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Interest withholding tax - Common issues

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1 Introduction

This paper will provide an overview of:

1. Australian interest withholding tax (**IWT**);
2. the exemption from IWT available to financial institutions under some of Australia's double tax agreements (**DTAs**);
3. the exemption from IWT available to eligible unit trusts under section 128FA;
4. the application of sections 128F/128FA to letter of credit facilities;
5. IWT in the context of offshore trust lenders with onshore investors;
6. the operation of section 128AC;
7. the general assessability of interest that has been subject to IWT or relevant exemption; and
8. gross up clauses in lending agreements (in respect of IWT and certain other amounts).

Rather than being a definitive guide to these matters, the focus of the paper is to consider a number of practical issues, including through discussion of scenarios commonly encountered.

Legislative references in this paper are to the *Income Tax Assessment Act 1936* (**1936 Act**) unless otherwise specified.

2 Overview of interest withholding tax

Australia imposes IWT of 10%[1] on interest paid by:[2]

a. Australian resident borrowers not acting at or through a permanent establishment outside Australia; or

b. non-resident borrowers carrying on business in Australia at or through a permanent establishment in Australia,

(together, **Australian Borrowers**) to either:

c. non-resident lenders not deriving interest in carrying on business at or through a permanent establishment in Australia; or

d. Australian resident lenders deriving interest in carrying on business at or through a permanent establishment outside Australia,

(together, **Offshore Lenders**).

IWT can also apply to interest paid in relation to other relationships, for example, interest paid by an Australian guarantor to an Offshore Lender or interest paid by an Australian debtor to an offshore supplier. The primary focus of this paper will be on interest paid in respect of borrower/lender relationships.

Although the liability to pay IWT rests with the non-resident payee (eg the Offshore Lender),[3] an obligation to withhold and remit the amount of IWT to the Australian Taxation Office (the **ATO**) is imposed on the Australian payer of interest (eg the Australian Borrower) under Subdivision 12-F of Schedule 1 of the *Taxation Administration Act 1953* (the **TAA**). The payer must withhold an amount under Subdivision 12-F of Schedule 1 of the TAA from a payment of interest if:[4]

a. the payee has an address outside Australia according to any record that is in the payer's possession, or that is kept or maintained on the payer's behalf; or

b. the payer is authorised to pay the interest at a place outside Australia.

However, an amount is not required to be withheld if no IWT is payable in respect of the interest.[5] This would include circumstances where a relevant exemption applies, such as the double tax agreement exemption for financial institutions resident in certain jurisdictions (discussed further at part 3 below).

Penalties may be applied against Australian payers that fail to withhold and remit the required amounts to the ATO, and the payer may also commit an offence.[6] Further, no deduction is allowed to

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1 Section 7(b) of the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*.
2 Section 128B(2) and (2A).
3 Section 128B(5).
4 Section 12-245 of Schedule 1 of the TAA.
5 Section 12-300 of Schedule 1 of the TAA.
6 Sections 16-25 to 16-43 and 16-80 of Schedule 1 of the TAA.

the borrower in respect of an interest payment until the relevant amount has been withheld and the withheld amount remitted to the Australian Taxation Office.[7]

[7] Section 26-25 of the *Income Tax Assessment Act 1997* (the **1997 Act**, and together with the 1936 Act, the **Tax Act**). See also Taxpayer Alert TA 2018/4 - *Accrual deductions and deferral or avoidance of withholding tax*.

3 Double tax agreement exemptions

3.1 Overview of double tax agreement exemptions

The DTAs between Australia and selected other countries provide for an exemption from IWT for interest paid to "financial institutions" (as defined). The relevant countries with which a DTA including the exemption exists are:[8]

a. the United States of America;[9]

b. the United Kingdom;[10]

c. France;[11]

d. Norway;[12]

e. Finland;[13]

f. Germany;[14]

g. Switzerland;[15]

h. South Africa;[16]

i. Japan;[17] and

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8 The double tax agreement between Australia and Chile also provides for a reduced rate of IWT of 5% in similar circumstances to the circumstance in which the financial institutions exemptions apply.

9 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 dated 6 August 1982 as amended by the United States Protocol (No 1) dated 27 September 2001 (**US DTA**).

10 Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains dated 21 August 2003 (**UK DTA**).

11 Convention between the Government of Australia and the Government of the French Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion dated 20 June 2006 (**French DTA**).

12 Convention between Australia and the Kingdom of Norway for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fiscal Evasion dated 8 August 2006.

13 Agreement between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fiscal Evasion dated 20 November 2006.

14 Agreement between Australia and the Federal Republic of Germany for the Elimination of Double Taxation with respect to Taxes on Income and on Capital and the Prevention of Fiscal Evasion and Avoidance dated 12 November 2015 (**German DTA**).

15 Convention between Australia and Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income dated 30 July 2013 as amended by the Protocol (**Swiss DTA**).

16 Agreement between the Government of Australia and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income dated 1 July 1999 as amended by the South African Protocol (No 2) dated 12 November 2008.

17 Convention between Australia and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income dated 31 January 2008 (**Japanese DTA**).

j. New Zealand,[18]

(together, the **Relevant Countries**).

The IWT exemption in the DTAs is in recognition that a 10% withholding may be excessive given the cost of funds for financial institutions.[19] The exemption is designed to reduce the cost of funds to borrowers who typically are required to gross up for IWT.[20] The exemption is consistent with the exemption under section 128F.[21]

Although the wording differs slightly between some of the DTAs, the exemptions essentially apply in the same circumstances. By way of example, the DTA between Australia and Germany[22] provides, at Articles 11(3) and (4):

> 3 ... interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may not be taxed in the first-mentioned State if:
>
> …
>
> (b) the interest is derived by a financial institution which is unrelated to and dealing wholly independently with the payer. For the purposes of this Article, the term "financial institution" means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.
>
> 4 Notwithstanding paragraph 3, interest referred to in subparagraph (b) of that paragraph may be taxed in the State in which it arises at a rate not exceeding 10 per cent of the gross amount of the interest if the interest is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

The DTAs exclude from the exemption:

a. financial institutions that derive the interest through a permanent establishment in the country in which the interest arises; and

b. the amount of any interest that exceeds the amount that would have been payable if a special relationship did not exist between the parties or between each party and a third party.

Some DTAs also specifically refer to the exemption not applying if one of the main purposes of entering into the debt claim or assignment was to take advantage of the exemption[23] or if anti-avoidance provisions apply.[24]

The ATO has issued a tax ruling in relation to the financial institutions exemption in Australia's DTAs with the US and the UK: Taxation Ruling TR 2005/5 *Income tax: ascertaining the right to tax United*

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18 Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion dated 26 June 2009.

19 See, eg Explanatory Memorandum to the *International Tax Agreements Amendment Act (No.1) 2008* at [2.34].

20 Ibid.

21 See, eg Explanatory Memorandum to the *International Tax Agreements Amendment Act (No.1) 2008* at [1.168].

22 German DTA.

23 Eg Article 11(9) of the UK DTA.

24 Eg Article 11(4)(b) of the US DTA.

States (US) and United Kingdom (UK) resident financial institutions under the US and the UK Taxation Conventions in respect of interest income arising in Australia (**TR 2005/5**). Given the similarities between the US and UK DTAs and the DTAs with the other Relevant Countries, TR 2005/5, although not technically legally binding, should provide useful guidance in respect of those other DTAs.

3.1.1 Meaning of "beneficial owner"

The meaning of "beneficial owner"[25] is discussed in the OECD's commentary on the model tax convention.[26] The commentary indicates that it is not intended that the term take on a narrow technical meaning, such as in trust law.[27] Rather, it is intended to exclude conduit type arrangements such as agents, nominees and conduit companies acting as fiduciary or administrator.

