TR 2004/D16 - Income tax: ascertaining the right to tax US and UK resident financial institutions under the United States and the United Kingdom Double Taxation Conventions in respect of interest income arising in Australia

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Draft Taxation Ruling

Income tax: ascertaining the right to tax US and UK resident financial institutions under the United States and the United Kingdom Double Taxation Conventions in respect of interest income arising in Australia

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

Class of persons/arrangement

1. This Ruling applies to residents of the United States and the United Kingdom that are classified as financial institutions for the purposes of either the Australia – United States Double Tax Convention, as amended by the Protocol, (the US DTC) or the Australia – United Kingdom Double Taxation Convention (the UK DTC) (collectively referred to as 'the Conventions').

2. This Ruling applies to those arrangements where interest is paid by an Australian resident or a permanent establishment in Australia of a non-resident to residents of the United States (US) and the United Kingdom (UK) that are financial institutions for the purposes of the Conventions. The financial institutions must beneficially own, or be beneficially entitled to this interest.

Issues discussed in Ruling

3. The Ruling discusses the requirements as to when a US or UK resident will not be subject to tax in Australia under the Conventions on interest income arising in Australia.

4. This Ruling focuses on the definition of 'financial institution' contained in Article 11(3)(b) of the Conventions. The definition of 'financial institution' distinguishes two types of entities; those that are 'banks' and those that are 'other enterprises'.

5. The definition also contains a number of undefined terms. Given these undefined terms, there has been some uncertainty as to whether a US or UK resident will be considered to be a 'financial institution' for the purposes of the Convention and subsequently whether it will be subject to Australian tax on interest income arising in Australia.

6. The Ruling and Explanation sections of this Ruling are presented in two parts:

A. ascertaining whether the US or UK resident is classified as a financial institution under Article 11(3)(b) of the Conventions; and

B. additional conditions for a financial institution to meet to determine whether it will be subject to tax on its interest income arising in Australia, namely:

- the financial institution is unrelated to and dealing wholly independently with the payer of the interest (Article 11(3)(b));
- the interest is not effectively connected with a permanent establishment of the US or UK resident in Australia (Article 11(6)); and
- the interest is not paid as part of an arrangement involving 'back to back' loans (Article 11(4)).

7. This Ruling is intended to assist both residents of the US and the UK establish their Australian interest withholding tax liability, and assist Australian borrowers determine their withholding tax obligations.

Date of effect

8. It is proposed that when the final Ruling is issued, it will apply in respect of withholding taxes from the date of effect of the Conventions. The US Protocol that amends the US Double Taxation Convention took effect for withholding taxes on 1 July 2003. The UK DTC took effect for withholding taxes on 1 July 2004. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Ruling

9. Where a US or UK resident:

- satisfies the definition of 'financial institution'; and
- is beneficially entitled to, or beneficially owns the interest; and
- is unrelated to, and dealing wholly independently with the payer of the interest,

and the interest arising in Australia is not:

- effectively connected with a permanent establishment of the US or UK resident in Australia; nor
- paid as part of an arrangement involving 'back to back' loans,

Australia has no taxing rights under Article 11(2) of the Conventions in respect of interest paid to the US or UK resident.

PART A: ascertaining whether the US or UK resident is classified as a financial institution under Article 11(3)(b) of the Conventions

10. The definition of a 'financial institution' is contained in Article 11(3)(b) of the Conventions and categorises residents into those that are 'banks' and those that are 'other enterprises'.

Banks

11. For the purposes of the Conventions, the Commissioner considers that a bank means a US or UK resident that is granted its principal banking licence in its country of residence being respectively the US or the UK, to take deposits and make advances, and satisfies the capital adequacy requirements to operate as a bank in that same place of residence.

12. Where a resident satisfies these requirements, it will constitute a financial institution and does not need to satisfy the other elements of the definition of what is a financial institution.

Other enterprises

13. 'Other enterprises' are those residents of the US or UK that are not classified as banks. This means that these enterprises must 'substantially derive their 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'.

14. In other words, the enterprise must substantially derive its profits from its 'spread activities', that is their profits must result mainly from the difference between the cost of raising funds and the return from providing finance.

Raising debt finance in the financial markets

15. Relying on similar concepts to those applied in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997), the term 'debt finance' means that the enterprise obtaining the funds must have an 'effectively non-contingent obligation' to provide an amount at least equal to the amount received. In this context, an 'effectively non-contingent obligation', takes its meaning from section 974-135 of the ITAA 1997. This type of financing would generally be economically equivalent to a loan.

16. The term 'financial markets' has the same meaning as that in the *Corporations Act 2001*. It means:

> A facility through which:
>
> (a) offers to acquire or dispose of financial products are regularly made or accepted; or
>
> (b) offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
>
> (i) the making of offers to acquire or dispose of financial products; or
>
> (ii) the acceptance of such offers.[1]

17. The linkage between the meaning of debt finance above, and the requirement that the enterprise obtains its debt finance in the financial markets, means that these funds must be raised on normal commercial terms.

Whether funds need to be raised directly

18. The definition of a 'financial institution' requires the enterprise to raise its own funds directly in the financial markets.

19. Where the fund-raising activity is undertaken by an associated entity within a corporate group that on-lends the funds to the enterprise carrying on the business of providing finance, the enterprise may not be raising its own funds in the manner required by the Article. As such, it may not satisfy this element of the definition and cannot qualify as a financial institution.

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[1] *Corporations Act 2001* section 767A.

