt United States branch income if the other technical requirements of s 23AH are satisfied.
64 The LLC would be a resident of an unlisted country under s 333 of the ITAA 1936 and its notional assessable income would therefore be determined on the basis of the assumptions in s 384. Any business profits derived by the LLC would either not be included in notional assessable income under s 384 or would be notional exempt income under s 403(a). The “subject to tax” requirement test in that section would be satisfied because the limited liability company’s income would be subject to United States tax in the hands of its members: See s 324. Distributions would be exempt under s 23AJ if the member is a company owning 10% or more of the voting interests in the company because its profits would be exempting profits by virtue of ss 378(1) and 377(1)(a), and distributions would therefore be exempting receipts under s 380.
65 These requirements mirror those in Art 10, UK–US Treaty for attaining the zero dividend tax rate in relation to dividends under that Treaty.
66 It is unlikely that much turns upon the different language used in paras [2(a)] and [3] of Art 10. The former refers to a company that “holds directly” at least 10% of the voting power of another company while the latter refers to a company that has “owned shares” representing 80% or more of the voting power in another company. While para [3] does not refer expressly to the direct ownership of shares, the reference to ownership without qualification is unlikely to be interpreted as including indirect ownership through corporate chains.
would not apply, for example, where an Australian company owns directly 50% of the shares in a United States company and then owns the remaining 50% indirectly through a wholly owned United States subsidiary.

The concept of “voting power” is not defined for the purposes of Art 10(3). If the dividend paying company has a simple capital structure consisting only of ordinary shares carrying equal voting rights, the question of whether the 80% threshold is satisfied will be easy to determine. However, the position would be less clear where a company has different classes of shares on issue and each class carries different voting rights. For example, a company could have ordinary and preference shares on issue, and the preference shares may carry voting rights in relation to issues that affect the rights of preference shareholders. Article 10 of the US Model Convention provides for a 5% tax rate on dividends paid to a company which beneficially owns at least 10% of the voting stock of the company paying the dividends. The Technical Explanation of that Model states that “shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a US corporation". It is likely that the United States will also interpret the voting power requirement in Art 10(3) in this way.

The Explanatory Memorandum does not explain how the voting power requirement will be interpreted in Australia. Applying Art 3(2) of the US Treaty, and looking to the Australian domestic tax law meaning of “voting power”, it is likely that it will be taken to refer to voting power on all issues and not only to voting power on the replacement of directors. Therefore, it is likely that the test will be applied differently in Australia from in the United States.

The holding period requirement in Art 10(3) is that shares representing 80% or more of the voting power of the company paying the dividends be held for a 12 month period ending on the date the dividend is declared. It is likely that this will be interpreted as meaning a period of 12 consecutive months preceding the date of declaration of dividend, rather than an aggregate period of 12 months. However, the particular shares in respect of which dividends are paid need not be held for that 12 month period. For example, if a company holds 80% of the shares and that shareholding is later increased to 100%, it is not necessary to establish that the additional 20% shareholding has been held for 12 months before the payment of a dividend. Obviously, the 12 month holding period requirement will in some circumstances be influential in the timing of dividend declaration.

The final requirement in Art 10(3) is that the shareholder is a “qualified person” under Art 16(2)(c) or is entitled to benefits in relation to the dividends under Art 16(5). Article 16(2)(c) provides that a company is a qualified person if the principal class of its shares is listed on a recognised stock exchange and those shares are regularly traded on one or more of such exchanges. A company is also a qualified person if at least 50% of the vote or value of the shares in the company is owned by five or fewer companies whose shares are listed on a recognised exchange and are regularly traded on such an exchange. Article 16(5) provides that a resident of a Contracting State that is not a qualified person is granted the benefits of the US Treaty if the competent authority of the other State determines that the establishment, acquisition or maintenance of the person and the conduct of its operations did not have as one of its principal purposes the obtainment of benefits under the Treaty. Consequently, a privately owned company with a subsidiary in the other country could be entitled to the zero rate if approval is obtained under Art 16(5) from the competent authority of the other State. The operation of Arts 16(2)(c) and (5), together with the other provisions of Art 16, is discussed in Part 2 of this article which is to be published in a later issue of this journal.

87 In other Australian treaties providing for a dividend rate lower than 15% and where that lower rate applies only if an ownership threshold is satisfied, the relevant threshold is usually 10% of the capital of the dividend paying company; see, for example, Art 10(2)(a), South African Treaty. The Argentinian Treaty and Protocol does contain a 10% voting power ownership threshold, but as with the US Treaty contains no definition of “voting power”.
89 In Kolotex Hosiery (Australasia) Pty Ltd v FCT (1975) 5 ATR 206 it was held that the expression “voting power” in ss 80A(1)(c) and 80C(1)(b)(i) of the ITAA 1936 “would include all voting power that may be exercised in the company, however conferred” and including the “voting power attached to or carried by shares”, per Gibbs J at 235.
As only two of the provisions of the limitation of benefits Article (Art 16) can apply to permit the dividend exemption, the requirements for obtaining that exemption are stricter than the requirements for obtaining other treaty benefits. In the US Treasury Explanation to the Protocol this stricter approach is justified on the basis that the dividend exemption places increased pressure on the limitation on benefits Article because the US Treaty is one of the few United States treaties that provides for such an exemption. In particular, the stricter test is designed to ensure that residents of third countries do not reorganise their structures so as to become eligible for the dividend exemption.

Under the United States system of company taxation, company profits are subject to income tax and are then subject to a gross-basis tax when distributed to non-resident shareholders. While dividends paid by a United States corporation to its Australian parent company would be exempt from Australian income tax under s 23AJ of the ITAA 1936, the United States dividend withholding tax has historically represented a significant impediment to the repatriation of profits generated in the United States, even at the 15% rate that applied before the US Treaty was amended by the Protocol. The zero dividend tax rate under the new dividends Article (Art 10) will remove that impediment by allowing Australian parent companies access to a greater amount of the cash generated in their United States subsidiaries. This will facilitate the repatriation of profits from United States group members to fund investment elsewhere in the group or to fund debt repayment. Profits sourced from United States members of the group could also be on-paid to non-Australian resident shareholders without any Australian tax cost. The exemption will also increase the amount of cash available for distribution to Australian tax resident shareholders. However, because the underlying United States company tax does not generate franking credits in Australia, any distributions by Australian parent companies from dividends received from United States group members would ultimately be taxed at the marginal tax rates of their shareholders. Therefore, the exemption will not eliminate the bias inherent in the imputation system, all other things being equal, for Australian companies to invest in Australia rather than to invest overseas. This issue was considered in the context of the Government’s review of Australia’s international tax rules, and the Board of Taxation recommended that the bias be addressed by providing resident shareholders with a 20% tax credit in respect of any dividends paid out of foreign source income. That recommendation was ultimately not accepted by the Government.

In relation to United States resident companies with Australian subsidiaries, the dividend withholding tax exemption will potentially allow untaxed Australian source profits to be repatriated from Australia without a dividend withholding tax cost. Achieving an Australian tax-free repatriation can be important in large infrastructure projects where untaxed profits may be generated in the early years of the project through a higher level of depreciation deductions for tax purposes...
than for accounting purposes. Tax free repatriation would not be available in a joint venture context where, for example, a United States corporation directly held a 50% shareholding in an Australian company. However, relief would be available if the United States corporation established a wholly owned Australian subsidiary to hold its 50% interest in the Australian project company. Unfranked dividends paid by the project company to the Australian subsidiary would be assessable to that company without inter-corporate dividend relief. However, if the dividend is on-paid to the United States parent company, an offsetting deduction would be available under s 46FA of the ITAA 1936 and if the US Treaty dividend withholding tax exemption is available, an Australian tax-free repatriation of the untaxed profits will have been achieved utilising an on-shore Australian corporate structure.

If dividends are not exempt from dividend withholding tax under Art 10(3), a 5% rate applies under Art 10(2)(a) if the person beneficially entitled to the dividends is a company which holds directly at least 10% of the voting power in the company paying the dividend. The most common situation where this rate will apply is where the shareholder is a company which owns between 10% and 80% of the shares in the company paying the dividend. A significant limitation on obtaining the 5% rate is that the 10% or greater voting power must be held “directly” in the company paying the dividends. The United States approach to the direct holding requirement is that if shares are held through fiscally transparent entities such as partnerships, each member of the entity is considered to hold their proportionate interest in the shares held by the intermediate entity. The Explanatory Memorandum is silent on whether the same approach will be adopted in Australia. The requirement that the beneficial owner directly holds the voting power could be construed as requiring direct share ownership that disqualifies ownership through interposed fiscally transparent entities. The most likely situation where this will arise is where a United States LLC or limited partnership holds a 10% or greater shareholding in an Australian company. Assuming that the LLC or limited partnership is treated as a partnership for United States tax purposes, the LLC or partnership would most likely be treated as a United States resident for treaty purposes to the extent that its income is subject to United States tax in the hands of its members. However, as the LLC or limited partnership would be a United States resident for treaty purposes by virtue of its partnership status, it is likely that it would not be a company for the purposes of Art 10(2)(a). In this event, the 5% rate would not be available unless Australia was prepared to look through the LLC or limited partnership to the underlying members, and those members were companies. Assuming that the LLC or limited partnership is not a partnership for Australian tax purposes under the new foreign hybrid entity rules, a potential hurdle in this context is that the 5% rate applies only if the United States...
company is beneficially entitled to the dividend.\textsuperscript{103} If the shareholder is an LLC with corporate members, the LLC would be viewed under Australian domestic law as the entity beneficially entitled to the dividends because it is the entity which legally and beneficially would own the shares in the Australian company.\textsuperscript{104} However, if the underlying members are companies, it would be consistent with the objective of Art 10(2)(a) to treat the members as beneficially entitled to the dividends so that the reduced rate could apply if the required 10% shareholding requirement is satisfied on tracing through the LLC.

If the zero or 5% rates do not apply, dividends may be taxed at a rate of 15%. As the zero and 5% rates apply only where the shareholder is a company, this rate will apply most often to dividends paid to individuals or to non-corporate investors, and to dividends paid to companies in respect of portfolio shareholdings.