The Japanese DTA includes a specific restriction on when an entity will be treated as a beneficial owner in certain circumstances.[28]

3.1.2 Meaning of "financial institution"

As outlined above, a "financial institution" includes both:

a. banks; and

b. other enterprises substantially deriving their profits through conducting spread activities, that is, 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.

These are considered in turn.

"Banks"

In TR 2005/5,[29] the ATO indicates that a "bank" must be authorised or licensed to carry on a banking business in the country of residence and must satisfy the capital adequacy requirements to be characterised as a bank (as opposed to a credit union, building society etc which may have lower capital adequacy requirements). A banking business is one that involves taking deposits (other than in part payment for identified goods and services) and making advances.[30] A bank does not need to satisfy the other requirements of the paragraph.

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25 Which should also apply to "beneficial ownership".

26 https://www.keepeek.com//Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017/commentary-on-article-11_mtc_cond-2017-14-en#page1.

27 At paragraphs 9 to10.2. of the Commentary on Article 11 concerning the taxation of interest.

28 Article 11(9) of the Japanese DTA.

29 At [12].

30 At [13] and [52].

TR 2005/5 notes that, in relation to the UK, entities appearing on the list of banks maintained by the UK Prudential Regulation Authority[31] will constitute "banks".[32]

Note that a member of a corporate group that contains a separate entity that is a "bank" must also meet the requirements to be a bank itself if it wishes to rely on this limb of the requirements for the exemption.[33]

Other enterprises

"Other enterprises" would typically include:[34]

a. credit unions;

b. building societies;

c. savings banks; and

d. saving and loans institutions,

on the basis that these types of entities:

e. raise debt finance in the financial markets; or

f. take deposits at interest; and

g. use those funds in carrying on a business of providing finance; and

h. substantially derive their profits from the above activities.

Raising debt finance in financial markets

TR 2005/5 indicates that an entity will be considered to be raising debt finance in financial markets if:

a. the funds obtained give rise to an "effectively non-contingent obligation" to return an amount at least equal to the amount received, as interpreted in Division 974[35] (eg traditional loans, securities lending arrangements and repurchase agreements);[36] and

b. the finance is raised through financial markets (retail or wholesale),[37] being facilities through which:[38]

    1. offers to acquire or dispose of debt finance products are regularly made or accepted (including offering loans); or

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31 https://www.bankofengland.co.uk/prudential-regulation/Authorisations/which-firms-does-the-pra-regulate.
32 At [14].
33 At [60].
34 TR 2005/5 at [16].
35 At [17].
36 At [65] and [70].
37 At [73].
38 At [18].

2. offers and invitations are regularly made to acquire or dispose of debt finance products that are intended to result or may reasonably be expected to result in the making (or acceptance) of offers to acquire or dispose of such debt finance products (including offering loans).

The terms on which the funds are raised must be normal commercial terms.[39]

Although it is possible for an enterprise to be considered to be raising finance through financial markets if it raises the funds from a related party lender that regularly provides finance to the public, raising finance from a corporate treasury entity or other group member that performs financing services for the group that does not lend to the public will not meet this requirement.[40] Raising finance through a pure conduit entity (not retaining a margin) established for the sole or principal purpose of acquiring debt finance in the financial markets for the enterprise may still be considered to be raising finance through financial markets.[41]

Taking deposits at interest

The phrase "taking deposits at interest" refers to the receipt of amounts of money into an account with the enterprise upon which interest is paid. The enterprise needs to be authorised under the relevant regulatory regime in the country of residence to receive money into such an account.[42] Provided that the enterprise is so authorised, deposits can also be received from related parties.[43]

Use funds in carrying on a business of providing finance

In order to qualify as a "financial institution", the entity must use the funds raised to conduct activities amounting to the carrying on of a business,[44] and that business must be one of providing finance. "Finance" in this sense is broader than the debt finance referred to in relation to obtaining debt finance in financial markets. Rather, it requires the provision of "funds or assets with an obligation (either contingent or non-contingent) on the recipient to return these funds or assets in the future."[45] Accordingly, it can apply to the provision of both debt and equity finance[46] and can include arrangements involving:[47]

a. securities lending arrangements (providing cash collateral or lending a security if there is an obligation to return it);

b. repurchase agreements if the seller has a non-contingent obligation to repurchase at a higher price;

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39 TR 2005/5 at [18].

40 TR 2005/5 at [75] – [76]. This is also confirmed in Note 6(a) of the UK DTA and in some of the Explanatory Memorandums amending the *International Tax Agreements Act 1953*, for example Explanatory Memorandum to the *International Tax Agreements Amendments Act (No. 1) 2007* at [1.128].

41 TR 2005/5 at [77] to [80].

42 TR 2005/5 at [20].

43 TR 2005/5 at [86]

44 TR 2005/5 at [25]; Taxation Ruling TR 97/11 *Income tax: am I carrying on a business of primary production?* contains the Commissioner's views on when an entity is carrying on business.

45 TR 2005/5 at [23].

46 TR 2005/5 at [89].

47 TR 2005/5 at [91] –[92].

c. redeemable preference shares; and

d. leasing under a finance lease.

Substantially deriving its profits

In order to meet the requirement that the entity is substantially deriving its profits from the relevant activities, these activities must constitute its main business activity, based on their contribution to overall profit.[48] This is confirmed in item 14(b) of the Protocol in respect of the Japanese DTA. The "main" activity need not account for the majority of the overall profit. It would be sufficient, for example, if 40% of profit was derived from the relevant activities while two other activities accounted for 30% each of the remaining profit.[49]

Profit should be measured using accounting principles, with gross profit, net operating income and operating profit being acceptable measures, evaluated over a reasonable timeframe.[50] The activities of the whole entity, including permanent establishments, must be considered.[51]

3.1.3 Meaning of "unrelated to and dealing wholly independently with"

"Unrelated to"

The term "unrelated" is not defined in the relevant DTAs. In TR 2005/5, the ATO considers that this term should not be interpreted literally such that even a minimal ownership interest would give rise to a relationship between the parties. Rather, it states that it is intended that the treatment of interest paid to a financial institution should mirror that afforded to publicly offered debt securities under Australia's domestic legislation.[52] These provisions provide an exemption from IWT, provided that the issuer of the security and the acquiring entity, or recipient of the interest, are not "associates" as that term is defined in section 318, as amended by section 128F.

As it is intended that a similar approach should be applied to the DTA exemption for financial institutions, TR 2005/5 explains that for the purposes of the exemption, two companies will be associates if one company is sufficiently influenced by the other and that on this basis "the Commissioner considers that a financial institution will be unrelated to the interest payer where, in considering the level of participation in the ownership or control of either the financial institution or the Australian payer by the other party, it can be concluded that neither is able to exert sufficient influence over the other party".[53] The ruling notes that one party holding redeemable preference shares with limited rights to direct the other party may not be able to exert sufficient influence over that other party and, accordingly, the parties may be unrelated.[54]

This position is confirmed in Item 14(a) of the Protocol in respect of the Japanese DTA.

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48 TR 2005/5 at [27].

49 TR 2005/5 at [138].

50 TR 2005/5 at [101] – [102].

51 TR 2005/5 at [28].

52 At [109].

53 At [112].

54 At [114]. See also ATO ID 2009/2.

"Dealing wholly independently with"

TR 2005/5 requires that, in order for the payer to be dealing wholly independently with the payer, the terms must be "arm's length" within the meaning of Taxation Ruling TR 2002/2:[55]

> Whether a loan satisfies the arm's length test will ultimately be determined by reference to the facts of each particular case and the outcome that might have been expected to arise between independent parties in comparable circumstances.