Taking deposits at interest

20. The term 'taking deposits at interest' takes on its ordinary meaning. The CCH Macquarie Business Dictionary defines 'deposit' as:

> a sum of money placed into an account with a financial institution. Deposits can range in maturity from a deposit in a passbook account, able to be withdrawn on demand (or on call), to a deposit made for a fixed period of time.[2]

This term refers to the taking of a sum of money as a deposit by a financial institution which pays interest thereon. In the context of the above dictionary definition, the term 'financial institution' takes on its ordinary meaning and refers to an enterprise that is authorised to take deposits under a regulatory regime. For the purposes of this Ruling, the enterprise must be an authorised deposit taking institution under the regulatory regime of either the US or the UK, to take sums of money in the form of deposits.

Using those funds in carrying on a business of providing finance

21. The term 'providing finance' takes on its ordinary meaning and in the Macquarie Dictionary is defined as:

> **3.** to supply with means of payment; provide capital for; obtain or furnish credit for.[3]

22. The meaning of 'providing finance' is a broader term than 'debt finance'. It is not limited to the provision of funds for which the lender receives a return that is non-contingent in nature. Rather, a provision of finance entails the *supply or provision* of funds or assets with an obligation on the recipient to return these funds or assets in the future. This obligation may be non-contingent in nature, connoting debt finance, or it may be contingent, connoting equity finance (for example, subscribing for shares in an initial public float).

23. In the context of the Conventions, the supply or provision of funds or assets must also be made as part of the enterprise's overall spread activities. Furthermore, the enterprise must also be *carrying on a business* of undertaking these 'spread activities'.

Substantially deriving profits

24. The term 'substantially deriving its profits' means that the 'spread activities' of raising debt finance in the financial markets or taking deposits at interest and using those funds in carrying on a business of providing finance, forms the resident's main business activity.

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[2] *The CCH Macquarie Business Dictionary* (Student Edition) CCH Australia Limited, Sydney, 1993, p 168.
[3] *The Macquarie Dictionary*, Second Edition, The Macquarie Library, New South Wales, 1992, p 649.

25. This spread activity constitutes the main business activity of the resident if such activity is the main contributor, in gross profit terms, to the overall profitability of the resident. This will need to be measured over a reasonable period to ascertain whether this activity is consistently the main activity of the enterprise.

26. Where financial institutions, resident in the US or UK, provide finance to an Australian resident through a permanent establishment in a third country it would be necessary to consider the entire activities of the US or UK resident, including the activities undertaken through the permanent establishment, to determine whether it is substantially deriving its profits from its spread activities.

PART B: additional conditions for a financial institution to meet to determine whether it will be subject to tax on its interest income arising in Australia

Whether the US or UK financial institution is unrelated to, and dealing wholly independently with the payer of the interest

27. For the purposes of Article 11(3)(b), the US or UK resident must be both unrelated to, and dealing wholly independently with the Australian payer.

28. The meaning of 'unrelated' means that there is no ownership or control based relationship between the payer of the interest and the financial institution, under which one party is able to exert influence over the activities of the other party.

29. In determining whether the parties will be regarded as dealing wholly independently with each other, paragraphs 4, 23 and 24 of TR 2002/2 provide guidance.

The interest is effectively connected with a permanent establishment of the US or UK resident in Australia

30. In cases where interest is paid by an Australian borrower to a permanent establishment of the financial institution in Australia, Article 11(6) of the Conventions specifies that the provisions of Article 7 (Business Profits) will apply. Notwithstanding that the US or UK resident may be a financial institution, the interest arising in Australia will be taxable in Australia.

Whether the interest is paid as part of an arrangement involving 'back to back' loans

31. Article 11(4) specifies that where a back-to-back loan arrangement involving related party or other debt is structured through a financial institution to avoid source country taxation, Article 11(3) will not apply.

Explanation

PART A: ascertaining whether the US or UK resident will be classified as a financial institution under Article 11(3)(b) of the Conventions

32. This Ruling provides guidance on the meaning and the application of the definition of 'financial institution' contained in Article 11(3)(b) of the Conventions.

33. The definition of 'financial institution' has been defined in the Interest Article of the Conventions as the following:

> …For the purposes of this Article, the term 'financial institution' means a bank or other enterprise substantially deriving its profits from raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.[4]

The meaning of undefined terms within the definition of Financial Institution

34. The definition of a 'financial institution' contains a number of terms that are not defined in the Conventions. These include:

- 'bank';
- 'raising debt finance in the financial markets';
- 'taking deposits at interest';
- 'providing finance'; and
- 'substantially deriving its profits'.

35. Article 3(3) of the UK DTC states:

> As regards the application of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the laws of that State for the purposes of the taxes to which this Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

36. Article 3(2) of the US DTC similarly provides that where a term is not defined in the Convention it takes on the meaning it has under the domestic tax law of the country applying the Convention unless the context otherwise requires.

37. Notwithstanding the different wording in Article 3(2) of the US DTC compared with Article 3(3) of the UK DTC, it is considered that there is no substantive difference in the application and operation of the General Definitions Article in both Conventions as it relates to undefined terms.

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[4] *International Tax Agreements Act 1953,* Schedule 1, Article 11(3)(b); Schedule 2, Article 11(3)(b).

38. Taxation Ruling 2001/13 provides the Commissioner's approach to the interpretation of undefined terms in a treaty (see paragraphs 63 to 76 of TR 2001/13). This approach is relied upon in this Ruling to provide meaning to the undefined terms referred to in paragraph 34.