**Dividends paid by RICs and REITs**

Article 10(4) is concerned with dividends paid by Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs). These are both United States entities which in certain circumstances are taxed on a flow through basis under a dividend deduction mechanism. RICs are essentially domestic United States corporations which are registered under the Investment Company Act 1940 (US) and which satisfy certain requirements in ss 851 and 852 of the IRC in relation to the nature of their investments and as to the distribution of income. In particular, s 851(b)(2) provides that the company must derive at least 90% of its gross income from dividends, interest, gains from the sale or disposition of stock, securities or foreign currencies, or other income derived with respect to the business of investing in such stock, securities or currencies. Further, s 851(b)(3) provides that at the close of each quarter of the RIC’s taxable year at least 50% of the value of its total assets must be represented by cash and cash items, government securities, securities of other RICs and securities of other issuers – but that the securities of any one such issuer cannot exceed 5% of the value of the RIC’s total assets, or 10% of the outstanding voting securities of the issuer. The distribution requirement under s 852(a)(1) is that the RIC must distribute each year an amount equal to at least 90% of its taxable income for that year.

If the RIC satisfies the requirements as to the nature of its assets and the quantum of its distributions, a deduction is allowed for any dividends that it pays.\textsuperscript{105} Dividends paid by a RIC to a non-resident of the United States would either be taxed at a rate of 30% of the gross dividend\textsuperscript{106} or would be subject to tax at the shareholder’s United States marginal tax rate if the holding in respect of which the dividends are paid is effectively connected with the conduct of a trade or business in the United States.\textsuperscript{107} Under Art 10(4) of the US Treaty, if the dividends are paid to an Australian resident, the zero and 5% rates provided for in Art 10(2) and (3) do not apply but the United States tax rate is capped at 15%. This approach is standard in United States treaties, and reflects the concern that if a lower rate were allowed in respect of RIC dividends, RICs could be used to convert dividends in respect of portfolio share investments that would be taxed at 15% if the shares were held directly into dividends paid by RICs and taxed at a lower rate if the shareholding in the RIC is significant.\textsuperscript{108} Therefore, the objective is to equalise the United States tax treatment of dividends on portfolio shareholdings held directly and those held indirectly through RICs. This concern does not arise in the

\textsuperscript{103} The LLC or limited partnership would not be a partnership under the new measures if it was not a controlled foreign company under Pt X, ITAA 1936: See Sch 10, item 15, proposed ss 830-10 and 830-15, TLAB7.

\textsuperscript{104} There is no universal tax treaty meaning of “beneficially entitled”: See Avery Jones JF, Depret H, Ellis MJ, Fontaneau P, Goldberg SH, Kilius J, Lenz R, Maisto G, Orrock DC, Roberts SI, Uckmar V, Van de Wiele M and Ward DA, “The Treatment of Trusts Under the OECD Model Convention” (1989) 23 Tax in Aust 686 at 691. Under domestic law “beneficial ownership” “means ownership for your own benefit as opposed to ownership as trustee for another” per Nourse LJ in J Sainsbury plc v O’Connor (Inspector of Taxes) [1991] 1 WLR 963 at 978. Unless there was an arrangement under which the LLC agreed to hold the shares on behalf of another person, it would be the beneficial owner of the shares and would therefore be beneficially entitled to dividends on the shares.

\textsuperscript{105} Section 852(b)(2)(D), IRC.

\textsuperscript{106} Sections 871(a) and 881(a), IRC.

\textsuperscript{107} Sections 871(b)(1) and 882(a), IRC.

\textsuperscript{108} United States Treasury, n 88, Technical Explanation to Art 10(3), US Model Convention.
reverse situation of a United States resident investing in a portfolio of Australian shares. This is partly because Australia unilaterally forgoes dividend withholding tax in relation to franked and foreign dividend account debited dividends, and also because the dividend deduction regime in s 46FA of the ITAA 1936 for unfranked dividends applies only in relation to the flow through of non-portfolio dividends.

REITs are widely held trusts, corporations or associations which satisfy certain requirements in relation to the nature of the income they derive and the assets they hold, and which are taxable as domestic United States corporations. The income test under s 856(c)(2)–(3) of the IRC requires, in broad terms, that at least 95% of the entity’s gross income be derived from dividends, interest, rents from real property, and gains from the disposal of stock, securities and real property; and that at least 75% of gross income consists of rent from real property, interest on obligations secured by mortgages on real property and gains from the sale or other disposition of real property. The assets test under s 856(c)(4) requires that at least 75% of the entity’s assets at the end of each quarter consist of real estate assets, cash, government securities, and, subject to limitations, non-government securities. In relation to non-government securities it provides that not more than 5% of the value of the entity’s assets may consist of securities of one issuer and securities having more than 10% of the value or voting power of an issuer may not be held. If these requirements are satisfied, dividends paid by the REIT are deductible in calculating its taxable income as long as an amount at least equal to 90% of that income, excluding net capital gains, is distributed each year. Distributions to non-residents of capital gains derived by a REIT from the disposal of a United States real property interest are treated as gains derived by the non-residents from a disposal of such an interest. Such distributions are consequently treated as income effectively connected with the conduct of a United States trade or business, and are taxed as capital gains rather than as dividends.

Income derived by foreign persons by way of rentals from United States real estate is subject to tax at a rate of 30% of the gross rentals, or at income tax rates on the net amount if the rentals are effectively connected with the conduct of a United States trade or business, or if the rentals would be taxed on a gross basis but the taxpayer elects to treat them as effectively connected with a United States trade or business. The provisions in Art 10(4)(c) of the US Treaty dealing with REIT distributions are generally intended to ensure that Australian residents do not structure investments in United States real property through REITs to achieve a lower rate of tax than would be the case if the investment were held directly. The first feature of this approach is that the zero and 5% dividend tax rates do not apply to REIT dividends. Therefore, the lowest possible United States tax rate is 15%. The circumstances in which the 15% rate applies are then limited by Art 10(4)(c) to situations in which the REIT investment is not effectively equivalent to a direct investment in United States real property. This contrasts with the position under the current dividend Article where all REIT dividends paid to Australian residents are taxed at a 15% rate.

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109 Section 856, IRC.
110 Section 857(a), IRC.
111 Section 897(h)(1), IRC. “United States real property interest” is defined in s 897(c) as an interest in real property in the United States or Virgin Islands and an interest in a United States real property holding corporation. In broad terms, a corporation is a United States real property holding corporation if the fair market value of its United States real property interests is equal to 50% or more of the value of the corporation’s total property.
112 Section 897(a)(1), IRC.
113 For non-United States resident individuals, United States source rents are taxed at 30% under s 871(a)(1) of the IRC. However, for individuals who are engaged in a trade or business within the United States, s 871(b) provides that income tax is payable at marginal rates on the taxable income which is effectively connected with the conduct of a trade or business in the United States. If rent is not effectively connected income, non-resident individuals can elect to treat it as effectively connected under s 871(d)(1), and in this event the net rental income is taxed at the relevant marginal rates. For foreign corporations, the 30% tax is imposed by s 881(a), effectively connected income is taxed on a net basis under s 882(a)(1), and an election to treat non-effectively connected rentals as effectively connected can be made under s 882(d).
114 The lower rate would arise because the dividends paid deduction under s 857, IRC would offset the REIT’s rental income, so that no United States tax would be paid at the REIT level, and the United States tax on the REIT dividends would, in the absence of Art 10(4), potentially be reduced under the US Treaty to zero or to 5%.
The first situation in which Art 10(4)(c) provides that the 15% rate applies is where REIT dividends are paid to individuals who hold an interest in the REIT that is not greater than 10%.\(^\text{115}\) This mirrors an equivalent provision (Art 10(3)) in the US Model Convention. The Technical Explanation to that Model states that individuals could in any event achieve a tax rate of 15% on net rental income derived directly, presumably by electing to treat the rent as effectively connected income.\(^\text{116}\) Therefore, the reasoning appears to be that a 15% rate for REIT dividends paid to individuals in respect of a small interest in a REIT would not result in individuals structuring their United States real property investments through REITs, and would also not result in significant United States revenue loss.

The second situation in which the 15% rate applies is where the “dividends are paid with respect to a class of stock that is publicly traded and the person beneficially entitled to the dividends holds an interest of not more than 5% of any class of the REIT’s stock”.\(^\text{117}\) The third situation in which the 15% rate applies is where the dividends are paid to a person who holds an interest of less than 10% in the REIT, and the REIT does not hold any interests in real property with a gross value of more than 10% of the value of all of the REIT’s interests in real property.\(^\text{118}\) In this case, the thinking is presumably that the diversified nature of the REIT’s investments is sufficient to ensure that Australian resident investors are not substituting investments in REITs for direct investments in United States real property.

The 15% rate also applies to REIT dividends where the holder of the interest in the REIT is a listed Australian property trust\(^\text{119}\) and a “look through rule” is satisfied.\(^\text{120}\) Under the look through rule, if the responsible entity for the LAPT knows that one or more unitholders each owns 5% or more of the beneficial interests in the LAPT, then each of those unitholders is deemed to hold its pro rata share of the LAPT’s interest in the REIT. Whether the 15% rate applies to the portion of the dividend that is attributed to that deemed holding of an interest in the REIT is then determined on the basis of the general rules in relation to REIT dividends described above. However, a look through is not required if the “grand-father” rule in Art 13(3) of the Protocol applies. Under that provision, REIT dividends are taxed in accordance with the old dividend Article (Art 10) at a rate of 15% where they are paid to a LAPT on shares owned by the LAPT on 26 March 2001, shares acquired by the LAPT pursuant to a binding contract entered into on or before that date, or shares acquired with respect to a reinvestment of dividends in relation to such shares.

There is the question of whether the 15% rate applies where the interest in the REIT is not held directly by a LAPT but rather, is held by a unit trust, all of the units in which are owned by a LAPT. This structure could arise where a LAPT directly holds an interest in a REIT and is then taken over by another LAPT. Article 10(4)(d) refers to dividends “paid to” an LAPT. This is in contrast to the reference in Art 10(4)(c) to dividends to which a person is “beneficially entitled”. The latter expression contemplates looking through trusts whereas the expression “paid to” arguably looks only to the entity to which the payment is made. The look through rule also contemplates that the LAPT will have a direct interest in the REIT by pro-rating direct interests in REITS to unitholders in the LAPTs which hold such interests. The requirement for a direct holding by the LAPT is also reinforced by the grand-fathering rule, which provides that the shares in respect of which the dividends are paid must be “owned” or “acquired” by a LAPT.