TR 2005/5 notes that if parties enter into multiple transactions that, alone, are not arm's length, but are arm's length if combined, those parties will not be treated as acting wholly independently.[56] However, the mere provision of credit support (eg in the form of a parent company guarantee) does not necessarily mean that the parties are not dealing wholly independently with one another.[57]

3.1.4 Back to back loans

If the exemption was available for back to back loans or similar arrangements, financing arrangements could be structured in a manner that would allow interest to be exempt in unintended circumstances.[58] For example, a UK parent company could enter into a back to back arrangement with a UK financial institution to lend to an Australian subsidiary and avoid IWT. Equally, a lender resident in a country other than a Relevant Country could structure a back to back loan through a financial institution in a Relevant Country to Australia. Accordingly, interest paid on back to back arrangements is, to the extent of the back to back arrangement, excluded from the exemption.[59]

We consider that there must be some element of traceability to give rise to a back to back arrangement. For example, a financial institution that otherwise meets the requirements for the exemption which obtains some of the debt finance used generally in its business from financial institutions resident in a country other than a Relevant Country, should not attract the application of the back to back exclusion.

We note that the provision of a related party guarantee should not give rise to a back to back arrangement that would prevent the exemption applying.[60]

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55 TR 2005/5 at [117] – [118] and TR 2002/2 *Income tax: meaning of 'Arm's Length' for the purposes of subsection 47A(7) of the Income Tax Assessment Act 1936 (ITAA 1936) dividend deeming provisions* at [4]. Paragraphs [23] and [24] of TR 2002/2 are also relevant.

56 At [120].

57 TR 2005/5 at [121].

58 TR 2005/5 at [127].

59 Explanatory Memorandum to the *International Tax Agreements Amendment Act 2003*, Chapter 1: the 2003 United Kingdom Convention at [1.133].

60 Eg see the Explanatory Memorandum to the *International Tax Agreements Amendment Act (No.1) 2007* at [1.131].

3.2 Scenario: Application of the financial institution exemption

Facts

- An Australian Borrower wishes to enter into a syndicated facility agreement (**SFA**) for $70m.
- It has identified three lenders:
    - a bank resident in the United Kingdom entering into the SFA through its Singapore branch (**Lender A**);
    - a subsidiary of a UK bank resident in Singapore (**Lender B**); and
    - a US fund that issues notes in commercial markets to fund loans it provides to commercial borrowers operating in a particular industry (**Lender C**).

Consideration of treatment under relevant DTA

Article 1 of the UK DTA provides that:

> This Convention shall apply to persons who are residents of one or both of the Contracting States.

Accordingly, the financial institutions exemption from IWT under the UK DTA may be applicable to Lender A,[61] but will not be applicable to Lender B as it is resident in Singapore.

Lender A should be eligible for the benefit of the financial institutions exemption in the UK DTA provided that the following criteria are met:

- it is a "financial institution", being a bank or other enterprise substantially deriving 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;
- it is unrelated and dealing wholly independently with the borrower;
- the interest is not paid as part of an arrangement involving a back-to-back loan or another arrangement that is economically equivalent and intended to have a similar effect to a back-to-back loan; and
- the anti-avoidance provisions do not apply.

In respect of Lender B, there is no applicable exemption from IWT under the DTA between Australia and Singapore. Accordingly, IWT will apply to any payment of interest made by the Australian Borrower to Lender B.

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[61] TR 2005/5 confirms that a financial institution resident in a Relevant Country that lends through a permanent establishment in a third country (not being a Relevant Country) can be eligible for the exemption (at [124]).

In respect of Lender C, whether or not the exemption for financial institutions in the US DTA will apply will require consideration of a variety of factors, including:

- the type of entity used and whether it is eligible for the benefit of the US DTA (in this regard, note that a partnership can have the benefit of the US DTA provided that the partnership itself or the partners are subject to US tax on the partnership's income and the limitation of benefits requirements are met); and
- if it is a fiscally transparent entity and is not eligible for the benefit of the US DTA, whether it may, through its members/partners be eligible for the benefit of another relevant DTA and, if so, whether the members/partners could relevantly be considered to be financial institutions for the purposes of the exemption.

4 Section 128FA: Public offer test for eligible unit trusts

An exemption from the requirement to pay IWT is available if the requirements of section 128FA are satisfied. Section 128FA operates on generally similar terms to section 128F, but only in respect of "eligible unit trusts".

For the section 128FA exemption to apply, the interest being paid by the eligible unit trust must relate to either a debenture (eg a note or bond) or a "debt interest" that is a syndicated loan satisfying certain requirements, which has been offered in a manner that satisfies the "public offer test".

A discussion of section 128F is included in our paper presented at the 2018 Financial Services Taxation Conference - "Practical issues for interest withholding tax and section 128F" (**2018 Paper**).

4.1 Meaning of "eligible unit trust"

The term "eligible unit trust" is defined in section 128FA to mean:[62]

a. a public unit trust (as defined in section 102P);[63] or

b. a unit trust in which all of the issued units are held by 2 or more "eligible unit holders".

4.1.1 Meaning of "unit trust"

A threshold issue is therefore whether the relevant trust is a "unit trust". That term is not defined in either the 1936 Act or the 1997 Act. The High Court has indicated in a land tax context that:[64]

a. "a priori assumptions as to the nature of unit trusts" do not generally assist in the process of ascertaining the terms of a trust and whether the rights conferred under it fall within a particular statutory definition; and

b. the term unit trust does not, in the absence of a statutory definition, have a "constant, fixed normative meaning".

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62 Section 128FA(8).

63 Disregarding subsection (2) of section 102P.

64 *CPT Custodian Pty Ltd v Commissioner of State of Revenue (Vic)* (2005) 224 CLR 98 at 109-110.

More recently, the High Court has considered the meaning of the term "unit trust" in the context of Division 6C.[65] The majority held that the meaning of the term "unit trust" in that context accords with the common usage of the expression "unit trust".[66] That is:[67]

> a species of a trust in which the beneficial interest in the trust fund is divided into units as discrete parcels of rights themselves capable of being dealt with, like shares in a company, as items of commerce.

The majority in *Elecnet* also pointed out that there was nothing in Division 6C to suggest that the notion of a unit trust represents a category of trust which can be placed on a spectrum, between the concepts of a "fixed trust" and a "discretionary trust".[68]

It follows that in assessing whether a trust is a unit trust, the interests in the trust estate must be sufficiently "unitised", having regard to the effect of the terms of the deed governing the trust.[69]

4.1.2 Meaning of "public unit trust"

Section 102P sets out circumstances in which a unit trust will be a public unit trust. While a detailed consideration of these circumstances is beyond the scope of this paper, broadly, a trust will be a public unit trust for the purposes of section 128FA if:[70]

a. any of the units in the trust have been listed for quotation on a stock exchange;

b. units in the trust are held by not fewer than 50 persons (having regard to the tracing rules in section 102P);[71] or

c. offers to subscribe for or purchase units in the trust (or invitations to make such offers) are made to the public or sections of the public and:[72]

   - the Commissioner is not of the opinion that such an offer was made with a purpose of enabling the trust to become a public unit trust;[73] and
   - the section of the public the offer or invitation is made to is not a small group of associated people.

As regards the test identified in c., there is High Court authority to the effect that an offer made to a particular group of persons which:

a. arises from a subsisting special relationship between the offeror and that group; and/or

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65 *Elecnet (Aust) Pty Ltd (as trustee for the Electrical Industry Severance Scheme) v Commissioner of Taxation* (2016) 259 CLR 73 (***Elecnet***).

66 *Elecnet* at [56] (Kiefel, Gageler, Keane and Gordon JJ).

67 *Elecnet* at [55] (Kiefel, Gageler, Keane and Gordon JJ).

68 *Elecnet* at [57] (Kiefel, Gageler, Keane and Gordon JJ).