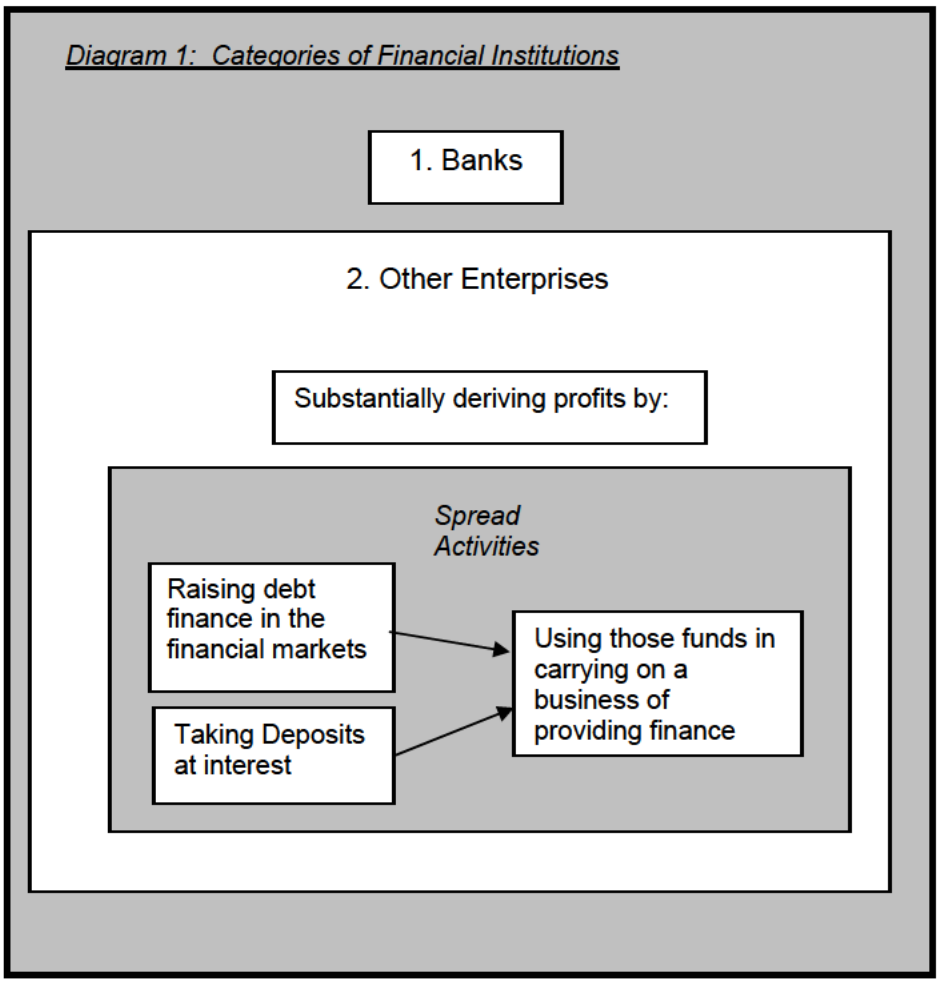
Banks

39. Some uncertainty has arisen as to whether the definition requires a 'bank' to meet all the elements of the definition in order to be a financial institution.

40. The drafting of the definition could allow two interpretations. A literal interpretation may suggest that both 'banks' and 'other enterprises' must substantially derive their profits by either taking deposits at interest or raising debt finance in the financial markets, and using these funds to carry on a business of providing finance in order to qualify as a financial institution.

41. Alternatively, the word 'bank' may be read in isolation from the rest of the definition such that a 'bank', as defined, qualifies as a financial institution.

42. The specific reference to banks within the definition allows these entities to be distinguished from other enterprises that are not banks. The Commissioner therefore considers the latter to be the better view. Accordingly, there are two categories of financial institutions: residents that are banks, and residents that are other enterprises. This is represented in Diagram 1.



43. As such, the requirements of substantially deriving profits, raising funds and carrying on a business of providing finance are only applicable to residents that are 'other enterprises'.

The meaning of the term 'Bank'

44. Article 11 of the Conventions does not define the word 'bank' nor is it defined elsewhere in the Conventions.

45. Article 3(2) of the US DTC and Article 3(3) of the UK DTC indicate that Australia's domestic law meaning of the term bank should apply unless the context requires otherwise.

46. For a bank to operate in Australia it must comply with the *Banking Act 1959*.[5] Although this Act establishes the legal framework for banks operating in Australia, it does not contain a definition of a bank. The term 'authorised deposit taking institution' (ADI) is used instead.

[5] *Banking Act 1959* section 8.

47. An ADI is defined as a body corporate that has been granted an authority to carry on a 'banking business' in Australia.[6] This authority is granted by the Australian Prudential Regulatory Authority (APRA).[7] A 'banking business' consists of 'both taking deposits (other than as part-payment for identified goods or services) and making advances'.[8]

48. While all banks are required to be ADIs, ADIs also include building societies and credit unions. For an ADI to use the word 'bank' in its title it must meet certain capital adequacy requirements as specified by APRA.[9] APRA Guidelines stipulate that these institutions must have a minimum of $50 million in Tier 1 Capital.[10] It is only these entities that are considered to be banks under Australian law.

49. In summary, the meaning of a bank for Australian domestic law purposes is a body corporate that has an authority to carry on a banking business in Australia and has at least $50 million in Tier 1 Capital.

