TR 2005/5EC - Compendium

Australian Government
Australian Taxation Office

Public advice and guidance compendium – TR 2005/5

Relying on this Compendium

This Compendium of comments provides responses to comments received on the Draft Taxation Ruling TR 2005/5DC2 *Income tax: ascertaining the right to tax United 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*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

Summary of issues raised and responses

Issue number	Issue raised	ATO response
1	There should be consistency in the terms adopted in the draft Ruling having regard to other relevant double-tax agreements (DTAs) which reduce interest withholding rather than provide an exemption. For example, the draft Ruling refers to an 'exemption' throughout, whereas certain DTAs (for example, the Australia-Chile and Australia-Israel DTAs[1]) only make available a reduction in interest withholding rates. The relevant DTA provisions are otherwise identical to the United States (US) and United Kingdom (UK) provisions.	Paragraphs 2A and 2B inserted by the Addendum ensure that the Ruling will also apply to DTAs which reduce interest withholding tax rates rather than provide for an exemption. The terms of the protocol to the DTA must be considered in determining whether the DTA includes a financial institution interest withholding tax rates exemption or reduction on identical terms as the US or UK Conventions.[2] To the extent the protocol modifies the DTA article and is different from the US or UK Conventions it is not on identical terms as the US or UK Conventions.

[1] *Convention between Australia and the Republic of Chile for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion* [2013] ATS 7; *Convention between the Government of Australia and the Government of the State of Israel for the Elimination of Double Taxation with respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance* [2019] ATS 20.

[2] *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1983] ATS 16; *United States Protocol (No. 1)* [2003 ATS 14]; *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* [2003] ATS 22.

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2	There is benefit in making reference to the meaning of banking, not only legislatively, but also in case law by making reference to relevant High Court authorities.	The Addendum has updated footnote 10 in paragraph 52 of the Ruling to add in citations to cases that consider the meaning of banking.
3	Paragraph 93 should be clarified to note that an arrangement involving making an upfront payment to another entity for the right to collect receivables from third parties would not constitute the provision of finance where the purchaser has no recourse to the seller for non-payment of the receivables, then that might be useful to clarify.	The Addendum has updated new paragraph 93A of the Ruling to clarify this.
4	The final Addendum should make clear that all types of profits from carrying on a business of providing finance, including fee income such as unused/commitment fees and syndication fees, are included in profits from spread activities for the purposes of the final Addendum. There are aspects of the current Ruling and draft updates which could be taken to suggest the opposite, or which are at least ambiguous on this point. For example, TR 2005/5 currently appears to exclude fees of any type from profits from spread activities, without considering the specific nature of the relevant income (for example, paragraph 103 states a merchant bank that obtains its profits from both fees and from its spread activities). The term 'spread' itself could be taken as suggesting net interest income, to the exclusion of other types of income. While a rationale for excluding underwriting fees is set out in the draft Ruling, there is no consideration of the bases on which other types of fees may be included or excluded. Even in the case of underwriting fees, the logic for exclusion appears to be based on contingencies around actual advancement of funds, which is a very narrow interpretation of the broader concept of carrying on a business of providing finance referred to in the actual DTA provision. Ultimately, the term 'spread activities' is merely shorthand terminology adopted for convenience in the current Ruling, and should not inform the interpretation of the actual DTA wording, which is substantially deriving its profits by raising debt finance in the financial markets or by	As per the changes made to paragraphs 26 and 27 and paragraphs 88 to 94 by the final Addendum, for an enterprise to meet the other enterprises definition the enterprise must substantially derive profits from using the funds in carrying on a business of providing finance. We agree that the business of providing finance is broader than debt finance and may generate income that is not interest. The term 'spread activities' introduced in paragraph 15 of the Ruling is used as a descriptive shorthand for the activities required by the other enterprises test and does not require net interest income. Whether income that is not interest such as fee income is profits from using funds in carrying on a business of providing finance (or spread activities), is a question of fact and degree. The circumstances under which enterprises derive fee income are varied. The fee income may be for advice or other services that do not involve the supply of funds or assets to a recipient. Whether the fee income is for the supply of funds or assets to the recipient will depend on the facts and circumstances. Paragraph 92A introduced by the final Addendum provides that financial advisory services or activities that do not involve the supply of funds or assets to a recipient are not the provision of finance. However, it is not practicable to provide useful guidance beyond this as it will depend on the facts and circumstances. Taxpayers can seek certainty on their specific circumstances by obtaining a private ruling.