69 Refer to *Elecnet* at [48]-[50], [53], [62] (Kiefel, Gageler, Keane and Gordon JJ) and at [89] (Nettle J).

70 Section 102P(1).

71 Sections 102P(10), (10A) and (12).

72 See also section 102P(9).

73 Section 102P(3).

b. has a rational connection with a restrictive and well-defined common characteristic of that group which sets the group apart,

may not constitute an "offer to the public" (although the particular circumstances of the offer in either case must be taken into account).[74]

There are also some disqualifying provisions in section 102P. For example, even if the trust satisfies one of the requirements identified above, the trust will not be treated as a public unit trust if 20 or fewer persons either:[75]

a. hold units, or have the right to acquire units, in the trust entitling them to 75% or more of the beneficial interests in the trust's income or property; or

b. are paid or credited, or had the right to be paid or credited, 75% or more of money paid or credited by the trustee of the trust in an income year.

There are also "closely held" provisions dealing with situations where there is an ability to vary or abrogate rights attaching to units, to alter the beneficial entitlements in units.[76]

If a trust is or would be regarded as closely held under the above tests, it still may be able to be treated as a public unit trust if the Commissioner is of the opinion, having regard to certain matters:

a. that it should be regarded as a public unit trust;[77] or

b. that there was no intention of a transferor that a transferee would exercise a right,[78] or that there was no intention of a person with the power to vary a right to in fact vary that right in the relevant manner,[79] (and therefore the relevant disqualifying test will not be satisfied in the first place).

It should be noted that subsection 102P(2) is disregarded for the purposes of section 128FA. Broadly, that subsection provides that unit trusts which, applying a 20% threshold, are held by, provide payments or credits to, or are controlled by, exempt entities, will be public unit trusts.

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74 *Corporate Affairs Commission (South Australia) & Anor v Australian Central Credit Union* (1985) 157 CLR 201 at 207-210 (Mason, Wilson, Deane and Dawson JJ). Refer also a slightly different test formulated by Brennan J at 212-213.

75 Sections 102P(4) and (7).

76 Section 102P(7).

77 Section 102P(5). This only applies in respect of the disqualifying test in section 102P(4) and is subject to section 102P(7). The EM to the *Taxation Law Amendment Bill (No 4) 1985* provides that a closely held trust will only be treated as a PUT when it is closely held for "a short time".

78 Section 102P(6). This only applies in respect of sections 102P(4) and (5).

79 Section 102P(8). This only applies in respect of the disqualifying test in section 102P(7).

4.1.3 Meaning of "eligible unit holder"

The term "eligible unit holder" is defined in section 128FA to include:[80]

a. the trustee of a public unit trust;

b. the trustee of a complying superannuation fund that has 50 or more members;

c. the trustee of a pooled superannuation trust;

d. the trustee of a complying approved deposit fund;

e. the trustee of a life insurance company;

f. a public company;[81] and

g. the trustee of a unit trust in which all of the issued units are held by 2 or more entities that are "eligible unit holders".

4.1.4 Timing issues

Certain requirements which must be satisfied in order for a trust to be an eligible unit trust give rise to timing considerations relevant to other criteria underlying the exemption. The two key considerations are:

a. Whether a trust is required to be an eligible unit trust at the time the trustee offers the debentures or debt instruments, or makes the invitations to become a lender under a syndicated loan.

b. Whether a trust is required to be an eligible unit trust at the time the trustee pays interest under the relevant debentures or debt interests.

It is reasonably clear, on the face of the legislation, that the exemption can only apply to interest paid by the trustee of an eligible unit trust.[82] While it is less clear from the wording of the provision that the trust must be an eligible unit trust at the time the trustee makes the offer or invitation, the explanatory memorandum to the statute which introduced section 128FA confirms that this is intended,[83] which makes sense in the context of the exemption. The drafting of sections 128FA(6), (6A) and (7) also generally provide support for this position.

Accordingly, where the exemption is relied upon, ongoing monitoring and testing of whether the borrower is in fact an eligible unit trust will be required to be carried out from the time of offer or invitation, and for the term of the loan.

These requirements are particularly relevant to trusts in which the number of unitholders varies from time to time. Take, for example, a trust which is an eligible unit trust because its units are held by not

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80 Section 128FA(8). The terms "complying superannuation fund", "pooled superannuation trust", "complying approved deposit fund" and "life insurance company" each take their meaning from the 1997 Act.

81 Within the meaning of section 103A.

82 Section 128FA(1).

83 Explanatory Memorandum to the *New International Tax Arrangements Act 2004* (Cth) at [2.7].

fewer than 50 persons (applying the tracing rules) on 2 July 2019, and so it is a public unit trust on that date.[84] The chapeau to section 102P(1) provides:

> a unit trust is a public unit trust in relation to a year of income if, at any time during the year of income:…

Should that trust come to be held, on 3 July 2019, by fewer than 50 persons, it should by virtue of that language remain a public unit trust, and thereby an eligible unit trust, for the entire of the income year.[85] Subsequent years would of course have to be examined separately.

Compare the position of a trust held by two eligible unit holders (one being a complying superannuation fund with 50 or more members) as at 2 July 2019. If, on 3 July 2019, the membership of the complying superannuation fund was reduced below 50 (and it was thereby excluded from being an eligible unit holder), the borrower trust would not be expected to remain eligible for the exemption.

4.2 Scenario: What constitutes an eligible unit trust?

Facts

Consider whether the following borrower trusts should be "eligible unit trusts" for the purposes of section 128FA.

1. A borrower unit trust in which all of the units are held by a complying superannuation fund (within the meaning of the 1997 Act).
2. A borrower unit trust in which all of the units are held by a public unit trust (within the meaning of section 102P).
3. A borrower unit trust in which 50% of the units are held by a complying superannuation fund and 50% of the units are held by a pooled superannuation trust (each within the meaning of the 1997 Act). Assume no units are offered to the public or listed.

In each case, assume no units are offered to the public or listed and none of the disqualifying provisions are relevant to the borrower unit trust.

Consideration

The definition of eligible unit trust in section 128FA provides as follows:

> eligible unit trust means:
>
> (a) a public unit trust; or
>
> (b) a unit trust in which all of the issued units are held by 2 or more eligible unit holders.

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84 Sections 102P(1)(c), (10), (10A), (12). Assume no disqualifying provisions apply.

85 Section 102P(1) and Explanatory Memorandum to the *New International Tax Arrangements Act 2004* (Cth) at [2.9].

Considering each of the above scenarios in turn:

1. A unit trust held entirely by a complying superannuation fund will not be an eligible unit trust by virtue of paragraph (b) of the definition in section 128FA, as only one eligible unitholder holds the issued units in the trust. Additionally, the unit trust will not be a public unit trust on the basis that section 102P(10A) provides that the "look through" tracing rules in section 102P(10) do not apply in respect of units held by a trust estate which is a complying superannuation entity (a term which covers complying superannuation funds). Accordingly, the trust should not be an eligible unit trust.

2. For the same reasons as above, a unit trust held entirely by a public unit trust will not be an eligible unit trust by virtue of paragraph (b) of the definition in section 128FA. However, provided the public unit trust is:

   - not a complying superannuation entity; and
   - is a public unit trust on the basis that its units are held by not fewer than 50 persons (on a trace through basis)[86] and does not infringe section 102P(4) or section 102P(7),

   then the borrower unit trust should also be a public unit trust and therefore will be an eligible unit trust for the purposes of section 128FA.

3. A borrower unit trust in which 50% of the units are held by a complying superannuation fund and 50% of the units are held by a pooled superannuation trust should be an eligible unit trust provided the complying superannuation fund has 50 or more members, as paragraph (b) of the definition of eligible unit trust should be satisfied.

4.3 Other requirements of section 128FA

The other requirements which must be satisfied for the section 128FA exemption to apply are largely similar to the requirements of section 128F, although they are not identical.[87] These requirements (and the key differences between section 128F and section 128FA) are outlined at a high level below.