Income derived by an LAPT is typically included in the assessable income of the LAPT unitholders through the operation of present entitlement clauses in the LAPT’s constitution. Where

\(^{115}\) Article 10(4)(c)(i), US Treaty.


\(^{117}\) Article 10(4)(c)(ii), US Treaty.

\(^{118}\) Article 10(4)(c)(iii), US Treaty.

\(^{119}\) The term “listed Australian property trust” is defined in Art 10(4)(d) of the US Treaty as “an Australian unit trust registered as a Managed Investment Scheme under the Australian Corporations Act in which the principal class of units is listed on a recognized stock exchange in Australia and regularly traded on one or more recognized stock exchanges”. The definition does not require the trust to hold interests in real property. However, as a practical matter it is likely to apply only to trusts in the property sector. Listed Australian property trusts are referred to in the Protocol, and in this article, as LAPTs.

\(^{120}\) Article 10(4)(d), US Treaty.
the LAPT’s income includes REIT dividends, foreign tax credits flow through to the unitholders for any United States dividend withholding tax. If the special measures for REIT dividends had not been included in the new dividend Article, those dividends would have been subject to United States tax of 30% if the 15% rate was not available under Art 10(4)(c). This would not be of significance for individuals on marginal rates higher than 30%. However, taxpayers on marginal rates lower than 30% would have been worse off in post-tax terms. This would be significant, for example, for complying superannuation funds which enjoy a 15% tax rate.

**Dividend definition**

For the purposes of the new Art 10, the term “dividends” is defined under Art 10(6) of the US Treaty as meaning:

income from shares, as well as other amounts which are subjected to the same taxation treatment as income from shares by the law of the State of which the company making the distribution is a resident for the purposes of its tax.

This is effectively the same as the definition in the old dividend Article, and the interesting question from an Australian perspective is the extent to which the treatment of payments as dividends or interest under the US Treaty is consistent with the treatment applying under domestic law as a consequence of the new debt-equity characterisation rules. Those rules characterise instruments as debt or equity for certain taxation purposes on the basis of an underlying principle that an instrument is in substance debt if the issuer has an effectively non-contingent obligation to repay an amount at least equal to the amount raised in issuing the instrument.

Interests in companies are treated as equity if they fall within one of the items in s 974-75 of the ITAA 1997 and are not also treated as debt interests. Therefore, interests that satisfy both the equity and debt tests are treated as debt. In broad terms, the four categories of equity interest are:

1. Membership interests.
2. Interests carrying a right to a return from the company where that right, or the amount of the return, is in substance or effect contingent on the economic performance of the company or a connected entity of the company.
3. Interests where the right to a return, or the amount of the return, is at the discretion of the company.
4. Interests that are convertible into equity interests.

A scheme gives rise to a debt interest if it involves a financing arrangement under which an entity receives a financial benefit and has an effectively non-contingent obligation to provide a financial benefit to another person at a later time where it is substantially more likely than not that the later benefit will at least equal the value received by the entity. This can result in interests that are, in form, equity being classified as debt. Consider, for example, redeemable preference shares carrying a right to fixed, cumulative dividends and which are to be redeemed for their issue price within 10 years of issue. These shares should be treated as debt interests because the issuer would have a non-contingent obligation to repay an amount equal to the issue price of the shares. Conversely,
consider a perpetual subordinated debt instrument where interest is not payable if the issuer has insufficient profits or has not paid dividends on its ordinary shares. If the interest is not cumulative, the perpetual debt is likely to be treated as equity because the return to the lender would be contingent on the performance of the issuer. The effect would be that the basic equity test would be satisfied, whereas the debt test would not be satisfied because the issuer would not have a non-contingent obligation to repay an amount equal to the issue price of the debt.

If an interest in a company is treated as equity, the issuer is not entitled to deduct payments of interest or dividends but is able to attach franking credits to those payments. For withholding tax purposes, distributions on equity interests are generally treated as dividends rather than as interest. By contrast, returns on debt interests are generally deductible if the general criteria for deductibility are satisfied, and they are not frankable for imputation purposes and are treated as interest for withholding tax purposes.

Returning to Art 10(6), the term “dividends” is taken primarily to mean “income from shares”. The term “shares” is undefined in the Treaty and therefore under Art 3(2) has the meaning attributed to it under domestic tax law. Section 6 of the ITAA 1936 defines shares in relation to a company as meaning “shares in the capital of the company”. That definition was not amended as part of the debt-equity characterisation measures discussed above. Therefore, non-share equity would not be shares for the purposes of the s 6 definition. Also, shares that are treated as debt interests under s 974-20 of the ITAA 1997 remain shares for the purposes of that definition. Consequently, dividends paid on such shares would be dividends for Art 10(6) purposes because they would constitute “income from shares”. The definition of “interest” in Art 11(5) is relevant in this context. Under that definition, “interest” includes amounts subjected to the same taxation treatment as interest under the law of the Contracting State in which the income arises. This would include dividends on shares that are treated as debt. However, the definition continues by excluding from interest amounts dealt with under the dividend Article. Therefore, as dividends on shares that are treated as debt would nevertheless constitute income from shares, the dividend Article would apply for treaty purposes rather than the interest Article.

The second element of the Art 10(6) “dividend” definition treats as dividends amounts other than income from shares that are subjected to the same tax treatment as income from shares by the law of the State of which the company making the distribution is resident. Interest payments on interests that are treated as equity under s 974-75 would be taxed in Australia on the same basis as dividends because, as discussed above, they would not be deductible, could be franked on the same basis as dividends, and would be subject to the dividend withholding tax provisions. The payments would not be interest for treaty purposes because of the “tie-breaker” in the Art 11(5) “interest” definition which provides that interest dealt with under the dividends Article is not interest for Art 11 purposes.

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126 Section 974-75(1), item 2, ITAA 1997.
127 Section 26-26(1), ITAA 1997 prohibits deductions for non-share distributions and for returns which have accrued on non-share equity interests. Section 974-115 provides that a non-share distribution is essentially a distribution in respect of an equity interest which is not a share. Therefore, interest payments on a perpetual note which is treated as equity under s 974-75 would be taxed in Australia on the same basis as dividends because, as discussed above, they would not be deductible, could be franked on the same basis as dividends, and would be subject to the dividend withholding tax provisions. The payments would not be interest for treaty purposes because of the “tie-breaker” in the Art 11(5) “interest” definition which provides that interest dealt with under the dividends Article is not interest for Art 11 purposes.
128 Dividends are generally frankable under s 202-40 of the ITAA 1997 unless they are unfrankable under s 202-45(c) due to being paid in respect of a share which is not an equity interest under Div 974. Debt instruments which are equity interests under Div 974 are referred to in the legislation as “non-share equity interests”. Section 215-1 provides that the imputation provisions apply to non-share equity interests in the same way that they apply to a membership interest. Therefore, interest on debt instruments which are equity under Div 974 could also be frankable under s 202-40.
129 Section 128AAA, ITAA 1936.
130 Section 25-85, ITAA 1997. If the distribution is a dividend, the amount of the deduction is capped under s 25-85(5) to an amount equal to 150 basis points over the company’s benchmark rate of return. In broad terms, the benchmark rate of return is the rate of return payable on comparable ordinary debt issued by the company.
131 Paragraph (d) of the definition of “unfrankable distribution” in s 202-45 of the ITAA 1997 provides that distributions paid on non-equity shares are unfrankable distributions.
132 The definition of “interest” for withholding tax purposes in s 128(1AB) of the ITAA 1936 includes dividends paid in respect of non-equity shares.
Therefore, the approach adopted in the Treaty for characterising payments in respect of hybrid instruments differs from that adopted in Div 974 by effectively giving priority to equity characterisation over debt characterisation. Interests that are, in form, equity generate dividend payments for treaty purposes whether they are debt or equity in substance. Interests that are, in form, debt generate interest payments for treaty purposes only if they are not, in substance, equity as determined under Div 974. This difference in treatment gives rise to the possibility of payments that are deductible for Australian tax purposes being dealt with under the dividends Article. This would potentially be of benefit if the zero or 5% dividend rates applied. For example, it may be preferable for a United States company wishing to inject debt funding into its Australian subsidiary to utilise shares that are classified as debt under Div 974. The zero dividend rate should apply in these circumstances. Further, the dividend Article does not contain a back-to-back funding rule of the type contained in Art 11(4). Therefore, it would be possible for the United States parent to back-to-back fund the share subscription and still obtain the benefit of the zero rate subject to the application of Pt IVA of the ITAA 1936.

The inclusion of a tie-breaker between the “dividend” and “interest” definitions is preferable to the approach adopted in most of Australia’s treaties. In the Russian Treaty, for example, “dividends” are defined as income from shares and amounts subjected to the same tax treatment as income from shares by the State of which the company making the payment is resident, while “interest” is defined as including interest on bonds or debentures, whether or not carrying a right to participate in profits, and all other income assimilated to income from money lent by the law of the Contracting State in which the income arises. Where both definitions are satisfied, it is not clear which is to prevail. Consider the example discussed above of preference shares paying fixed rate, cumulative dividends that are to be redeemed for their issue price within 10 years of issue. Dividends paid on these shares would be dividends in terms of the Treaty “dividend” definition because they are income from shares. However, the dividends would also be interest because by virtue of the characterisation of the shares as “debt” under Div 974, the dividend payments would constitute “income assimilated to income from money lent”. Similarly, a debt instrument with interest payments contingent on available profits could be characterised as equity under Div 974, and for Treaty purposes the interest payments could be characterised as both interest and dividends. There are no indications in the Russian Treaty as to how this overlap is to be resolved. The intention inherent in the reference to domestic law characterisation in both the “dividend” and “interest” Treaty definitions appears to be to follow domestic law characterisation. On that basis, it could be argued that interest and dividend characterisation for Treaty purposes should follow debt and equity characterisation under domestic law. The fact that the Treaty definitions only have regard to domestic law to extend what would ordinarily be treated as dividends or interest, rather than as a generally stated approach, is not particularly helpful in this context. However, it appears to be the only sensible basis on which the overlap can be resolved.