50. It is apparent from the above analysis, that when determining the liability for Australian tax, a meaning of the term bank that is limited to Australia's domestic law meaning[11] will not be applicable to US or UK residents that operate from the US or the UK respectively. Rather, as the Article is intended to apply to residents of the US or the UK, the context requires that the term bank must allow these residents to undertake their banking business in their country of tax residence.

51. While there are differences between the jurisdictions, residents operating as banks in the United States and the United Kingdom have similar regulatory requirements as those of Australian banks.

52. The banks in these jurisdictions must comply with their domestic regulatory requirements and satisfy certain capital adequacy standards to distinguish them from other types of financial institutions.

53. Those US or UK residents that may be allowed to operate a banking business in the US or the UK on the basis that they have a foreign banking licence outside the US or UK may not have to satisfy similar regulatory requirements. As such, the term would not be interpreted to include these types of entities as banks.

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[6] *Banking Act 1959* section 5, subsection 9(3).
[7] APRA is the prudential regulator of banks, insurance companies, superannuation funds, credit unions, building societies and friendly societies in Australia.
[8] *Banking Act 1959* section 5.
[9] *Banking Act 1959* section 66.
[10] 'Guidelines on Authorisation of ADIs', paragraph 13, www.apra.gov.au.
[11] See paragraph 49.

54. Having regard to both Australia's domestic law meaning and the treaties' context in paragraph 50, it is the Commissioner's view that the term 'bank' means residents of the US or UK that:

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

55. Residents that operate as credit unions, building societies and saving and loans institutions, that have lower capital adequacy requirements than those required of banks in that jurisdiction will not satisfy the meaning of the term 'bank'. These residents, however, may still be considered to be a financial institution where they satisfy the requirements for 'other enterprises'.

Other enterprises

56. The second part of the definition of financial institution relates to other enterprises and contains a number of undefined terms.

57. Other enterprises are required to substantially derive their profits by raising debt finance in the financial markets or taking deposits at interest and using those funds in carrying on a business of the provision of finance. The combination of these elements reflects the intent of the Article to extend the withholding tax concession to those enterprises that substantially derive their profits from what may be termed their 'spread activities', that is those enterprises that operate on a margin between the cost of borrowing and the return from lending. This is reflected in the following words of the relevant Explanatory Memoranda:

> The exemption for interest paid to financial institutions recognises the agreed 10% withholding tax rate on gross interest can be excessive given their cost of funds.[12]

The meaning of 'raising debt-finance in the financial markets'

58. In examining the meaning of 'raising debt finance', it is clear that the inclusion of the word 'debt' refers to a particular type of finance raising. Therefore, a traditional loan of funds from the financial markets would be a form of raising debt finance, while the

[12] Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.131; Explanatory Memorandum to the International Tax Agreements Amendment Bill (No.1) 2002, Chapter 2: Protocol amending the Convention with the United States of America, paragraph 2.46.

raising of finance through an issue of ordinary shares to the public, being a form of equity financing, would not.

59. It will not always be apparent from the nature of modern financing arrangements whether certain arrangements constitute one of raising debt or equity finance. With the development of innovative financial products as a means of raising finance, the traditional legal boundaries to distinguish 'debt' from 'equity' are no longer appropriate in this context.

60. There is no definition of the term 'raising debt-finance' in the Conventions nor is the term specifically used in Australia's tax law. However, the term 'raising debt finance' relies on similar concepts as applied in Division 974 of the ITAA 1997 to distinguish debt from equity. An object of this Division is to establish a test to determine whether an arrangement gives rise to a debt interest or an equity interest in order to distinguish what amounts are deductible from amounts that may be frankable.[13] This approach has regard to the economic substance of the rights and obligations arising under a financing arrangement, rather than the mere legal form.[14]

61. Although the objects of this Division are different to Article 11(3)(b) of the Conventions, and slightly different terms are used, the economic concept underlying these terms is analogous.

62. The tests within the Division focus on a single organising principle to distinguish debt from equity – the effectively non-contingent obligation of an issuer to return to the investor an amount at least equal to the amount invested.[15] This 'effectively non-contingent obligation' takes its meaning from section 974-135 of the ITAA 1997. This test recognises the basic indicator of the economic character of a debt, the non-contingent nature of the returns.[16]

63. It is the Commissioner's view that it is consistent with the context of the Conventions to apply this principle in interpreting this term. Therefore where a financial arrangement or arrangements result in an effectively non-contingent obligation to provide an amount at least equal to the amount received, this will constitute 'raising debt finance' for the purposes of the Conventions.

64. For example, under security lending arrangements and repurchase agreements an enterprise may sell securities with an effectively non-contingent obligation to purchase those securities back at a later date at a higher price reflecting an imputed interest rate. These activities are consistent with the context of Article 11(3)(b) which is to include within the definition of raising debt finance those arrangements that in economic substance are akin to a loan. The Commissioner therefore considers these financing arrangements to be within the meaning of raising debt finance.

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[13] *Income Tax Assessment Act 1997* subsection 974-10(1), Note.
[14] *Income Tax Assessment Act* 1997 subsection 974-10(2).
[15] *Income Tax Assessment Act* 1997 subsection 974-20(1).
[16] *Income Tax Assessment Act 1997* subsection 974-10(2), Note 1.

65. The Commissioner does not consider that an arrangement must give rise to a 'debt interest' under Division 974 for it to constitute 'raising debt finance'. However, as the debt-test in Division 974 incorporates the principle referred to in paragraph 62, an arrangement that satisfies this test would clearly constitute 'raising debt finance'.