4.3.1 Australian Borrowers

Unlike section 128F,[88] there is no express requirement within section 128FA that the trust or the trustee be an Australian Borrower when issuing the debenture or debt interest and paying interest.[89] However, because interest withholding tax will generally only apply to interest paid offshore by

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86 Section 102P(1)(c), having regard to sections 102P(10) and 102P(12).

87 Section 128FA adopts a number of the key operative provisions and definitions used in section 128F.

88 Sections 128F(1)(a) and (b), 128F(1A)(a), (b) and (c).

89 Section 128FA provides that certain wholly owned non-resident subsidiaries of an eligible unit trust based in specified countries may also get the exemption. However, no countries are currently specified in the regulations. The equivalent provision in section 128F allows such subsidiaries based in the USA to access the exemption.

Australian Borrowers, the exemption would not otherwise be relevant. The express requirement might therefore have been done away with when introducing section 128FA.

4.3.2 Debentures and debt interests

As with section 128F, the interest must relate to a debenture (defined inclusively and, broadly, in a manner consistent with the definition in section 128F) or a debt interest other than a debenture. Unlike section 128F, section 128FA can only apply to debt interests other than debentures which are "syndicated loans".[90]

In order to be characterised as a syndicated loan, the relevant loan or other form of financial accommodation must be provided under a "syndicated loan facility", being a facility with at least two lenders. A syndicated loan facility is a written agreement:[91]

a. that describes itself as a "syndicated loan facility" or "syndicated facility agreement";[92]

b. between one or more borrowers and at least two lenders (or one lender with the ability to add other lenders);

c. under which lenders agree to lend, or provide other financial accommodation, severally but not jointly; and

d. under which at least $100m is available when the first loan or other financial accommodation is to be provided.

If there are multiple borrowers under an agreement, the agreement will only be a syndicated loan facility if each borrower is a member of the same wholly owned group, is a party to the same joint venture or is an associate of the other borrowers.[93]

4.3.3 Public offer and exceptions from the exemption

Section 128FA adopts the provisions of section 128F, adapted as necessary to apply to the trustee of an eligible unit trust (rather than a company), for the purposes of working out whether the issue of a debenture or a debt interest satisfies the public offer test.[94] That is, the five public offer tests in section 128F(3) (in respect of debentures or debt interests) and the three public offer tests in section 128F(3A) (in respect of invitations to lenders under syndicated loan facilities) are used under section 128FA (as modified). Section 128FA is also available in respect of global bonds.[95]

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90 Sections 128FA(1) and (2); cf sections 128F(1)(c), (1A)(d). It is also possible for a type of debt interest to be prescribed by regulation. However, no such regulations currently apply.

91 Section 128FA adopts the definition of "syndicated loan" and "syndicated loan facility" from sections 128F(9), (10) and (11).

92 This requirement is strictly interpreted in relation to section 128F (see Explanatory Memorandum to the *Tax Laws Amendment (2007 Measures No. 3) Act 2007* at paragraph 7.40 and PBR 1011837940581 where the Commissioner held that a loan agreement that was a "Facility Agreement" was not a syndicated loan facility).

93 Section 128F(13).

94 Sections 128FA(6), 128FA(6A) and section 128FA(7).

95 Refer to sections 128F(4) and (10).

The same exceptions from the exemption therefore also apply in respect of section 128FA, except that the trustee of the eligible unit trust takes the place of the "company" for the relevant sections,[96] and the definition of associate is modified.[97]

Broadly, these exceptions will apply if:

a. at the time of issue of a debenture the trustee of the eligible unit trust knew, or had reasonable grounds to suspect, that a debenture would be acquired by an offshore associate (see below) of the trustee, who was not acting in a permitted capacity (see below); or

b. at the time of invitation to become a lender under a syndicated loan facility, the trustee knew, or had reasonable grounds to suspect, that an offshore associate is or will become a lender under the facility and that the associate is not acting in a permitted capacity.

An "offshore associate" is an "associate"[98] who is either a non-resident of Australia not acquiring the debenture or participating in the syndicated loan facility in carrying on business at or through a permanent establishment in Australia or a resident of Australia acquiring the debenture or participating in the syndicated loan facility in carrying on business at or through a permanent establishment outside of Australia.

Permitted capacities include the capacity of a dealer, manager or underwriter in relation to the placement of the debenture, or in the capacity of a clearing house, custodian, funds manager or responsible entity of a registered scheme.

Additionally, payments of interest subsequently paid to offshore associates other than in a permitted capacity will not be exempt from IWT. For that purpose, permitted capacities are the capacity of a clearing house, paying agent, custodian, funds manager or responsible entity of a registered scheme.

4.3.4 ATO advice and guidance

There are generally fewer ATO advice and guidance products relating to section 128FA than there are in respect of section 128F. However, to the extent a piece of advice or guidance relating to section 128F concerns an aspect of that section which is largely or wholly replicated in section 128FA, the Commissioner would presumably interpret and/or apply the advice or guidance in the same way.[99]

This would be expected to occur, for example, in relation to the requirement that offers and invitations must be genuine.[100]

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96 Section 128F(7)(a).

97 Section 128FA(7)(b) and the definition of "associate" in section 128FA(8).

98 Ibid.

99 This is, to an extent, confirmed in, for example PBR 1011513838371.

100 Refer to part 3.3.3 of the 2018 Paper and to Taxation Determination TD 1999/24 *Income Tax: interest withholding tax exemption under section 128F of the Income Tax Assessment Act 1936 – how may a company satisfy the introductory requirements in paragraphs 128F(3)(a) and (b) that a debenture must be offered on a debenture by debenture basis?*

4.4 Scenario: Accession of a company borrower

Facts

- An Australian resident eligible unit trust (**Borrower Trust**) makes an invitation to a range of banks to become lenders under a facility agreement. The invitation and the facility agreement comply with all the requirements of section 128FA.
- At a later date, Borrower Trust's wholly owned resident subsidiary company (**Borrower Co**) accedes to the facility agreement as an additional borrower.

Consideration of treatment under section 128FA

Interest paid by Borrower Co to offshore lenders under the facility agreement should not qualify for the exemption under section 128FA.

Despite the facility agreement and the invitation complying with the requirements of section 128FA, the exemption can only apply in respect of interest paid by an eligible unit trust. Borrower Co will not satisfy the definition of eligible unit trust. While section 128FA operates on very similar terms to section 128F (particularly in relation to the public offer and the form of a "syndicated loan"), there is no provision for the exemption to extend to company borrowers.

The position may be different had Borrower Co also been an initial borrower under the facility agreement, and had made section 128F compliant invitations to potential lenders (in addition to or in conjunction with Borrower Trust's 128FA compliant invitations).

Another alternative to consider is if a note issuance had instead been carried out by Borrower Trust. In that case, a separate section 128F compliant offer for additional notes could be made at a later date by Borrower Co.

5 Letter of credit facilities

5.1 Scenario: Application of section 128F/128FA (public offer test exemption) to a letter of credit facility

Facts

- An Australian entity (company or eligible unit trust) wishes to enter into a $200m letter of credit facility and expects that it will necessary to syndicate the facility.
- Can the facility be entered into in a manner that satisfies the public offer test in section 128F or 128FA?

Application of public offer test provisions

A letter of credit is essentially a letter from a bank guaranteeing a payment by the bank's client to a third party.