The overlap problem does not arise under the US Treaty because of the rule in Art 11(5) that amounts dealt with under the dividend Article are not treated as interest for the purposes of Art 11. That rule reflects the approach taken in the US Model Convention and in recent United States treaties to resolve any overlap between the definitions of “interest” and “dividends” in United States treaties, and makes sense in the context of United States domestic law. The general approach of the United States courts to characterising transactions for tax purposes is that substance, rather than form, controls the characterisation. If an interest in a company is, in substance, debt, it

133 Article 11(4) provides that the exemption for interest provided by Art 11(3) does not apply where interest is paid as part of an arrangement involving back-to-back loans.
134 Articles 10(4) and 11(3), Russian Treaty.
137 Gregory v Helvering 293 US 465 at 469-470 (1935). Section 385(a), IRC represents a legislative attempt at debt-equity characterisation. It authorises the Secretary to the United States Treasury to issue regulations to determine whether an interest in a corporation is to be treated as stock or indebtedness for tax purposes. Regulations were issued in December 1980, but were withdrawn from 5 August 1983 by United States Treasury Decision TD 7920, 1983-2, Cumulative Bulletin 69 on the basis that
is treated as debt for tax purposes.\textsuperscript{138} It follows that it is unlikely that payments in respect of an instrument characterised as debt, while in form equity, would be treated as income from shares for United States purposes. Consequently, unlike the Australian position it is unlikely that the rule in the interest Article that provides that amounts dealt with under the dividends Article are not interest could result in payments that are treated as interest under United States domestic law being treated as dividends for treaty purposes.

**Payment of dividends by company resident in other State**

Article 10(7) provides that where a company which is resident in Australia or the United States derives profits or income from the other State, that other State may not tax dividends paid by the company unless:

- either the person beneficially entitled to the dividends is resident in that other State; or
- the holding in respect of which the dividends are paid is effectively connected with a permanent establishment in that other State.

In the case of a United States corporation with an Australian permanent establishment, this would prevent Australia from treating dividends paid by the United States corporation out of Australian permanent establishment profits as Australian source income under s 44(1)(b) of the ITAA 1936. Similarly, the United States would be prevented from taxing dividends paid by an Australian resident company out of United States branch profits.\textsuperscript{139} The equivalent rule in the old Art 10(5) of the US Treaty allowed Australia to tax dividends paid by a United States corporation out of Australian permanent establishment profits if such profits represented at least 50% of the gross income of the corporation from all sources. Shelter from Australian tax on such dividends would often be available under treaty business profits Articles if the dividends constituted business profits of the shareholder. However, such treaty relief was not always available at the shareholder level and while it would generally be difficult for the ATO to collect tax from foreign shareholders in United States corporations, the technical exposure to tax could be problematic in practice. The removal of that exposure under the new Art 10 is consistent with the approach in most recent Australian treaties,\textsuperscript{140} and is generally consistent with the Australian approach of not imposing a branch profits tax.

The overriding of s 44(1)(b) of the ITAA 1936 by Art 10(7) is an important consideration in determining whether an investment by a United States resident company should be by way of an Australian subsidiary or a branch, particularly if the relevant activity is expected to generate untaxed profits. Under the old dividend Article (Art 10), repatriation of such untaxed profits would have generated a 15% dividend withholding tax liability if a subsidiary structure was used. If a branch was used, no Australian tax would be payable in connection with the repatriation of the cash from Australia. However, s 44(1)(b) would potentially apply when the United States company paid

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\textsuperscript{138} RA Hardman v United States 87-2 USTC 89,509 (1987).

\textsuperscript{139} Under s 861(a)(2)(B), IRC dividends received from a foreign corporation are treated as income from sources in the United States except where less than 25% of the gross income from all sources of the corporation for the three previous taxable years was effectively connected with the conduct of a trade or business in the United States. Such dividends are then subject to tax at a rate of 30% under ss 871(a) and 881(a), IRC.

\textsuperscript{140} See, for example, Art 10(6), Russian Treaty. Unlike Art 10(6) of that Treaty, and equivalent provisions in other recent treaties, Art 10(7), US Treaty does not specifically provide that the protection is not available in relation to dividends paid by dual resident companies. However, a specific rule to that effect is not required in Art 10(7) because dual resident companies are not residents of a Contracting State for the purposes of the US Treaty. This follows from the interaction of the definitions of “United States corporation” and “Australian corporation” in Art 3(1), US Treaty. A company which is incorporated in the United States and is tax resident in Australia (for example, because its central management and control is in Australia and it carries on business in Australia) is not a “United States corporation” as defined in Art 3(1)(g)(ii) because it would be a domestic corporation for United States tax purposes. Therefore, the company would not be a resident of Australia under Art 4(1)(a) or a resident of the United States under Art 4(1)(b), and would not be a resident of a Contracting State for the purposes of Art 10(7). Consequently, Art 10(7) would not prevent Australia taxing dividends paid by a dual resident company out of Australian source profits.
dividends to its shareholders. Under the new Art 10, if a subsidiary is used it will be possible to pay unfranked dividends to a United States parent company free of withholding tax – provided that Art 10(3) applies. If a branch is used, s 44(1)(b) will not apply when the United States investor company pays dividends. Therefore, as far as profit repatriation is concerned, branch and subsidiary structures will be tax neutral (from an Australian tax perspective) for United States resident corporate investors where the United States investor could utilise the exemption in Art 10(3) if it used an Australian subsidiary.

If, as discussed above,141 an LLC which is treated as a partnership for United States tax purposes is viewed as a partnership for all purposes under the US Treaty, the protection provided by Art 10(7) would not be available in relation to dividends paid by the LLC because the dividends would not be paid by a “company”. Protection from Australian tax may be separately available to the LLC members under Art 7 to the extent that the dividends are business profits that are not attributable to an Australian permanent establishment. The foreign hybrid measures in the TLAB7 would not assist in this context unless the LLC were a controlled foreign company for the purposes of Pt X of the ITAA 1936 because absent that status the LLC would continue to be viewed as a company from an Australian tax perspective.

The prohibition in Art 10(7) on the taxation of dividends paid by a company resident in the other State is not limited by its terms to dividends paid to persons who are entitled to treaty benefits. Therefore, on its face, Art 10(7) would prevent Australia from taxing dividends paid by a United States corporation to a United Kingdom resident shareholder. Article 1(1) provides that the US Treaty applies only to persons who are residents of one or both of the Contracting States. However, this general rule applies “except as otherwise provided in this Convention”. As the only limitations on the application of Art 10(7) are where dividends are paid to a resident of the State in which the company’s income is derived, or are derived in connection with a permanent establishment in that State, it follows that Art 10(7) is a provision in which the US Treaty benefits persons who are not resident in either State.

**Branch profits tax**

Article 10(8) permits Australia and the United States to impose a branch profits tax. As Australia does not impose such a tax, Art 10(8) will only be relevant to Australian companies with United States permanent establishments. The United States branch profits tax is imposed under s 884(a) of the IRC at a rate of 30% of a foreign corporation’s “dividend equivalent amount” for the taxable year. The dividend equivalent amount is a measure of the branch profits that are effectively repatriated from the United States branch. It is defined as the corporation’s “effectively connected earnings and profits for the taxable year adjusted” for changes in “United States net equity”.142 United States net equity is the excess of the corporation’s United States assets over its United States liabilities. Increases in United States net equity reduce the effectively connected earnings and profits, thereby reducing the dividend equivalent amount, because they reflect a retention of profits within the branch. Conversely, reductions in United States net equity increase the dividend equivalent amount because the reduction in the amount of the branch’s net assets as at the beginning of the year is taken to be equivalent to a distribution to the extent of the reduction.

Article 10(6) of the old dividend Article allowed each Contracting State to impose a tax on a company resident in the other State in addition to the taxes referred to in Art 2 (Taxes Covered). The amount of the tax was capped at 15% of the company’s after-tax taxable income. This provision was designed to deal with the additional five percentage points of tax imposed by Australia on the Australian source income of non-resident companies when the US Treaty was entered into in 1982.143

141 See the discussion above under “Fiscally transparent entities”.
142 Section 884(b), IRC. “Effectively connected earnings and profits” are earnings and profits that are attributable to income that is effectively connected with the conduct of a trade or business in the United States. In broad terms, earnings and profits are taxable income as adjusted by s 312 of the IRC.
143 See CCH Editorial Staff, n 10, at [13,059] for the United States Treasury Technical Explanation of the old Art 10(6), US Treaty. At the time, Australia’s rate of income tax for companies was 46% and an additional five percentage points of tax was imposed on non-resident companies, effectively as a proxy for a dividend withholding tax-equivalent tax on repatriated profits.
However, it was drafted sufficiently broadly to permit the imposition of the United States branch profits tax. Be that as it may, the limitation in Art 10(6) did not make sense in the context of that tax because it was calculated by reference to after-tax taxable income rather than by reference to branch “distributions”. Consequently, on its face and in a case where there was a substantial repatriation of prior year branch earnings, Art 10(6) could have limited the branch profits tax to an amount equal to 15% of the after tax taxable income of the company attributable to the branch for the year of repatriation. Section 884(e)(2) of the IRC appears to recognise this limitation by providing that the rate of branch profits tax is limited to the rate specified in any treaty for branch profits tax or dividends, and then providing that any other limitations imposed by the relevant treaty shall apply.144

The new Art 10(8) is more closely integrated with s 884 of the IRC by specifically providing that, in the case of the United States, the additional tax that the United States is permitted to impose on branch profits may be imposed only on an amount representing the dividend equivalent amount of the Australian corporation’s United States income. This removes the limitation based on current year after-tax taxable income. The new Art 10(8) also prevents the United States from imposing its branch profits tax where the Australian company is a qualifying person under Art 16(2)(c) or is entitled to the benefits of the Treaty under Art 16(5), and it limits the rate of tax to 5% in other cases. The former limitation equates the treatment of United States branches with that of United States subsidiaries in cases where the Australian company satisfies the listing requirements of Art 16(2) or satisfies the Commissioner of Internal Revenue that it has not been established, acquired or maintained for a principal purpose of obtaining treaty benefits.