66. The expression 'financial markets' is also undefined in the US and UK DTCs. While the term 'financial markets' is not defined in Australia's taxation law, the *Corporations Act 2001* defines a financial market as the following:

> A facility through which:
>
> (a) offers to acquire or dispose of financial products are regularly made or accepted; or
>
> (b) offers or invitations are regularly made to acquire or dispose of financial products that are intended to result or may reasonably be expected to result, directly or indirectly, in:
>
> (i) the making of offers to acquire or dispose of financial products; or
>
> (ii) the acceptance of such offers.[17]

67. This broad meaning of financial markets is consistent with the context of the definition. The term is used in conjunction with the term 'raising of debt finance' and as such is considered to accommodate raising debt finance in both the wholesale and retail markets.

68. Raising funds in these markets would indicate that the funds must be raised on normal commercial terms. For example, with regard to long term finance the amount to be repaid would not merely be at least equal to the amount received but should reflect the time value of money appropriate to the risk involved to properly reward the financial market participants.

The meaning of the term 'taking deposits at interest'

69. The phrase, 'taking deposits at interest' is not defined in the Conventions.

70. The term 'interest' is defined in Article 11(5). While the term has a wide meaning, its scope is more limited when used in the context of taking deposits at interest.

[17] *Corporations Act 2001* subsection 767A(1).

71. The Macquarie Business Dictionary defines 'deposit' as:

> a sum of money placed into an account with a financial institution. Deposits can range in maturity from a deposit in a passbook account, able to be withdrawn on demand (or on call), to a deposit made for a fixed period of time.[18]

72. The definition indicates that to take deposits at interest a sum of money must be placed in an account with an enterprise that is a financial institution. In the context of the above dictionary meaning, the term 'financial institution' takes on its ordinary meaning and means an enterprise that is authorised under a regulatory regime (such as APRA in the case of Australia) to take deposits at interest. This distinguishes a deposit from a mere loan.

73. An alternative view is that a provision of funds (at interest) by entity A within a corporate group to associated entity B that carries on a business of providing finance is considered to be the taking of deposits at interest by entity B, even though entity B is not an authorised deposit taker. The basis for this view is that the funds provided, in a company group context, are characterised more as a deposit of monies than a mere loan. The Commissioner does not agree with this view. Rather, it is considered that the term 'deposits at interest' has a particular contextual meaning – it is limited to the placement of monies with an enterprise that is authorised to take deposits at interest. Therefore, where funds are placed with an associated entity within a company group, such funds will not be considered to be a 'deposit', unless the entity receiving the funds is itself an authorised deposit taking institution.

74. This interpretation is consistent with the context of the Convention as it recognises that enterprises that are not banks, such as building societies and saving and loan associations, are authorised deposit taking institutions and raise their funds in this manner.

Whether funds must be raised directly

75. While it is clear that the text of Article 11(1) of the Conventions is directed towards the 'resident' that is either beneficially entitled to or beneficially owns the interest,[19] the terms of Article 11(3)(b) are directed towards whether *the enterprise* in question is a financial institution and sets out certain criteria to be satisfied. An issue in turn arises whether a related party may raise the debt finance in the financial markets, and then on-lend these funds to the resident so that the resident may provide finance to other parties.

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[18] *The CCH Macquarie Business Dictionary* (Student Edition) CCH Australia Limited, Sydney, 1993, p 168.

[19] The Article 11(1) of the UK DTC refers to beneficially owned while Article 11(1) of the US DTC uses the term beneficially entitled.

76. This can occur where a non-resident may operate as part of a corporate group and the funds that it uses to provide finance may have been raised by its parent or another associate. The specific wording of Article 11(3)(b), however, relates to 'the enterprise' itself satisfying the tests in question. Accordingly, it is the activities of the enterprise that are paramount.

77. Where the fund-raising activity is undertaken by an associated entity within a corporate group that on-lends the funds to the enterprise carrying on the business of providing finance, the enterprise may not be raising its own funds in the manner required by the Article, that is by raising debt finance in the financial markets. As such, it may not satisfy this element of the definition and cannot qualify as a financial institution.

The meaning of the term 'Using those funds in carrying on a business of providing finance'

78. The Convention requires that the funds raised by debt finance or by taking deposits must be *used* to carry on a business of providing finance. This indicates that there must be a connection between the provision of finance and the raising of funds in the required manner. The requirement of *using those funds* will be satisfied where these activities are undertaken concurrently in carrying on a business.

79. The term 'providing finance' in the definition of financial institution is not qualified by stating whether this must be undertaken through debt or equity financing. The ordinary meaning of the term 'finance' as defined in Macquarie Dictionary is quite wide. It relevantly states:

> **3.** to supply with means of payment; provide capital for; obtain or furnish credit for.[20]

80. A provision of finance, as the definition indicates, involves more than the mere purchase of an asset for consideration which is the exchange of one asset for another asset. A provision of finance entails the supply or provision of funds or assets with an obligation on the recipient to return the funds or assets in the future. This obligation may be non-contingent in nature, connoting debt finance, or it may be contingent, connoting equity finance (for example, subscribing for shares in an initial public float).

81. For example, the leasing of an asset under a finance lease or a securities lending arrangement may constitute the provision of finance.

82. It should be noted that while the above activities may constitute the providing of finance they may not generate payments in the form of interest under Article 11(5) of the Conventions. Notwithstanding that the enterprise may be classified as a financial

[20] *The Macquarie Dictionary*, Second Edition, The Macquarie Library, New South Wales, 1992, p 649.

institution, the exemption only applies to the interest that the US or UK resident receives. Therefore, unless the US or UK resident is deriving interest income from Australia there will be no income category to which the exemption would apply.