Under sections 128F(1) and 128FA(1), for the exemption to apply to interest paid on a debt interest that is not a debenture, the debt interest must be, relevantly, a "syndicated loan". While a letter of credit is not a traditional loan since there is no upfront advance of funds, and there may never be an advance of funds if a demand is not made on it, the definition of "syndicated loan" refers to:[101]

> … a loan or *other form of financial accommodation* that is provided under a syndicated loan facility, being a facility that has 2 or more lenders [emphasis added]

"Financial accommodation" is not defined. However, in *International Litigation Partners Pte Ltd v Chameleon Mining NL (Receivers and Managers Appointed)*, the High Court stated, in the context of Chapter 7 of the *Corporations Act 2001*:[102]

> The expression "a contract, arrangement or understanding ... [for] any form of financial accommodation" (emphasis added) is of considerable width of denotation. For example, an agreement by a bank to lend its name to a bill of exchange for the accommodation of its customer provides a form of financial accommodation, as is reflected in the expression "accommodation bill". The same may be said for the provision of a guarantee of the obligations to the creditor of the principal debtor. The extension by a bank to a customer of an overdraft facility provides a form of financial accommodation in respect of the presently undrawn portion of the overdraft. [Footnote omitted]

Similarly to a guarantee, a letter of credit guarantees the obligations of the principal debtor to another and should be regarded as the provision of "financial accommodation".

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101 Section 128F(9).

102 (2012) 246 CLR 455 at [28].

Accordingly, provided that:

1. the letter of credit facility describes itself as a "syndicated loan facility" or "syndicated facility agreement";[103]
2. there are at least two lenders;[104]
3. each lender agrees severally, but not jointly, to provide financial accommodation to the borrower;[105]
4. the borrower will have access at the time the first financial accommodation is to be provided to at least $100m;[106] and
5. the invitation to become a lender under the syndicated facility agreement satisfies the public offer test,[107]

any interest paid under a letter of credit facility should be able to be exempt under section 128F or section 128FA (as applicable).

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103 Sections 128F(11) and (12) and 128FA(8).
104 Sections 128F(9) and 128FA(8).
105 Sections 128F(11) and (12) and 218FA(8).
106 Ibid.
107 Sections 128F(1) and 128FA(1).

6 Offshore trust lender

6.1 Scenario: Interest paid to offshore trust with Australian investors

Facts

- A resident borrower (**X Co**) borrows from a non-resident trust and pays interest to that entity. The loan is not section 128F/128FA compliant.
- The trust has investors that are both Australian residents and non-residents.
- Is interest withholding tax required to be withheld in respect of amounts to which the Australian residents will become presently entitled?

Consideration of withholding requirements

As outlined above in part 1, the payer must withhold an amount under Subdivision 12-F of Schedule 1 of the TAA from a payment of interest if:[108]

a. the payee has an address outside Australia according to any record that is in the payer's possession, or that is kept or maintained on the payer's behalf; or

b. the payer is authorised to pay the interest at a place outside Australia.

Accordingly, *prima facie*, X Co is required to withhold from interest payments it makes to the lender.

However, section 12-300 of Schedule 1 of the TAA provides:

> This Subdivision does not require an entity:
>
> (a) to withhold an amount from a *dividend, from interest (within the meaning of Division 11A of Part III of the Income Tax Assessment Act 1936) or from a *royalty if no *withholding tax is payable in respect of the dividend, interest or royalty; or
>
> (b) to withhold from a dividend, from interest (within the meaning of that Division) or from a royalty more than the withholding tax payable in respect of the dividend, interest or royalty (reduced by each amount already withheld from it under this Subdivision).

Section 128A(3) states:

> For the purposes of this Division, a beneficiary who is presently entitled to a dividend, to interest or to a royalty included in the income of a trust estate shall be deemed to have derived income consisting of that dividend, interest or royalty at the time when he or she became so entitled.

Accordingly, if the lender is a trust and has a presently entitled Australian resident beneficiary, it may be able to satisfy X Co that no Australian interest withholding tax should be payable in respect of the portion of the interest to which the relevant beneficiary is so entitled, and, accordingly, no withholding

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[108] Section 12-245 of Schedule 1 of the TAA.

should be required. However, practically, a beneficiary may not be presently entitled to income at the time it is paid (depending on the terms of the trust deed) and, on this basis, Australian interest withholding tax may be required to be withheld. In this case, the beneficiary should be entitled to a credit for the amount withheld.[109]

[109] Section 18-30 of Schedule 1 of the TAA.

7 Section 128AC: Hire purchase arrangements

7.1 Introduction

Section 128B(5) imposes a liability to pay IWT on an Offshore Lender deriving income that consists of "interest" paid by an Australian Borrower. The current rate of IWT is 10%, subject to relief under an applicable double tax treaty.

Section 128AC subjects to IWT the implicit interest charge paid by a resident to a non-resident under hire-purchase and similar agreements (referred to collectively as "relevant agreements"). Broadly, section 128AC deems certain amounts paid under relevant agreements to be income that consists of interest for the purposes of Division 11A of Part III of the 1936 Act and specifies the formula to be used to determine these amounts of deemed interest (this formula is, broadly, based on the "rule of 78"[110]).

7.2 Relationship between section 128AC and royalty withholding tax

Taxation Ruling TR 98/21,[111] sets out the Commissioner's views regarding the relationship between section 128AC (interest withholding tax) and section 128B(5A) (royalty withholding tax) in respect of payments made under cross-border leases. A detailed discussion of the potential application of royalty withholding tax to payments under a cross border lease is beyond the scope of this paper, but in summary the Commissioner's approach in TR 98/21 is:

a. where it is clear from the outset that the purchase or repurchase of the relevant equipment is paramount, payments made under a cross border equipment leasing transaction are not subject to royalty withholding tax. Section 128AC may apply to an instalment payment under a cross border lease that constitutes a hire purchase agreement for section 128AC purposes and which contains an implicit interest component; and

b. conversely, where the main object of the cross border leasing transaction is the hire of the relevant equipment, royalty withholding tax under section 128B(5A) applies (this may be the case even where the hirer has the option to purchase the relevant equipment).

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110 Refer, for example, to the discussion of the "rule of 78" in Taxation Ruling TR 93/16 - *Income tax: application of the Rule of 78 or other methods in calculating the interest component of instalments paid under a fixed term loan or extended credit transaction.*

111 TR 98/21 *Income Tax; withholding tax implications of cross border leasing arrangements* (**TR 98/21**).

7.3 What agreements does section 128AC apply to?

The term "relevant agreement" is defined in subsection 128AC(1) to mean:

a. a hire-purchase agreement; or

b. a lease or any other agreement relating to the use by a person of property owned by another person, being a lease or agreement under which:

- the lessee or person using the property is entitled to purchase or require the transfer of the lease property or property subject to the agreement on the termination or expiration of the lease or agreement; or
- the lease term or term of the agreement is for all, or substantially all, of the effective life of the lease property or property subject to the agreement.

The term "hire-purchase agreement" is not defined for the purposes of the definition of "relevant agreement" in section 128AC (although the 1997 Act contains a definition of "hire-purchase agreement" in subsection 995-1(1), this definition is not applicable to section 128AC: see subsection 995-1(2) of the 1997 Act).

In TR 98/21, the Commissioner presents a broad interpretation of the meaning of "hire-purchase agreement" as used in section 128AC, taking the view that section 128AC should be interpreted to catch:[112]

> all leasing transactions in which the purchase element is paramount and which have a financing element.

Accordingly, in order for the lease to be a "hire-purchase agreement" for purposes of section 128AC, the following elements must be satisfied:

- it must be a "leasing transaction" for legal purposes;
- there must be a "financing element"; and
- the purchase element must be "paramount".

According to the Commissioner, the question of whether the "paramount purpose" of a cross border lease is a purchase must be decided by:[113]

> having regard to all surrounding circumstances and commercial consequences of the transaction (such as the passing of the incidents of ownership and economic risks to the lessee and other matters)

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112 TR 98/21 at [64] and [74].