INTEREST
The Protocol inserted a new interest Article (Art 11) into the US Treaty. The new Article generally preserves the existing 10% tax rate, but provides for a zero source country rate for government lenders and for certain financial institutions. The retention of a general rate of 10% reflects the approach typically taken by Australia in its tax treaties. By contrast, the United States preference, as indicated in the US Model Convention, is for a zero rate of source country tax on interest.145

The rules in the old interest Article dealing with interest derived in connection with a business carried on through a permanent establishment and interest paid between related parties are preserved and are not discussed below. New provisions dealing with the meaning of “interest” for the purposes of Art 11, interest calculated by reference to profits, interest paid by securitisation vehicles and the United States branch interest rules have been included in the new Article and are discussed below. The interest source rule, which has been changed in some respects, is also discussed below.

Rate of tax
The first situation in which the zero rate of tax on interest applies is where interest is derived:

- by one of the Contracting States;
- by a political or administrative subdivision or local authority of such State;
- by any other body exercising governmental functions in a Contracting State; or
- by a bank performing central banking functions in a Contracting State.146

From an Australian perspective this exemption is not significant because interest income derived by a foreign government instrumentality is in any event exempt from withholding tax under the principle of sovereign immunity where the interest is derived in connection with the exercise of governmental functions.147 In this context, interest derived from a commercial activity is not taken to be derived

144 This limitation is also recognised in the Regulations under s 884 of the IRC. Section 1.884-1(g)(4)(i)(B) of the Treasury Regulations provides that in the case of Australian corporations, branch profits tax is imposed at the rate of 15% of the corporation’s dividend equivalent amount. However, s 1.884-1(g)(4)(ii) of the Treasury Regulations provides that in addition to the reduction in the rate of tax, any other limitations in the treaty on the imposition of the branch profits tax shall apply.
145 Article 11(1), US Model Convention.
146 Article 11(5)(a), US Treaty.
from the performance of governmental functions. The theory underlying the exemption is that tax on a gross basis at a rate of 10% is too high for financial institutions given that their net profit on a financing transaction is the margin between their cost of funds and the rate at which the funds are lent out. The requirement that the parties be unrelated means that the exemption would not apply to intra-group loans such as a loan from a United States parent company to an Australian subsidiary, or a loan from an in-house finance company to an Australian member of the group. Given the cost of funds that the in-house finance company would incur, it would be consistent with the theory underlying the exemption to exempt interest paid to such a company from withholding tax. Presumably, the exemption has not been extended to this situation because of a general nervousness on the part of the tax authorities in relation to cross-border related party transactions. The limitation suggests that from an Australian perspective it would be more tax effective for foreign based groups to inject any United States bank borrowings into their Australian group directly from the lenders rather than indirectly through United States based in-house finance companies.

The Explanatory Memorandum is silent on when parties will be regarded in Australia as being “related” for the purposes of Art 11(3)(b). The ITAA 1936 and ITAA 1997 contain a number of provisions under which entities are treated as related, but the definitions are inconsistent and none are particularly relevant to Art 11. Article 11(8), which deals with payments of interest in excess of an arm’s length amount, applies where there is a “special relationship” between the parties. This language is also used in the OECD Model, and the commentaries to the Model state that this relationship would include the situation where interest is paid to a person who controls the payer or where there is any community of interests as distinct from the legal interest giving rise to the payment of interest. While Art 11(8) refers to “special” relationships and Art 11(3)(b) uses the concept of the parties being unrelated, it is likely that the required level of relationship in both provisions will be interpreted to be the same so that in both cases a relationship will be present if there is an ownership or other control interest, and if the parties act together towards a common interest. The ordinary meaning of “related” is “associated” or “connected,” and this also would encompass ownership interests and connection through acting towards a common interest.

The US Treasury Explanation states that a financial institution will be unrelated to the payer of interest for the purposes of Art 11(3)(b) if they are not treated as associated enterprises under Art 9 of the US Treaty. That provision applies where an enterprise of one State participates directly or indirectly in the management, control or capital of an enterprise of the other State and conditions

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148 ATO Interpretative Decision ID 2002/45. See also Explanatory Memorandum at [2.45].
149 Other United States Treaties which do not generally exempt interest from source country taxation contain a similar exemption. See for example the bilateral Treaties between the United States and Belgium, Cyprus and Mexico: Convention Between the United States of America and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1970; the Convention Between the Government of the United States of America and the Government of the Republic of Cyprus for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1984; and the Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1992.
150 Explanatory Memorandum at [2.46].
151 Section 6F(2) of the ITAA 1936 provides that companies are related for the purposes of the dual resident investment company definition if there is at least 50% control of voting power or entitlement to dividends, or if a company or its directors are accustomed to act under the directions of another. For the purposes of the underlying foreign tax credit rules, s 160AFB of the ITAA 1936 provides that companies are related if there is control of 10% or more of voting power. Under the commercial debt forgiveness provisions of Sch 2C of the ITAA 1936, companies form part of a related group if there is 100% common ownership. None of these definitions are concerned with matters relevant to Art 11, US Treaty, nor are any other uses of the “related” concept in the legislation: See for example s 46B, ITAA 1936 and s 26-35, ITAA 1997.
152 OECD Model Convention, n 61: See commentary on Art 11 at [33] – [34].
operate in their commercial or financial dealings which differ from those which might be expected between enterprises dealing wholly independently. The US Treasury Explanation to the US Model Convention states that the necessary element in these relationships is “effective control, which is also the standard for the purposes of section 482 [of the IRC]”.155 “Control” for the purposes of the transfer pricing provisions of s 482 is broadly defined to include any kind of control “including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose”.156 This is broadly consistent with the approach, suggested above, that will most likely apply when it is necessary to determine for Australian purposes whether parties are unrelated for the purposes of Art 11(3)(b).

Article 11(3)(b) also requires that the parties are “dealing wholly independently” with each other. This is similar to the concept in domestic law of “dealing at arm’s length”.157 It is recognised under domestic Australian case law that parties which are at arm’s length may nevertheless deal with each other on a non-arm’s length basis where there is no real bargaining, where one of the parties submits the exercise of its will to the dictation of the other or where there is collusion between the parties to achieve a particular result.158 A question that will arise in practice is whether the independent dealing requirement will be satisfied where a United States financial institution lends to an Australian resident member of a foreign based group, in circumstances where funds would not have been advanced on the same terms in the absence of a parent guarantee. The Explanatory Memorandum and US Treasury Explanation are silent on this point.159 It could be argued that if, for example, a higher interest rate would have been charged in the absence of a parent guarantee, the provision of a loan at a lower interest rate is not the result of a wholly independent dealing between the lender and the subsidiary. However, the better view is that the dealings between the lender and the subsidiary are wholly independent for the purposes of Art 11(3)(b) if the terms of the loan are the same as those the lender would provide to any other subsidiary company with an equivalent level and quality of parent support. In these circumstances, the dealings between the lender and subsidiary would be the same as those between the lender and any other comparable borrower.

Interest is only exempt from source country tax under Art 11(3)(b) if it is derived by a financial institution. The term “financial institution” is defined as “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”. The US Treasury Explanation states that investment banks, brokers and commercial finance companies which obtain their funds by borrowing from the public would be financial institutions for the purposes of Art 11(3)(b).160 However, while those types of organisation would generally be viewed as financial institutions, the definition contains a number of technical requirements that must be satisfied in each case. One requirement is that the entity must substantially derive its profits from the defined activities. “Substantially” in this context should mean that a significant, but not necessarily predominant, part of the profits arises from those activities.161 Presumably, the fact that the entity is in loss should not be relevant, but if the entity is structured so that it never makes a profit, because, for example, any profit is stripped out through fee payments, it would not qualify unless the fees were viewed as profit

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156 Section 1.482-1(i), Treasury Regulations.
157 Article 9, US Treaty also has a “dealing independently” test and the Explanatory Memorandum to the Bill which was introduced to give domestic effect to the US Treaty explains that Art 9 will apply where dealings are not at arm’s length: See Explanatory Memorandum accompanying the Income Tax (International Agreements) Bill 1983 (Cth), p 21.
159 The Explanatory Memorandum does say at [2.49] that the provision of a loan guarantee by a related party to a United States financial institution would not generally be viewed as a back-to-back loan. However, there is no explanation of whether the provision of a guarantee is relevant in determining whether a borrower and lender are dealing independently.
161 See Tillmanns Butchers Pty Ltd v Australasian Meat Industry Employees Union (1979) 34 FLR 331 at 348 where Deane J held that the word “substantial” in the phrase “substantial loss or damage” can mean “real or of substance as distinct from ephemeral or nominal”, and can also mean “large, weighty or big”. See also Re Cashin [1992] 2 Qd R 63 at 65 where Demack J said that used in a quantitative sense “substantial” does not necessarily mean most but may mean only “much” or “some”.

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distributions. The definition is entity specific. Therefore, if the entity in the group which takes deposits or raises funds in the financial markets is not the entity which makes the relevant loan, then the lender would not be a financial institution even though the definition would be satisfied if applied on a group basis.

In connection with the requirement that non-deposit taking enterprises raise debt finance in the financial markets, it is not clear exactly what type of funding will qualify as financial market debt finance. If the entity raises funds, generally through the types of mechanisms that satisfy the public offer test in s 128F of the ITAA 1936, then that should be sufficient to establish that funding is raised in the financial markets. No assistance is provided in Art 11 as to when funding will be treated as “debt finance”. That expression is not used in the debt-equity rules of Div 974 of the ITAA 1997 and is not otherwise defined in domestic Australian tax legislation. As the purpose of the definition is only to determine the character of the lending entity, and is not to determine the tax treatment of any particular instrument issued by that entity, it should generally be sufficient to rely on the treatment in the entity’s accounts of a funding as debt to classify it as debt finance. The funds must be used to “carry on a business of providing finance”. If an entity raises debt in the financial markets to acquire debt securities in the secondary market, this would appear not to involve a business of providing finance as finance is in these circumstances provided to the issuer when the relevant security is issued and not when it is subsequently assigned. Whether a special purpose company which raises funds in the financial markets to fund a single loan to a resident of the other State is carrying on business for the purposes of the definition would turn on the facts of the particular case. If such a company was established with a view to deriving a profit from its activities it should be carrying on business for this purpose. Finance leasing activities should constitute the conduct of a business of providing finance.