83. On the other hand, fee income derived by an enterprise principally engaged in underwriting activities or the provision of advisory services, would not constitute providing finance as no funds or assets are provided by the enterprise which impose an obligation to return these funds or assets in the future.

84. The definition also necessitates that the enterprise must be using these funds in *carrying on a business* of providing finance. This indicates that the enterprise must regularly raise funds and use these funds in providing finance. For example, if a manufacturing company (that does not satisfy the definition of financial institution), sets up a particular entity to undertake a single loan transaction, it is unlikely that this entity would be carrying on a business of providing finance. The context indicates that provision should be limited to particular types of entities, that is, those that undertake spread activities on a recurring basis.

85. An enterprise which is engaged in subscribing for shares in an initial public float or purchases bonds as part of its investment strategy would not be *carrying on a business of providing finance*. For example, the purchase of shares or bonds by an insurance company forms part of its investment activities in the conduct of its insurance business, rather than forming part of a separate 'spread activity' business.[21]

The meaning of the term 'substantially deriving its profits'

86. An enterprise is required to be substantially deriving its profits from carrying on a business of 'spread activities' (see paragraph 57).

87. In *Commissioner of Superannuation v. Scott* (1987) 71 ALR 408 the meaning of 'substantially' was interpreted when the Court decided whether the respondent was wholly or substantially dependent upon her husband at the time of his death. In this case, the juxtaposition of the word 'wholly' influenced the judges' decision that:

> the meaning, in relation to a person in the expression 'wholly or substantially dependent', [is] that that person is primarily, essentially or in the main dependent upon another person.[22]

88. In the case of *Commissioner of Taxation v. Comcorp* (1996) 70 FCR 356 at 395 the Federal Court examined the issue of whether a person substantially complied with a provision of a deed. Justice Carr decided that in this instance 'substantially' involved a degree of compliance and was used in a relative sense rather than in an

[21] Refer to TR 93/27 paragraph 20 quoting from *FC of T v. Australian Mutual Provident Society* (1953) 88 CLR 450.
[22] (1987) 71 ALR 408 at 413.

absolute sense.[23] The meaning of 'substantially' is therefore different to what may be considered 'substantial'.

89. In considering these cases, the Commissioner is of the view that when the word 'substantially' is used in the context of an enterprise substantially deriving its profits from specific activities, namely 'spread activities', it is also used in a relative sense. The relevant term 'substantially' when used in conjunction with 'deriving profits', requires that the main source of the enterprise's gross profits be derived from its business of undertaking 'spread activities'.

90. As the amount of profits that an enterprise generates will fluctuate from year to year, the enterprise's gross profits should be evaluated over a reasonable period of time in relation to each business activity to ascertain whether the main source is from its 'spread activities'.

91. For example, a company that is in the manufacturing business may derive the majority of its gross profits in a particular year from its corporate treasury, when its manufacturing activities suffer a downturn in profitability. However, notwithstanding the profit result in that particular year, its main source of gross profits over time is normally from its manufacturing activities. As a consequence, it would not be considered a financial institution.

92. While the spread activities need not be the sole activity of the enterprise, it will need to constitute its main activity when compared with each other activity that it undertakes. The amount of absolute profit derived from its spread activities is therefore not determinative.

93. It has been suggested that the view adopted in this Ruling may differ from that provided by the United States in their Technical Explanation.[24] The United States Technical Explanation notes that where investment banks, brokers and commercial finance companies obtain their funds by borrowing from the public, they will be considered to be financial institutions.[25]

94. The Commissioner notes that these types of entities may be classified as financial institutions where they meet the requirements. However, for this to occur, it is necessary that these entities substantially derive their profits from their spread activities.

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[23] 70 FCR 356 at 395.

[24] See discussion of the interpretative value of Technical Explanations in TR 2001/13, paragraph 125.

[25] Department of the Treasury Technical Explanation of the Protocol between the Government of the United States of America and the Government of Australia signed at Canberra on September 27, 2001, Amending the Convention between the United States of America and the Government of Australia with respect to taxes on income signed at Sydney on August 6, 1982, Article 7 paragraph 3.

PART B: additional conditions for a financial institution to meet to determine whether it will be subject to tax on its interest income arising in Australia

Whether the US or UK financial institution is unrelated to, and dealing wholly independently with the payer of the interest

95. Article 11(3)(b) requires that the US or UK financial institution must be unrelated to and dealing wholly independently with the Australian payer if the interest is not to be subject to Australian tax.

96. This requirement has two elements, both of which must be satisfied. The financial institution must be unrelated to the payer, and must deal wholly independently with the payer. These elements are both undefined in the Conventions.

Unrelated

97. Given that the term 'unrelated' is not defined in the Conventions, it takes its meaning from the context in which it appears in the Conventions. As the term 'unrelated' is used in conjunction with the additional requirement for the financial institution to deal wholly independently with the payer, this suggests that the meaning of the term 'unrelated' is influenced by these other words in the Article. It is therefore not limited to a literal interpretation whereby even a minimal ownership interest would connote that the parties are related. Furthermore, the Explanatory Memoranda to the Conventions indicate that the intention of the Article is to align the treatment of interest paid to US and UK financial institutions with the domestic interest withholding tax exemption currently available under section 128F.[26]

98. Therefore the requirement of being 'unrelated' must be such that the relationship is not capable of affecting the dealings between the financial institution and the payer. Taking this factor into account, 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 party is able to influence the activities of the other party. As such, this test is aligned with the approach adopted in section 128F that excludes from the exemption, debentures acquired by an associate.[27]

99. For example, Company A that has a portfolio interest in the shareholding of Company B (and no other means of controlling Company B) will be treated as being unrelated for the purposes of the Article 11. The ownership interest is such that Company A will not be able to influence the activities of Company B.