113 TR 98/21 at [7].

TR 98/21 lists various factors that are considered relevant to the question of whether the paramount purpose of the transaction is one of purchase.[114] The factors are:

- whether the lessee has a call option or equivalent over the equipment;
- whether the lessor has a put option or equivalent over the equipment;
- when any purchase option is exercisable and whether the exercise is effectively irrevocable;
- whether the equipment is specially adapted to the special requirements of the lessee;
- whether the equipment is likely to have any value to another person on the expiration of the lease if the lease is not for the life of the equipment;
- whether the lease term is for the life of the equipment so that the equipment is likely to have no or an insignificant market value at the end of the lease;
- which party bears the financial risks associated with the funding of the equipment;
- whether there are security arrangements in relation to payments under the lease and, if so, the nature of those security arrangements;
- how the residual value (if any) is calculated; and
- whether an upfront payment or payments satisfies the payment obligations of the lessee and whether such payment is effectively irrevocable.

7.4 Amount of "interest" subject to withholding tax under section 128AC

The "total interest" potentially subject to withholding tax is, broadly, equal to:

- the sum of all "attributable agreement payments" under the lease (ie so much of any payment made or liable to be made under the lease as represents consideration for the use, sale or disposal of the equipment); less
- the "eligible value" of the equipment (ie the market value of the equipment at the time at which the equipment commenced).

The amount of each "attributable agreement payment" that is deemed to be income that consists of interest is so much of the "attributable agreement payment" that does not exceed the "notional interest" in relation to that payment. The "notional interest" in relation to the "attributable agreement payment" is equal to the sum of the "formula interest" in relation to the "attributable agreement payment" plus the "carry forward interest" in relation to the immediately preceding "attributable agreement payment".

[114] TR 98/21 at [31].

The "formula interest" is equal to the amount ascertained in accordance with the following formula:

$$\frac{2AC}{B(B+1)}$$

Where: **A** is the "total interest";

B is the total number of "attributable agreement payments" liable to be made under the lease; and

C is the number that is **B** reduced by the number of attributable agreement payments made under the lease before the attributable agreement payment concerned.

The "carry forward interest" is the amount (if any) of the notional interest that exceeds the "attributable interest payment".

7.5 Application of a double tax agreement

The application of a DTA to payments made in respect of a cross border lease depends on the precise terms of the relevant double tax agreement.

As an example, in the US DTA, "interest" is defined as follows:[115]

> Interest from government securities or from bonds or debentures (including premiums attaching to such securities, 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 by the law of the Contracting State in which the income arises.

It is unclear precisely what is intended to be encompassed by the phrase "*income which is subjected to the same taxation treatment as income from money lent*". However, the Explanatory Memorandum to the *International Tax Agreements Bill (No. 1) 2001* (the **US DTA EM**) indicates that the interest component of rental payments under a hire-purchase agreement is intended to be characterised as "interest" for the purposes of the US DTA. The US DTA EM states:[116]

> The definition encompasses items of income such as discounts on securities and *payments made under certain hire purchase arrangements* which, in the case of Australia, are treated as interest or amounts in the nature of interest. [emphasis added]

A similar position is adopted by the Commissioner in Taxation Ruling TR 2007/10,[117] which states:[118]

> As a result, where a ship or an aircraft is leased under [a hire-purchase agreement], the leasing profits will not give rise to a deemed permanent establishment under Article 5(4)(b) of the [US DTA]…Unless a permanent establishment

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115 Article 11(5) of the US DTA.

116 Paragraph 2.51 of the US DTA EM.

117 Taxation Ruling TR 2007/10 *Income tax: the treatment of shipping and aircraft leasing profits of United States and United Kingdom enterprises under the deemed substantial equipment permanent establishment provision of the respective Taxation Conventions* (**TR 2007/10**).

118 TR 2007/10 at [32].

> otherwise arises, the interest component arising from the financial accommodation inherent in these types of leases is dealt with under the Interest Article (Article 11) of the…[US DTA]

It follows that the interest component of the rental payments under a cross border lease calculated under section 128AC should be characterised as "interest" for the purposes of Article 11 of the US DTA.

Generally, interest arising in Australia which is paid to a resident of the United States may be taxed in Australia at a 10% rate under Article 11(2) of the US DTA. However, no IWT applies if the financial institution exemption, discussed at part 3 above, is available.[119]

7.6 Relationship between Division 240 and section 128AC

As outlined above, under section 128AC, IWT is payable on hire-purchase payments made by an Australian hirer to an offshore owner, to the extent that those payments are attributable to interest.

Despite the fact that Division 240 treats some hire purchase agreements as a sale for the purposes of the depreciation and capital allowance deductions provisions, there is nothing in either Division 240 or the definition of "hire purchase agreement" which deems a hire purchase to be a sale for the operation of any other provisions of the Tax Act. However, where Division 240 applies, any interest component paid by an Australian hirer to an offshore owner should still fall within section 128AC and be subject to IWT.

The ATO view in ATO ID 2005/263[120] is that, if an arrangement is covered by both Division 240 (hire purchase) and section 128AC (deemed interest for interest withholding tax purposes in respect of hire purchase agreements and other arrangements), the "interest" calculation for IWT purposes is conducted under section 128AC, which may differ from the calculation of interest under Division 240.

ATO ID 2005/263 set outs the following fact scenario and analysis:

> **Facts**
>
> The taxpayer is a resident of Australia for tax purposes.
>
> In July 2003, the taxpayer entered into an agreement with a non-resident plant supplier for plant used by the taxpayer in carrying on a business for the purpose of producing assessable income. The agreement conferred upon the taxpayer a right to use and possess the plant, and an option to purchase the plant at the end of the term of the agreement.
>
> On the facts of the case:
>
> - Division 240 of the ITAA 1997 would apply to the agreement which met the paragraph (a) definition of 'hire purchase agreement' in subsection 995-1(1) of the ITAA 1997.

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119 Article 11(3)(b) of the US DTA.

120 ATO Interpretative Decision ATO ID 2005/263 - *Income Tax: Deemed interest in respect of a hire purchase agreement for non-resident interest withholding tax purposes* (**ATO ID 2005/263**).

- Section 128AC of the ITAA 1936 would apply to the agreement in accordance with Taxation Ruling TR 98/21.

The plant supplier has an address outside Australia.

Reasons for Decision

In the present case both Division 240 of the ITAA 1997 and section 128AC of the ITAA 1936 applied to the arrangement between the taxpayer and the non-resident plant supplier.

Division 240 of the ITAA 1997 has no effect for the purposes of Division 11A of Part III of the ITAA 1936 (paragraph 240-15(b) of the ITAA 1997). Hence, the implicit interest component of actual rental payments made, or liable to be made, under the hire purchase agreement would be determined according to the requirements of section 128AC of the ITAA 1936.

This gives the result that the "interest" calculations under the 2 regimes may be different, such that an Australian lessee (under a hire purchase agreement) may claim a deduction for notional interest under Division 240 of a different amount than the deemed interest in respect of which it is required to withhold IWT under section 128AC. This result gives rise to administrative issues for Australian lessees under hire purchase agreements, requiring 2 separate calculations to be made in respect of the same payments under the same arrangements.

8 Assessability of interest

8.1 Scenario: Interest paid to non-resident

Facts

- An Australian borrower pays interest to a non-resident lender that is either subject to IWT or exempt under section 128F.
- Will the lender be subject to further Australian tax?

Consideration of income tax treatment of interest payment

Interest withholding tax is a final tax for non-resident lenders, with the relevant interest income received being not assessable and not exempt.[121] Alternatively, interest paid to a non-resident lender might instead be non-assessable, non-exempt income as a result of :[122]

1. the interest being derived by a superannuation fund for foreign residents that is exempt from tax on that income in the country in which the non-resident resides;
2. the application of section 128F or section 128FA (public offer test); or
3. the application of section 128GB (exemption for offshore borrowings by offshore banking units).

Accordingly, a non-resident lender will not be assessed in Australia on interest received from an Australian Borrower if that interest is subject to IWT or exempt from such IWT on the basis of one of the above exemptions.