The availability of the exemption is limited by an anti-avoidance rule in Art 11(4)(a). Under that rule, the 10% rate applies “if interest is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have similar effect to back-to-back loans”. In the absence of this rule, back-to-back loans might be utilised to overcome some of the impediments to obtaining the zero rate. For example, such loans could be used by third country residents or to effect loans from related parties or non-financial institutions. In addition to the back-to-back loan exclusion, Art 11(4) provides that nothing in Art 11 is to be construed as restricting the right of a contracting state to apply its domestic anti-avoidance provisions. Therefore, the inclusion of the specific anti-avoidance rule would not preclude the application of Pt IVA of the ITAA 1936 in relation to back-to-back loans to Australian borrowers.

In its narrowest form, a back-to-back loan would involve a loan from one company to another on condition that the borrower on-lends to a third company. However, the rule also covers transactions that are economically equivalent to back-to-back loans and where it is intended that the transaction has a similar effect as a back-to-back loan. The essence of a back-to-back loan is that A provides funds to B on the basis that B will put C in funds. Consider a case where A lends to a financial institution B, the borrowed funds go into B’s general pool of funds for use in its day to day business and B later draws on that pool to make a loan to C. While the funds borrowed by B cannot be traced to the loan from B to C, the arrangement is, arguably, economically equivalent to a

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162 This is recognised in s 442 of the ITAA 1936, for example, which provides that if the CFC assumes the rights of a lender under a loan then it is deemed to have provided the loan to the borrower and, accordingly, passes the active income test.

163 The fact that the company would be involved in only a single transaction would not mean that it would not be carrying on a business: See American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue [1978] AC 676 where it was held that the leasing of a factory and warehouse amounted to a business, and Lilydale Pastoral Co Pty Ltd v FCT (1987) 15 FCR 19, 18 ATR 508 where the purchase of a property for the purpose of renting it out was held to constitute an undertaking of a business or commercial nature.

164 For example, if a Netherlands resident company lent money to a United States corporation which lent to an Australian borrower, interest on the United States to Australian resident loan would be exempt from Australian withholding tax under Art 11(3)(b), US Treaty if the requirements of that provision were satisfied. Interest paid by the United States corporation to the Netherlands lender would be exempt from United States withholding tax under Art 12, Convention Between the United States of America and the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income 1992.
back-to-back loan. This is because, in effect, the funding provided by A to B frees up funds for B which later allows it to lend to C. However, the critical question is whether there is an intention to create an arrangement that is similar in effect to back-to-back loans. If the arrangement was that A would lend to B on the understanding that B would lend to C, the requisite intention could be present. However, this should not be the case where the loans arise in the ordinary course of B’s business as banker to the group of which A and C are a part, and where there is no intentional linkage between the loans. This is recognised in the Explanatory Memorandum which states at [2.47] that the back-to-back rule is “directed at preventing related party and other debt from being structured through financial institutions to gain access to the withholding tax exemption”. Clearly, there is no “structuring” in circumstances where there is no intentional linkage between the loans.

The Explanatory Memorandum states that a back-to-back arrangement would include a transaction or transactions structured in such a way that a United States financial institution derives interest arising in Australia and pays, directly or indirectly, all or substantially all of that interest to another person who would not be entitled to similar benefits with respect to that interest if it were derived directly. The reference to an on-payment of “substantially all” of the interest indicates that it is intended that the fact that the United States financier earns a margin and is therefore not a pure conduit does not preclude the operation of the rule. The Explanatory Memorandum also states at [2.49] that a loan guarantee provided by a related party to a United States financial institution would not generally be treated as a back-to-back arrangement. This contrasts with the position under the old “thin capitalisation” regime where a related party guarantee of a loan from an unrelated person could give rise to foreign debt – presumably on the theory that this was equivalent to a loan from the unrelated person to the guarantor, and an on-lending of that amount to the borrower.

The US Treasury Explanation states at p 15 that the preservation in Art 11(4)(b) of domestic anti-avoidance provisions ensures that, among other things, the United States could apply the provisions of s 1.881-3 of the Treasury Regulations. That section contains conduit financing rules that are intended to prevent back-to-back transactions entered into for the purpose of avoiding United States tax. They replace judicial doctrine and administrative practice – the precise scope of which was uncertain. Under the conduit financing rules, the Internal Revenue Service can, for the purposes of s 881 of the IRC, ignore the participation of one or more intermediate entities in a financing arrangement where those entities are acting as conduit entities. In a tax treaty context, this has the effect of preventing the conduit entity from claiming benefits under any tax treaty between its country of residence and the United States. However, the entity ultimately providing the finance under the arrangement may be entitled to claim benefits under any treaty between its country of residence and the United States.

The key concepts of “financing arrangement” and “conduit entity” are explained in elaborate detail in the Regulations. In general terms, the focus of these concepts is on back-to-back

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165 Explanatory Memorandum at [2.48].
166 Section 159GZF(1A), ITAA 1936 (repealed by Act No 162, 2001, s 3 and Sch 1, item 4).
167 In Aiken Industries Inc v Commissioner of Internal Revenue (1971) 56 TC 925 it was held that a Honduran corporation which acquired notes issued by a United States corporation and was debt funded by its Bahamian parent corporation was not entitled to the reduced tax rate on interest under Art IX of the Convention Between the United States of America and the Republic of Honduras for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income. This was because the interest payments were not “received by” it, due to the matched cash in-flows and out-flows. The Internal Revenue Service subsequently applied that approach in cases where the foreign intermediary earned a margin under the back-to-back financing: Blessing, n 57 at [10.02][2](ii)[ii]. However, in Northern Indiana Public Service Co v Commissioner of Internal Revenue (1995) 105 TC 341 it was held that Aiken Industries did not apply to a finance subsidiary which borrowed at a rate of 17.25% and on-lent at a rate of 18.25%, because in these circumstances the subsidiary was not a mere conduit or agent.
168 Section 1.881-3(a)(1), Treasury Regulations. Section 881 of the IRC is the provision under which “fixed or determinable annual or periodical” income, profits and gains (such as interest) of a company are taxed on a gross basis at a rate of 30%. That rate is typically reduced under United States tax treaties.
169 Section 1.881-3(a)(3)(C), Treasury Regulations.
arrangements that have been deliberately structured with a view to avoiding United States tax. “Financing arrangement” is broadly defined to mean a series of transactions by which:

- an entity referred to as the “financing entity” advances money or other property, or grants rights to use property;
- another entity, referred to as the “financed entity”, receives money or other property through intermediate entities; and
- there are financing transactions linking the financing entity, the intermediate entities and the financed entity.\(^{170}\)

Financing transactions are debt, redeemable shares, any lease or licence, and any other transaction through which money is advanced or property provided.\(^{171}\) The scope of the Regulations is then narrowed by an exclusion for arrangements where the financing entity is unrelated to the financed entity and intermediate entity, and did not know or have reason to know that the financing arrangement is a conduit financing arrangement.\(^{172}\) The concept of a “conduit entity” then further narrows the scope of the rules. An intermediate entity is treated as a conduit entity if its participation reduces the amount of tax payable under s 881, the participation of the intermediate entity is pursuant to a “tax avoidance plan”, and either the intermediate entity is related to the financing entity or the financed entity, or it would not have participated in the financing arrangement but for the fact that the financing entity engaged in the financing transaction with it.\(^{173}\) The key limitation here is that there must be a tax avoidance plan. This is a plan one of the principal purposes of which is the avoidance of tax imposed by s 881.\(^{174}\) The only relevant purposes are those relating to the participation of the intermediate entity. In determining those purposes, regard is had to all facts and circumstances and also to certain matters specified in the Treasury Regulations. In particular, consideration must be given to:

- whether the participation of the intermediate entity significantly reduces the tax that otherwise would have been imposed under s 881;\(^{175}\)
- whether the intermediate entity had sufficient funds of its own to make the advance to the financed entity, the period between the funding of the intermediate entity and the funding of the financed entity (with a short interlude pointing towards a tax avoidance purpose);\(^{176}\) and
- whether the financing transaction occurred in the ordinary course of the active conduct of complementary or integrated trades or businesses.\(^{177}\)

From a practical perspective, it is unlikely under current law that there will be significant structuring of financing transactions through Australia to take advantage of the US Treaty exemption under Art 11 for United States source interest derived by Australian financial institutions. This is because it would be difficult to extract interest received by an interposed Australian entity without an

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\(^{170}\) Section 1.881-3(a)(2)(i)(A), Treasury Regulations.

\(^{171}\) Section 1.881-3(a)(2)(i)(A), Treasury Regulations.

\(^{172}\) Section 1.881-3(a)(2)(ii)(A), Treasury Regulations. This requires that the financing entity knows or has reason to know facts sufficient to establish that the participation of the intermediate entity in the arrangement is pursuant to a tax avoidance plan. It is presumed under the Regulations that the financing entity does not know that the financing arrangement is a conduit financing arrangement if it establishes that the intermediate entity is actively engaged in a substantial trade or business.

\(^{173}\) Section 1.881-3(a)(4)(i), Treasury Regulations.

\(^{174}\) Section 1.881-3(b)(1), Treasury Regulations.

\(^{175}\) Under s 1.881-3(b)(2)(i), Treasury Regulations, the District Director of the Internal Revenue Service determines whether there is a significant reduction in the tax which would otherwise have been imposed. A reduction in tax can be treated as significant if the absolute amount of the reduction in tax is large even if the rate reduction is only small.

\(^{176}\) In Example 16, contained within s 1.881-3(e) of the Treasury Regulations, a period of one year between the date on which a foreign parent company lends money to a foreign subsidiary and the date on which that subsidiary lends the money to a United States subsidiary is considered to be a short period of time and this points to a tax avoidance purpose.

\(^{177}\) This latter requirement is satisfied if the loan is a trade receivable or if the parties are actively engaged in banking, insurance, financing or similar trade or business: s 1.881-3(b)(2)(iv), Treasury Regulations.
Australians are more likely to be a concern for Australia because of the possibility of using United States treaties with third countries to route back-to-back financing transactions into Australia.