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[26] Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.131.
[27] *Income Tax Assessment Act 1936*, subsections 128F(6) and 128F(9).

Dealing wholly independently with the payer

100. Even if the parties are unrelated to each other it is still necessary that the parties are dealing with each other wholly independently. As noted above, the term, 'dealing wholly independently with the payer' is used within Article 9 of the Conventions to determine whether enterprises are associated.

101. The Explanatory Memorandum for Article 9 of the Australia – UK DTC states the following:

> Consistent with Australia's modern treaty practice, the inclusion of the expression 'dealing wholly independently with one another' in paragraph 1 recognises dealings on a truly independent basis as the appropriate benchmark for determining whether the transactions have taken place on normal, open market commercial terms.[28]

102. In determining whether a transaction has taken place on normal, open market commercial terms, an arm's length test is applied. The Commissioner is of the view that for the purposes of Article 11 it is also necessary to examine whether the Australian payer and the financial institution operate on an arm's length basis.

103. Taxation Ruling TR 2002/2 examines the meaning of 'arm's length' for the purpose of subsection 47A(7) of the *Income Tax Assessment Act 1936* (ITAA 1936).

104. Paragraph 4 of that Ruling states that:

> 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.

105. Therefore, the Commissioner is of the view that Taxation Ruling TR 2002/2, in particular paragraphs 4, 23 and 24, may be relied upon to determine whether parties are acting independently with each other for the purposes of Article 11.

106. If a financial institution is unrelated to the payer of interest, but is not dealing wholly independently with the payer then the exemption from interest withholding tax will not apply. For example, if enterprises enter into two or more transactions that in total may reflect an arm's length dealing, but are not individually arm's length, then the parties would not be regarded as dealing with each other wholly independently.[29]

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[28] Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.102.
[29] Refer to *Collis v. FCT* 96 ATC 4831; (1996) 33 ATR 438.

Whether the interest is effectively connected with a permanent establishment of the beneficial owner in the country in which the interest arises

107. The Australia – UK Explanatory Memorandum states that:

> Interest derived by a resident of one country which is paid in respect of an indebtedness which is effectively connected with a permanent establishment of that person in the other country, will form part of the business profits of that permanent establishment and be subject to the provisions of Article 7 (Business profits). Accordingly, the rate of limitation of 10% and the exemption for financial institutions do not apply to such interest in the country in which the interest is sourced.

108. In cases where interest is paid by an Australian borrower to a permanent establishment of the financial institution in Australia, Article 11(6) of the Conventions specifies that the provisions of Article 7 (Business Profits) will apply. This interest will be taxable in Australia.

109. However, where financial institutions, resident in the US or UK, provide finance to an Australian resident through a permanent establishment in a third country the interest will not be taxable in Australia provided the other conditions in the Article are satisfied.

110. The permanent establishment is not a separate legal entity but rather the fixed place of business through which the enterprise carries on its business in the other jurisdiction. Consequently, the activities undertaken through the permanent establishment are being undertaken by the US or UK resident. It is therefore necessary to consider the entire activities of the US or UK resident against the criteria in Article 11 of the Conventions, including the activities undertaken through the permanent establishment.

Whether the interest is paid as part of an arrangement involving 'back to back' loans

111. Article 11(4) states that:

> Notwithstanding paragraph 3, interest referred to in subparagraph (b) of that paragraph may be taxed the State in which it arises at a rate no 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.

112. The aim of this provision is to prevent related party and other debt being structured through a financial institution to gain access to the withholding tax exemption.

113. This intent is reflected in the Australian Explanatory Memorandum for the UK DTC which states the following:

> The exemption will not be available for interest paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and structured to have a similar effect. The denial of the exemption for these back-to-back loan type arrangements is directed at preventing related party and other debt from being structured through financial institutions to gain access to

a withholding tax exemption. The exemption will only be denied for interest paid on the component of a loan that is considered to be back-to-back.[30]

114. It will be necessary to determine whether 'back to back' loans exist on a case by case basis due to the range of arrangements which may arise.

Examples

Banks

Example 1

115. Company A is a resident of the United States, under the US DTC. It has been granted its principal banking licence from the United States Federal Depository Insurance Corporation to undertake banking activities in the United States. In obtaining this licence, the company must satisfy the US capital adequacy requirements to undertake a banking business in the United States.

116. As Company A, has its principal licence in the United States and satisfies the United State's capital adequacy requirements to operate as a bank, it is considered a bank for the purposes of Article 11(3)(b) of the US DTC and as a consequence is a financial institution (see paragraphs 11 and 54).

Other enterprises

Example 2

117. Company C is a resident of the United Kingdom, under the UK DTC. It is authorised to take deposits under the United Kingdom Financial Services Authority and is classified as a building society under the United Kingdom *Building Society Act 1986*. It derives the majority of its profits from taking deposits and providing loans.

118. Company C will not be a bank for the purposes of the Convention, but as it is an authorised deposit taking institution and its main business involves taking deposits at interest and using those funds to carry on a business of providing finance, it will constitute a financial institution under Article 11(3)(b) of the UK DTC (see paragraphs 20, 69 to 74).