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	taking deposits at interest and using those funds in carrying on a business of providing finance. In practice, enterprises that carry on a business of providing finance derive profits from those activities which include not only interest but various types of fees, such as unused/commitment fees and syndication fees. All such profits should be taken into account in applying the DTA wording, in the same way as net interest income. The label 'spread activity' adopted by the ATO as shorthand to describe the relevant activities should be clearly acknowledged as such, with the considerations taken into account in applying the DTA test based on the actual terminology used in that test. The concept of carrying on a business of providing finance is a broad concept and should not be construed narrowly. In practice, income such as unused/commitment fees and syndication fees are derived from activities which are an integral part of the relevant bank or other financial institutions business of providing finance, and directly connected with the activities comprising of the providing of finance (including, in the case of unused/commitment fees, ensuring that sufficient capital reserves are available to fulfil requests for funding under the relevant facility agreement).	
5	The draft Ruling interprets the term 'substantially' as requiring that spread activities constitute the enterprise's main activity. Although noting that this is not a bright-line test, the draft Ruling goes on to state that where spread activities are the source of 50% or more of overall accounting profits, this is a strong indicator that an enterprise substantially derives its profits from spread activities (see paragraph 100B of the draft Ruling). In this way, the draft Ruling effectively interprets 'substantially' as requiring that spread activities represent the dominant activity of the enterprise. The cases cited in support of this at paragraphs 97 and 98 of the draft Ruling are not directly on point, and while they may provide some support for interpreting the term in a relative sense (rather than merely an absolute sense), the draft Ruling does not explain the rationale for its conclusion that the term should be read as 'main' (in the sense of dominant), having regard to the context of the DTA	We maintain the view that the meaning of 'substantially' is different to what may be considered 'substantial' (see paragraph 98 of the Ruling). The interpretation of 'substantially', as adopted in the Ruling, requires the profits from the 'spread activities', when compared with the profits from all other activities, to be the main contributor to the overall profits of the enterprise. We do not agree that the interpretation requires the spread activities to be the dominant activity of the enterprise and consider it to be the correct interpretation based on an ordinary meaning of the text, considered together with the context, object and purpose of the treaty. The purpose of the Addendum, in expanding the explanation, is to make it clear that 'substantially deriving its profits' means that the 'spread activities', must be the main contributor to the profits of the enterprise when compared with all other activities and removes any

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	provision. There is nothing in the DTA provision or the Explanatory Memorandums accompanying introduction of the relevant DTAs into domestic law, that requires such a conclusion. The interpretation of 'substantially adopted' in the current version of the Ruling is open on the wording of the DTA provision; that is, the main activity compared to each of the other activities, rather than the main activity compared to all the other activities combined. The former interpretation is consistent with the interpretation of the principal purpose tests in section 832-725(h) of the *Income Tax Assessment Act 1997*, sections 177J and 177DA of the *Income Tax Assessment Act 1936* and certain DTA provisions modified by the Multilateral Instrument.[3]	doubt that may have previously existed that this is the case.
6	We agree with the position expressed in the draft Ruling that the term 'substantially deriving profits' should not be a bright-line test, and the DTA test should be applied on a case-by-case basis. The strong indicator threshold referred to in the draft Ruling should also be helpful in providing certainty for taxpayers. While the proposed guidance included in paragraph 103 of the draft Ruling suggests a range of factors can be taken into account, the final Addendum should provide more detail and a practical methodology which taxpayers can apply in situations where the relevant strong indicator threshold is not met, in a particular year or over a longer reference period. This should include additional guidance and examples of the acceptable methods taxpayers can apply to determine if accounting profits are substantially derived from spread activities over a reasonable period. Currently, Examples 4 and 4A of the draft Ruling provide for a testing period of more than one year (that is, 3 and 5 years), but do not go	The final Addendum updates the Ruling to outline the principles and factors for determining whether the other enterprise is substantially deriving its profits from 'spread activities'. Whether the other enterprise is substantially deriving its profits from 'spread activities' is a matter of fact and degree and will depend on the particular facts and circumstances. As a result, each situation needs to be assessed on a case-by-case basis on its facts and circumstances. The business and individual circumstances of enterprises carrying on a business of providing finance are diverse. Differences in the types of financial services and products provided, variations in operating circumstances between enterprises and that these change over time, mean that it is not practicable to provide useful guidance that will remain relevant. Taxpayers can seek certainty on their specific circumstances by obtaining a private ruling.

[3] *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* [2019] ATS 1.

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	into detail with respect to the required steps in performing the calculation. For example, as stated in Example 4, if Company P's profit from its spread activities constitute less than half of its overall profits in a particular year, then it is necessary to carefully consider its situation on a case-by-case basis to examine whether it satisfies the test. As noted, paragraph 103 of the draft Ruling does not provide adequate guidance in this respect.	