Under United States domestic law, an exemption from tax is provided for interest derived by non-resident individuals in respect of deposits with United States banks179 and for United States “portfolio interest” derived by non-resident individuals and foreign corporations.180 Interest is considered portfolio interest where the debt obligation meets certain requirements and is not received by a person who is a 10% shareholder in the corporation which issued the debt obligation. If the debt is in registered form, the exemption applies only if a statement is provided to the issuer that the beneficial owner of the obligation is not a United States person.181 Interest is considered portfolio interest if there are arrangements reasonably designed to ensure that the debt obligation will be sold only to non-United States persons and that interest is paid outside the United States. Interest paid in relation to a loan from a bank entered into in the ordinary course of the bank’s business is not portfolio interest.182 Therefore, apart from the US Treaty, interest on loans from Australian companies to United States subsidiaries, and on loans from Australian banks to United States resident lenders, is not exempt from United States tax. Under the US Treaty, interest on parent to subsidiary loans will remain subject to United States tax but loans from Australian banks to United States resident borrowers will be potentially exempt from United States tax. The tax treatment of portfolio debt will remain unchanged.

The potential benefit provided by Art 11(3)(b) as far as Australian borrowers are concerned is that it offers an alternative to s 128F of the ITAA 1936 structures. For United States lenders, it also facilitates direct lending to Australian borrowers rather than lending through Australian branches or subsidiaries. An important practical consideration in relation to the back-to-back loan anti-avoidance rule in Art 11(4) is what borrowers will need to do to establish whether the funding they receive has been provided by way of a back-to-back loan. In the context of an arm’s length borrowing, borrowers would not ordinarily be aware of the ultimate source of funds. It may be that the revenue authorities will usually be satisfied that the borrower has made sufficient inquiries if it obtains a representation from the lender that the funds have not been provided under a back-to-back loan arrangement.

Definition of interest

“Interest” is defined in Art 11(5) as meaning “interest from government securities or from bonds or debentures … whether or not secured by mortgage and whether or not carrying a right to participate in profits, interest from any other form of indebtedness, as well as income which is subjected to the same taxation treatment as income from money lent” under the law of the State in which the income arises. As already discussed above, amounts dealt with under the dividends Article (Art 10) are not treated as interest. The old Art 11 defined “interest” as including income which under domestic law of the relevant Contracting State is “assimilated to” income from money lent. As the definition was inclusive, amounts which were interest under ordinary concepts were also dealt with under the Article. The new Article has a similar scope because the Art 11(5) definition is also broad enough to encompass interest according to ordinary concepts and amounts treated as interest under domestic law. A significant difference is that Art 11(5) contains a tie-breaker that was not present in the old Article and which resolves any overlap with the dividends Article in favour of that Article. The reference to bonds or debentures carrying a right to participate in profits is also a new development.

178 In the circumstances where interest could flow through Australia free of tax by virtue of an issuance of debt satisfying the requirements of s 128F of the ITAA 1936 the United States borrower could likely directly fund the borrowing offshore free of United States withholding tax using the portfolio debt exemption discussed later in the text.

179 Section 871(h)(1), IRC.

180 Sections 871(h)(1) and 881(c)(1), IRC. The exemption relates to the 30% gross basis tax imposed under ss 871 and 881. It does not apply where the interest is effectively connected with the conduct of a trade or business in the United States. Such interest is subject to income tax under ss 871(b)(1) and 882 of the IRC.

181 Section 871(h)(2)(B), IRC. Under s 163(f)(2) of the IRC, debt obligations are required to be registered if they are issued to the public “unless there are arrangements reasonably designed to ensure” that the obligations will only be sold to non-United States persons and interest is paid outside the United States.

182 Section 881(c)(3)(A), IRC.
Profit participation payments on such instruments will be treated as dividends under Art 10 if the underlying instrument is equity under Div 974 of the ITAA 1997. Where the instrument is debt under that Division, a question arises as to whether the profit participation payments are interest. If they are not interest, they would be dealt with under the business profits or other income Articles (Arts 7 and 21 respectively).

An example of a debt instrument with profit participation payments would be a 10 year note paying interest at a fixed rate plus a percentage of the issuer’s profits. This is similar to the instrument considered in Commissioner of Taxation (WA) v Boulder Perseverance Ltd (1937) 58 CLR 223. While the issue there was not whether the profit participation payment was interest, the analysis in the judgment suggests that it would not have an interest character but rather would represent a distribution of profit. Another example of a debt instrument where the return might not be dividends or interest is a cumulative perpetual note which pays interest at a rate above the issuer’s benchmark rate of return, and where interest which is not paid during any year because of the unavailability of profits accumulates and must be paid out within five years. In Taxation Ruling TR 2002/15 the Commissioner states that payments on perpetual notes are not interest on a loan because such notes do not give rise to a debtor-creditor relationship. Again, if such payments are neither interest nor dividends for the purposes of the US Treaty, they would fall to be dealt with under the business profits and other income Articles (Arts 7 and 21 respectively).

Rental payments made in connection with equipment leases can in some circumstances be treated as interest under ITAA 1936 and ITAA 1997. Under s 128AC of the ITAA 1936 payments under hire purchase agreements and under leases where the lessee is entitled to purchase the property on termination or expiry, or where the lease term is for all or substantially all of the effective life of the lease property, may be characterised in part as interest for interest withholding tax purposes. Division 240 of the ITAA 1997 treats hire purchase agreements for tax purposes as involving the sale of the property combined with the provision of a loan by the financier. The arrangements to which s 128AC and Div 240 apply are different in some respects. For example, Div 240 would not apply to a lease for substantially all of the effective life of the leased asset where the lessee has no right or obligation to buy the asset. This difference is not significant for the purposes of Art 11. If an amount is interest under s 128AC or under Div 240 it should be interest within the meaning of Art 11(5).

Interest determined with reference to profits

Article 11(9)(a) provides that interest that is “determined with reference to the profits of the issuer or of one of its associated enterprises” may be taxed in the State in which it arises at a rate of 15%. For this provision to apply, the payment must be interest for Art 11 purposes. Therefore, from Australia’s perspective Art 11(9)(a) would not apply to contingent interest payments that are treated as non-share dividends under s 974-120 of the ITAA 1997 because those payments would be dealt with under the dividends Article (Art 10). Also, as discussed above, profit share payments on debt instruments would not be interest under Australian domestic law and consequently would not be interest for

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183 The note would be a debt interest under s 974-20 of the ITAA 1997 because the issuer would have an effectively non-contingent obligation to repay an amount equal to the amount received on the issuance of the note.

184 In Commissioner of Taxation (WA) v Boulder Perseverance Ltd (1937) 58 CLR 223 at 231 and 234 the High Court considered that the fixed interest represented the compensation for the use of capital while the contingent component represented a distribution of profit. The court also referred to a United Kingdom case, AW Walker & Co v Commissioners of Inland Revenue [1920] 3 KB 648, which involved a loan paying fixed interest plus an entitlement to a portion of profits. It was held in that case that the profit share payments were not interest.

185 Example 2.13 contained within the Explanatory Memorandum for the New Business Tax System (Debt and Equity) Bill 2001 (Cth) confirms that it is intended that this instrument would be classified as a “debt interest” under s 974-20 of the ITAA 1997.

186 ATO Taxation Ruling TR 2002/15 at [61]. The reasoning underlying this conclusion is that the holder of the perpetual note has only a contingent entitlement to repayment of principal on insolvency or liquidation of the issuer or, on an alternative analysis, has no entitlement to repayment at all: See [68] – [69]. The Ruling considers a non-cumulative perpetual note. However, the reasoning on this point should apply equally to a cumulative perpetual note.

187 A distribution is a non-share distribution under s 974-115 of the ITAA 1997 if it is made in relation to a non-share equity interest. Under s 974-120, all non-share distributions are treated as non-share dividends. Such dividends are frankable by virtue of ss 202-40 and 215-1 of the ITAA 1997, and by operation of s 128AAA of the ITAA 1936 are subject to dividend withholding tax rather than interest withholding tax when paid to a non-resident.
Art 11 purposes. Interest on limited recourse debt would ordinarily not be interest determined by reference to profits. Consider, for example, a borrowing under which interest is calculated by reference to a common financial benchmark but where the lender has recourse only to certain assets, and to the income or profits earned from those assets, in the event of default. In this case interest would continue to accrue whether or not the borrower was profitable, but ultimately, whether interest is paid may depend to some extent on the profits derived by the borrower from the relevant assets. However, the non-recourse feature is not relevant to the determination of the amount of interest but rather is concerned with the recovery of interest.

Article 11(9)(a) is based on Art 11(5)(a), US Model Convention. That Article provides that interest is taxed at 15% where it is determined with reference to:

receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person

This in turn mirrors an exception to the portfolio interest exemption under United States domestic law. Therefore, under domestic law the United States taxes contingent interest payments made to a non-resident at a rate of 30%, and in its treaties it typically agrees to reduce that rate to 15%. It appears that this is intended to ensure that a zero United States tax rate cannot be achieved for amounts that are effectively in the nature of a distribution rather than an interest expense.

The provisions in the US Model Convention and in United States domestic law dealing with contingent interest are broader in scope than Art 11(9)(a) of the US Treaty because they also apply to payments determined by reference to a range of variables other than profit. The recently concluded UK-US Treaty contains a provision that mirrors the US Model Convention. It may be that the potential for abuse under the US Treaty is considered to be lower because the zero rate applies only to interest derived by government entities and financial institutions, whereas under the UK-US Treaty and the US Model Convention the zero rate applies to all interest other than interest derived in connection with a permanent establishment. The expectation might be that both categories of investor would typically prefer debt-like returns rather than equity-like returns, and consequently would be less likely to abuse the zero rate by converting distributions to interest.

From an Australian perspective, the preservation of a 15% rate by Art 11(9)(a) is of no significance since interest withholding tax is imposed at a rate of 10%. Therefore, the only significance of Art 11(9)(a) as far as Australia is concerned is to ensure that the zero rate in Art 11(3) cannot apply to interest determined with reference to profits.