Example 3

119. Company D is a resident of the United Kingdom. It raises its funds by issuing promissory notes and commercial bills. It then uses these funds to provide finance leases.

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[30] Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.133.

120. These methods of raising funds are arrangements that are entered into that result in an effectively non-contingent obligation to provide an amount at least equal to the amount received. The issuing of promissory notes and commercial bills therefore constitute raising debt finance (see paragraphs 15 and 63).

121. The use of a finance lease is a method of providing capital and would be considered to be providing finance (see paragraphs 21 to 22 and 79 to 80).

122. Company D would constitute a financial institution under the UK DTC.

Substantially deriving profits

Example 4

123. Company G is a resident of the United States and is a subsidiary of a parent company that is a bank. Company G conducts an insurance business and does not hold a banking licence Over a period of three years Company G, on average, derives 90% of its gross profits from insurance premiums and 10% from the carrying on of spread activities.

124. Company G is not a financial institution as its main business activity does not involve undertaking spread activities but rather insurance activities (see paragraphs 14 and 92). Although a subsidiary of a parent company that is a bank, Company G itself is not a bank, as defined.

Example 5

125. Over a period of three years, Company I has derived 40% of its gross profit from its spread activities, 30% of its gross profit from advice work, and 30% of its gross profit from other business activities.

126. When compared to Company I's other separate activities over a reasonable time its main business is from its spread activities (see paragraphs 14, 90 and 92). It does not matter that the spread activities do not amount to the majority of its overall profits.

Permanent establishment

Example 6

127. Company L is a US resident and is classified as a financial institution under the US DTC and has a permanent establishment in Australia. Company L is beneficially entitled to interest that arises in Australia which relates to an indebtedness that is effectively connected to its branch (permanent establishment) in Australia.

128. Although Company L is beneficially entitled to the interest, the interest will be taxable in Australia on a net basis under the Business Profits Article (see paragraphs 30 and 108).

Unrelated

Example 7

129. Company X is a resident of the UK and is a Financial Institution under the UK Convention. Company X makes a loan to its wholly owned subsidiary, Company Y, in Australia.

130. Given Company X's ownership interests in Company Y, Company X is in a position to influence the activities of Company Y. Company X and Company Y are therefore not unrelated for the purposes of the UK Convention (see paragraphs 28 and 98). The interest paid by Company Y to Company X will be subject to tax in Australia.

Example 8

131. Company M is an Australian resident that borrows funds from public Company N that is a resident of the United Kingdom (and a financial institution for the purposes of the UK Convention). Company M has a small portfolio shareholding in Company N.

132. Company M's participation in Company N's ownership will not influence the activities of Company N. It is therefore treated as being unrelated for the purpose of the UK Convention (see paragraphs 28 and 98).

Back to back arrangements

Example 9

133. Company K is a resident of Australia and is wholly owned by Company J, a resident of the United Kingdom. Company J wishes to lend funds to Company K to assist its Australian operations. Company J decides that, rather than providing funds directly to Company K, it will make an arrangement with a financial institution in the United Kingdom whereby it will provide funds to the financial institution, and the financial institution will then on-lend these funds to Company K. As a result of this loan, Company K pays interest to the financial institution.

134. The interest that the financial institution receives from Company K will not be exempt as the arrangement is considered to be 'back to back' (see paragraphs 31 and 112).

Your comments

135. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

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Detailed contents list

136. Below is a detailed contents list for this draft Taxation Ruling:

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1 September 2004

Previous draft:
Not previously issued as a draft

Related Rulings/Determinations:
TR 92/20; TR 93/27; TR 2001/13; TR 2002/2

Subject references:
- banks
- double taxation agreements
- finance
- financial institutions
- foreign banks
- interest
- non-resident interest withholding tax
- United States
- United Kingdom

Legislative references:
- ITAA 1936 47A(7)
- ITAA 1936 128F
- ITAA 1936 128F(6)
- ITAA 1936 128F(9)
- ITAA 1997 Div 974
- ITAA 1997 974-10(1)
- ITAA 1997 974-10(2)
- ITAA 1997 974-20(1)
- ITAA 1997 974-135
- TAA 1953 Pt IVAAA
- Banking Act 1959 5
- Banking Act 1959 8
- Banking Act 1959 9(3)
- Banking Act 1959 66
- Corporations Act 2001 767A
- Corporations Act 2001 767A(1)
- International Tax Agreements Act 1953 Sch 1
- International Tax Agreements Act 1953 Sch 2
- Building Society Act 1986 (UK)

Case references:
- Commissioner of Superannuation v. Scott (1987) 6 AAR 143; (1987) 12 ALD 38; (1987) 71 ALR 408; (1987) 13 FCR 404
- Commissioner of Taxation v. Comcorp (1996) 21 ACSR 590; (1996) 70 FCR 356
- FC of T v. Australian Mutual Provident Society (1953) 88 CLR 450
- Collis v. FCT 96 ATC 4831, (1996) 33 ATR 438

Other references:
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- Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention
- Explanatory Memorandum to the International Tax Agreements Amendment Bill (No.1) 2002, Chapter 2: Protocol amending the

Convention with the United States of America - Department of the Treasury Technical Explanation of the Protocol between the Government of the United States of America and the Government of Australia signed at Canberra on September 27, 2001, Amending the Convention	between the United States of America and the Government of Australia with respect to taxes on income signed at Sydney on August 6, 1982 - 'Guidelines on Authorisation of ADIs', paragraph 13, www.apra.gov.au

ATO references
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