If interest is exempt from IWT under a relevant DTA on the basis that it is being paid to a relevant financial institution (see part 3 above), section 128B will not apply and the interest should be exempt from Australian tax under the DTA.[123]

8.2 Scenario: Interest paid to resident incurring interest through permanent establishment outside Australia

Facts

- An Australian Borrower pays interest to a resident lender in carrying on business through a permanent establishment in a country outside Australia that is either subject to IWT or exempt under section 128F.

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121 Section 128D.

122 Ibid.

123 For example, under Article 11 of the UK DTA.

- Will the lender be subject to further Australian tax?

Consideration of income tax treatment of interest payment

Section 128D does not apply to Australian resident lenders who derive interest in carrying on business at or through a permanent establishment in a country outside Australia. As residents are taxable in Australia on worldwide income, interest income derived by a resident of Australia through a permanent establishment outside Australia is *prima facie* assessable in Australia. However, if a DTA applies, the relevant business profits article may grant the "host country" taxing rights,[124] and an Australian tax credit or characterisation of the income as being non-assessable non-exempt[125] may prevent double taxation.[126]

[124] For example, Article 7(1) of the UK DTA.

[125] For example, section 23AH.

[126] As required under the relevant Elimination of Double Taxation Article, for example Article 22 of the UK DTA.

9 Gross up clauses in loan agreements

An agreement under which interest is payable will often include an indemnity clause which applies to IWT and to other amounts withheld or paid on account of taxes. Such a clause is often referred to as a "gross up" clause, under which a lender will, in specified circumstances, receive additional amounts, such that they receive the same amount they would have been paid had no withholding applied or tax been payable.

9.1 Gross up for IWT

A key issue for lenders and borrowers entering into agreements will be whether there is a gross up for IWT. As a starting point, the parties will generally consider whether IWT is expected to, *prima facie*, apply, and if so, whether an exemption from IWT is expected to be available (eg under section 128F/128FA or under a DTA). If no IWT is expected to apply at any point during the term of the loan (eg on account of the lender being a resident not operating through an offshore permanent establishment), a lender may accept there being no gross up clause for IWT.

If IWT is expected to be payable, or if the lender requires a gross up clause to be included in the transaction documents, any payments made to an Offshore Lender will generally be required to be grossed up. However, if an exemption is expected to be available, the gross up clause may take a different form, and certain exclusions from the gross up may be negotiated by the borrower. This is discussed further below.

9.1.1 Public offer test risk

Where the exemption from IWT relies on the application of section 128F or section 128FA, a question arises as to which party should bear the risk of the public offer test not being satisfied. Parties will generally rely on advice from their legal representatives as to whether the interest is being paid under, relevantly, a "debenture" or a compliant "syndicated loan". Legal representatives may also be able to provide advice on whether or not a particular method of offer or invitation should satisfy the test.

However, the application of the statutory exemptions also turn on a number of factual requirements which parties must be satisfied are met. One such matter is whether the offer is a "genuine offer"; some others are, for example, those relevant to the test under section 128F(3)(a), as to whether the relevant lenders are "carrying on a business of providing finance, or investing or dealing in securities, in the course of operating in financial markets" and are not associates of one another. Finally, confirmation is nearly always sought that the public offer test is not failed because the borrower knows or has grounds to suspect that one of the lenders is an offshore associate of the borrower at the time of issue, or invitation, and at the time of payment of interest.

Some of these matters are therefore typically dealt with by way of representations made by lenders and by borrowers. These representations serve to allocate the public offer test risk between the parties. For example, a lender will often receive no gross up for IWT if the public offer test fails on account of the "offshore associate" exclusion. On the other hand, the borrower may have to gross up the lender should section 128F or section 128FA not apply on some other basis.

Public offer test risk also arises in the context of "change of lender clauses". These clauses need to be reviewed on a case by case basis. A common approach is that a new lender will only be entitled to a gross up for IWT to the extent a previous lender was so entitled. The result is that on introducing a new lender into an agreement in substitution for an outgoing lender, the residency of that lender and the other facts relevant to whether an exemption from IWT should be available must be considered.

9.1.2 Risk in relation to DTAs

A degree of risk also arises where the parties rely on an exemption (or reduction) in IWT under a DTA. This is generally dealt with by way of representations given by the lender as to whether it is eligible for the relevant exemption or reduction under the DTA.

9.1.3 "Additional amount" language

The precise language used in a gross up clause for IWT may impact whether any IWT is payable in respect of the amount actually paid under the gross up clause.

Relevantly, in *FCT v Century Yuasa Batteries* (1998) 98 ATC 4380 (***Century Yuasa***), the Full Federal Court held that interest:[127]

> is the return, consideration or compensation for the use or retention by one person of a sum of money belonging to, or owed to another, and that interest must be referable to a principal.

Accordingly, the Court went on to find that amounts paid to the lender by a borrower under a tax indemnity were:[128]

> neither interest nor in the nature of interest but were an indemnity against [the lender's] liability for income tax

The gross up clause the subject of that decision provided for "an additional amount" to be payable in respect of any deduction or withholding required by law to be made for or on account of tax.

The Commissioner has recognised the impact of *Century Yuasa* in Taxation Ruling TR 2002/4 - *Income tax: taxation implications of the Century Yuasa Batteries decision* (**TR 2002/4**), which provides that:[129]

> 14. Payments made under clauses similar to that found in [*Century Yuasa*] are indemnification of tax payments and not interest.
>
> …
>
> 15. Clauses which escalate interest are not indemnification of tax clauses.

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127 *Century Yuasa* at 4383.

128 *Century Yuasa* at 4384.

129 TR 2002/4 also considers several other taxation consequences arising from *Century Yuasa*, such as whether and how a payment under a tax gross up clause will be taxed in the hands of a lender and the deductibility of the payment for a borrower.

It follows that gross up clauses which "escalate interest" are likely to cause payments under those clauses to be characterised as interest, or amounts in the nature of interest, and therefore subject to IWT. Further withholding by the borrower might therefore be required under such a clause.

Notably, the Australian Pacific Loan Market Association's precedent syndicated facility documentation uses the following definition in its tax gross up and indemnity clause:

> **"Tax Payment"** means either the increase in a payment made by an Obligor to the Lender under Clause [x.x] (*Tax Gross-up*) or a payment under Clause [x.x] (*Tax indemnity*).

In our view, there is a risk in using this language and we generally recommend amending it as follows:

> **"Tax Payment"** means either the payment of an additional amount by an Obligor to the Lender under Clause [x.x] (*Tax Gross-up*) or a payment under Clause [x.x] (*Tax indemnity*).

9.2 Other exclusions from gross up clauses

Various other amounts imposed in relation to taxation regimes are generally excluded from gross up clauses, although could in practice be subject to negotiation between the parties. These amounts include:

a. withholding required in relation to the United States of America's *Foreign Account Tax Compliance Act,* known as FATCA (it is extremely unusual for an Australian borrower to gross up for FATCA withholding, on the basis that it would generally only be imposed if a lender had failed to provide relevant information or to apply for an exemption);

b. amounts required to be deducted from payments as a result of the Commissioner issuing notices or directions under garnishee type powers;[130]

c. amounts required to be withheld on account of a lender failing to quote an appropriate Australian Business Number, an Australian tax file number or proof of a relevant exemption from these withholding regimes;[131] and

d. amounts of tax calculated by reference to the net income of the lender.

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[130] Section 260-5 of Schedule 1 to the *Taxation Administration Act 1953* (Cth) and section 255 of the 1936 Act. Gross up exclusions generally also cover "analogous provisions" and may apply in respect of any jurisdiction, not just the Commonwealth.

[131] A similar and broader exclusion in respect of a failure to quote a name, address, registration number or similar details may also be included.