Securitisation vehicles

Article 11(9)(b) contains a special rule in relation to interest paid in respect of ownership interests in securitisation vehicles. It provides that such interest is taxed in accordance with domestic law to the extent that it exceeds the normal rate of return on publicly traded debt instruments with a similar risk profile. This is intended to preserve United States taxation of so-called “excess inclusions” arising in relation to interests in real estate mortgage investment conduits, otherwise known as “REMICs”.

Entities can elect to be treated as REMICs where substantially all of their assets are debt obligations secured by mortgage over real property and interests in the entity are either “regular interests” or “residual interests”. An interest is a regular interest if it “entitles the holder to receive a specified
principal amount … and interest”. 192 Any other interest in the REMIC is a residual interest. 193 Regular interests are treated as debt instruments for tax purposes, and holders of such interests are taxed on the specified interest component of the payments they receive from the REMIC. 194 The net income of the REMIC, calculated after deducting expenses including the interest payments to the regular interest holders, is taxed to the residual interest holders. The taxable income of any holder of a residual interest in a REMIC cannot be less than the “excess inclusion” in relation to that interest. 195 The excess inclusion is the excess of the amount of income derived by the residual holder over an imputed interest amount calculated as 120% of the long-term federal rate. 196 As the taxable income of a residual interest holder cannot be less than the amount of any excess inclusion, net operating losses cannot be deducted from the excess inclusion and the amount of the inclusion is therefore taxed at the relevant United States tax rate. The policy appears to be to prevent REMICs from being used to reduce the tax that would otherwise be paid in relation to a pool of mortgage receivables by issuing the residual interest in the REMIC to a taxpayer with net operating losses. 197

Article 11(9)(b) allows the United States to tax excess inclusions derived by Australian residents in relation to residual interests in REMICs in accordance with United States domestic law. This means that such amounts would be taxed at a rate of 30% unless the holding of the interest is effectively connected with a United States trade or business, in which case ordinary income tax rates would apply. While Art 11(9)(b) is not limited by its terms to REMICs, as a practical matter it is unlikely to be of any significance in relation to Australian securitisation vehicles. 198

United States branch interest rules

Article 11(10) applies where a resident of one State is subject to tax in the other State on business profits that are attributable to a permanent establishment in that other State, or may be taxed in the other State under the income from real property or alienation of property Articles (Arts 6 and 13 respectively), and is entitled to a deduction in that other State for interest expenses. It provides that if the deductible interest expense exceeds the amount of interest paid by the permanent establishment or paid in relation to debt secured by real property in the other State, the excess amount is treated as interest arising in that other State. Consequently, the excess interest may be taxed in the State in which the permanent establishment or real property is located, subject to the limitations provided elsewhere in Art 11.

This provision is designed to preserve the right of the United States to impose its so-called “branch interest tax”. That tax arises where a foreign corporation engaged in a trade or business in the United States has “allocable interest” that is in excess of the interest paid by the trade or business. 200 The foreign corporation is liable for United States tax on that excess interest at a rate of 30%. 201 The objective of this tax is to ensure that any amounts of interest that are deductible in calculating the taxable income attributable to a United States trade or business are also subject to United States tax. 202 Interest that is paid by a United States trade or business of a foreign corporation is subject to United States tax unless exempted by treaty. 203 However, the amount of interest that is deductible in calculating the taxable income of a foreign corporation which is effectively connected with a United States branch is limited to the amount of interest paid by the branch.

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192 Section 860G(a)(1), IRC.
193 Section 860G(a)(2), IRC.
194 Section 860B, IRC.
195 Section 860C, IRC.
196 Section 860E(a)(1), IRC.
197 Section 860E(c), IRC.
198 Blessing, n 57 at [1-0.02][1][b][xi].
199 Even if it were to apply to a beneficial interest held by a United States resident in an Australian securitisation trust, any amount of net income consisting of interest to which the beneficiary was presently entitled would be taxed at the 10% withholding tax rate under Australian domestic law: See s 128A(3), ITAA 1936.
200 Section 884(f)(1)(B), IRC.
201 Sections 884(f)(1)(B) and 881(a), IRC.
203 Under s 884(f)(1)(A), IRC such interest is deemed to be paid by a domestic corporation. Consequently, it has a United States source under s 861(a)(1) of the IRC and is subject to tax at a rate of 30% under s 881(a) of the IRC.
States trade or business can exceed the amount of interest paid by that trade or business because interest deductions are determined under a formulary allocation approach. In broad terms, interest expense is allocated to the United States trade or business on the basis either that the foreign corporation’s United States assets are treated as being debt funded in the same proportion as the corporation’s worldwide assets are debt funded, or by using a fixed debt to asset ratio where an election is made. If the actual debt used to fund the United States assets is greater than the amount of debt allocated under the Regulations, the allowable interest deduction is scaled down. Conversely, if the amount of debt used to fund the United States assets is less than the amount of debt allocated to the United States trade or business under the Regulations, additional interest deductions are allowed. It is that additional interest amount that attracts the operation of the branch interest tax and Art 11(10).

In the case of an Australian company with a United States permanent establishment, any excess interest calculated under the branch interest provisions would be deemed for United States tax purposes to be paid to that company by a wholly owned United States corporation. The effect of Art 11(10) would then be to limit the rate of United States tax on the interest notionally derived by the Australian corporation to a rate of 10%. There was no equivalent provision in the old Art 11. However, under United States domestic law the excess interest of an Australian company would be taxed at the 10% Treaty rate if it satisfies the limitation on benefits Article (Art 16) under the US Treaty and also is a qualified resident of Australia under the United States branch profits rules. Therefore, the practical effect of Art 11(10) is to legislate into the US Treaty the position that generally applied already under United States domestic law.

**Source rule and removal of Article 11(6)**

Australia’s treaties typically provide that interest borne by a permanent establishment outside both States is sourced in the State where the permanent establishment is located. This has the effect that Australia has no taxing claim in relation to such interest because the interest is not income that Australia is entitled to tax under the interest article of the relevant treaty and, therefore, is not sourced in Australia for treaty and Australian domestic law purposes under the relevant treaty source Article. The new Art 11(7) provides that interest arises in a State where the payer is a resident of that State or where the payer of the interest is not resident in the State but the interest is borne by a permanent establishment of the payer in the State. The reference in the old Art 11 to interest borne by a permanent establishment outside both States having a source in the place where the permanent establishment is located has been omitted from the new Art 11. Therefore, under the new formulation

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204 Section 1.882-5, Treasury Regulations.

205 Under s 1.882-5(c)(1), Treasury Regulations, the amount of the foreign corporation’s United States connected liabilities for a year is calculated by multiplying the amount of its United States assets by either the “actual ratio” or “fixed ratio”. The actual ratio is calculated by dividing the corporation’s worldwide liabilities for the year by its worldwide assets: s 1.882-5(c)(2)(i), Treasury Regulations. Therefore, the actual ratio allocates liabilities to the United States assets on the same basis that the corporation’s worldwide assets are debt funded. The fixed ratio allocates liabilities on the basis of a fixed ratio for banks of 93% and for non-banks of 50%. See 1.882-5(c)(4), Treasury Regulations.

206 Section 1-882-5(d)(4), Treasury Regulations. The amount of the interest deduction in this case is calculated by multiplying the interest paid or accrued by the United States trade or business by a fraction calculated by dividing the amount of the United States liabilities allocated under the Regulations by the United States booked liabilities. Booked liabilities are essentially the liabilities reflected in the accounts of the United States trade or business. As the allocated liabilities will exceed the booked liabilities in this case, the effect of the regulation is to deny a deduction for part of the interest paid by the United States trade or business.

207 Section 1.882-5(d)(5), Treasury Regulations. The additional interest expense is calculated by multiplying the excess of the liabilities allocated to the United States trade or business under the Regulations over the booked liabilities by the average interest rate applying to the foreign corporation’s United States dollar liabilities which are shown on the books of its non-United States offices or branches.

208 Section 884(f)(1)(B), IRC.

209 Section 1.884-4(c)(3)(i), Treasury Regulations. The “qualified resident” concept, as defined in s 1.884-5 of the Treasury Regulations, operates as a statutory version of the US Treaty’s limitation on benefits Article and contains some tests which are similar to the new Art 16.

210 See for example Art 11(5), South African Treaty.

211 See for example Art 22(1), South African Treaty.
all interest paid by an Australian resident, including interest paid in connection with a third country permanent establishment, arises in Australia for Art 11 purposes and, under Art 27(1)(a) of the US Treaty, is sourced in Australia for domestic tax purposes. Interest paid by an Australian resident in connection with a business carried on outside Australia through a permanent establishment, as defined in s 6 of the ITAA 1936, would not be subject to interest withholding tax and under general source principles would not ordinarily give rise to Australian source income. However, the deemed Australian source conferred on the interest under the US Treaty would result in the interest being included in the assessable income of the lender. 212 To avoid this potential overreaching of Australia’s tax jurisdiction, s 6(4) was inserted into ITAA 1953. 213 The consequence of the amendment is that nothing in the US Treaty has the effect of subjecting to Australian tax any interest paid by a resident of Australia to a resident of the United States that, apart from the US Treaty, would not be subject to Australian tax.

The new Art 11 does not contain a provision equivalent to Art 11(6) of the old interest Article. That provision prohibited Australia from taxing interest paid by a United States resident unless it was sourced in Australia within the meaning of Art 11(7), derived by an Australian resident or was effectively connected with a permanent establishment in Australia of the person deriving the interest. That rule was useful in overcoming s 25(2) of the ITAA 1936 which can treat interest paid by a United States resident company to a non-Australian resident bank as having an Australian source where the borrowing is secured over property in Australia. With the removal of Art 11(6) it is necessary to look to the State of residence of the lender to determine whether treaty protection is available to the lender under the business profits Article of a tax treaty between that State and Australia.

212 Section 128D of the ITAA 1936 would not exempt the interest in these circumstances because that section applies only to income which is subject to withholding tax, or would be subject to withholding tax, apart from certain exemptions which are not relevant for present purposes.

213 Section 6(4) was inserted by s 4, International Tax Agreements Amendment Act (No 2) 2002 (Cth).