

TR 2005/D18 - Income tax: interest withholding tax - cross-border interbranch funds transfers within resident authorised deposit-taking institutions



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This document has been finalised by TR 2006/9.



Draft Taxation Ruling

Income tax: interest withholding tax – cross-border interbranch funds transfers within resident authorised deposit-taking institutions

Contents	Para
What this Ruling is about	1
Date of effect	6
Ruling	7
Explanation	15
Example	35
Your comments	41
Detailed contents list	42

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 deals with the application of the interest withholding tax provisions in Division 11A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) to interest paid to non-residents by resident authorised deposit-taking institutions (ADIs).
2. This Ruling applies to non-residents that are paid interest by an ADI that is an Australian resident with off-shore permanent establishments (PE) for taxation purposes.
3. For the purposes of this Ruling:
 - an ADI is a body corporate that has been granted a banking licence to operate a banking business in Australia under the *Banking Act 1959*; and
 - an offshore PE is a PE of the ADI in a country outside Australia at or through which the ADI carries on business.
4. This Ruling does not discuss whether there is a PE in existence.¹ Generally, a PE is a fixed place of business through which business is wholly or partly carried on.
5. This Ruling does not affect the application of any interest withholding tax exemption available to the non-resident where the non-resident satisfies the requirements for exemption.²

¹ See Taxation Ruling TR 2002/5.

² For example, an exemption from interest withholding tax may be available to the non-resident under a provision such as section 128F of the ITAA 1936 or pursuant to an international tax treaty.

TR 2005/D18

Date of effect

6. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. 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

7. A non-resident is liable to interest withholding tax under subsection 128B(5) of the ITAA 1936 where interest is paid to it by an ADI and the interest is not incurred by the ADI in carrying on business in a country outside Australia at or through an offshore PE.

8. A liability for interest withholding tax does not arise for a non-resident under subsection 128B(5) for interest paid to it by an ADI where the interest is wholly incurred by the ADI in carrying on business in a country outside Australia at or through its offshore PE in that country. Subparagraph 128B(2)(b)(i) provides that the interest derived by the non-resident is not income to which section 128B applies.

9. Where the ADI, through its head office, borrows funds from a non-resident and uses the funds in carrying on business in a country outside Australia at or through its offshore PE, the interest outgoing associated with those funds is attributable to the PE. An interest withholding tax liability does not arise under subsection 128B(5).

10. Where funds are borrowed from a non-resident by the ADI through its offshore PE and are used in the ADI's Australian head office operations, the interest outgoing associated with those funds is attributable to the head office. Subsection 128B(2) provides that section 128B applies to the interest and subsection 128B(5) imposes an interest withholding tax liability on the non-resident.

11. To the extent that borrowed funds are only used in part by the ADI in carrying on business in a country outside Australia at or through its offshore PE for the purpose of deriving income, the associated interest outgoing is apportioned. Subsection 128B(6) provides that interest withholding tax is payable under subsection 128B(5) only on that portion of the interest not attributable, or not reasonably attributable, to the PE under subsection 128B(8).

12. When the purpose or use of the borrowings changes within the ADI, the extent (if any) that the associated interest outgoing is attributable to the ADI's offshore PE must be determined. A change in the amount of interest outgoing attributable to the offshore PE has a corresponding effect on the interest withholding tax liability of the non-resident for section 128B purposes.

13. Where it is not possible to trace the end use of borrowings to attribute the associated interest outgoing due to the borrowings being placed in a pool of funds, the interest outgoing is, subject to paragraph 31, attributable to that part of the ADI (that is, offshore PE or Australian head office) through which the funds were borrowed. Where the interest outgoing is attributable to the offshore PE of the ADI, the non-resident is not liable for interest withholding tax under subsection 128B(5). Where the interest is attributable to the ADI's Australian head office, an interest withholding tax liability arises under subsection 128B(5).

14. To the extent that a non-resident has an interest withholding tax liability on an amount of interest under section 128B of the ITAA 1936, the interest is non-assessable non-exempt income as defined in section 6-23 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Explanation

General liability to interest withholding tax

15. Under Division 11A of the ITAA 1936, a non-resident is liable to interest withholding tax on certain interest income that it derives. Pursuant to subsection 128B(5) of the ITAA 1936, interest withholding tax is payable on interest income to which section 128B applies.

16. Subsection 128A(2) provides that interest is paid when it is reinvested, accumulated, capitalized, carried to any reserve, sinking fund or insurance fund or otherwise dealt with on behalf of, or at the direction of, the non-resident.

Interest to which section 128B of the ITAA 1936 applies

17. Interest is defined for withholding tax purposes in subsection 128A(1AB). It includes amounts in the nature of interest, amounts paid in substitution for interest, amounts received in exchange for interest in connection with a washing arrangement and dividends paid in respect of non-equity shares. Interest does not include an amount to the extent to which it is a return on an equity interest in a company.

TR 2005/D18

18. Subparagraph 128B(2)(b)(i) provides that section 128B applies to interest income derived by a non-resident and paid by a resident that does not wholly incur the interest in carrying on a business in a country outside Australia at or through an offshore PE. Thus, section 128B does not apply to an amount of interest paid to a non-resident where the interest outgoing is wholly incurred by the ADI in carrying on business in a country outside Australia at or through the ADI's offshore PE in that country.

19. Subsection 128B(8) provides that interest is only an outgoing incurred in carrying on business in a country outside Australia at or through a PE in that country to the extent the interest is incurred in gaining or producing, or is reasonably attributable to, income that is or may be derived in carrying on business at or through the PE in that country. To the extent that the interest does not meet these requirements, subsection 128B(6) provides that it is subject to interest withholding tax under subsection 128B(5).

Interest outgoing not incurred in carrying on business at or through an offshore PE – subsection 128B(8) of the ITAA 1936

20. Subsection 128B(8) sets out when interest paid to a person by another person is not an interest outgoing incurred, by that other person, in carrying on business in a country outside Australia at or through a PE in that country. Like subsections 128B(2) and (6), it refers to an interest outgoing being 'incurred'. Broadly, an interest outgoing is incurred if there is a presently existing obligation to pay the interest.³ Interest need not be paid to be incurred, however paragraph 128B(8)(a) makes it clear that the subsection only applies to interest that has been paid⁴, in which case, it is clear that the amount has been incurred by the resident ADI. Therefore, for subsection 128B(8) purposes, the issue is not whether the interest has been incurred, but whether there is a sufficient nexus between the interest outgoing and income that is, or may be, derived by the ADI otherwise than in carrying on business in a country outside Australia at or through its offshore PE in that country.

21. An interest outgoing is incurred by the ADI for the purpose of gaining and producing income of the offshore PE to the extent the funds borrowed by the ADI from the non-resident are used in the operations of the offshore PE to produce that income. This is a question of fact to be determined according to the circumstances of the ADI.

³ *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at 627; 81 ATC 4031 at 4037; (1981) 11 ATR 505 at 514, *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506-7, *New Zealand Flax Investments v. FC of T* (1938) 61 CLR 179, Taxation Ruling TR 94/26 and Taxation Ruling TR 97/7.

⁴ Paragraph 16 discusses when interest is paid.

Whether interest is 'reasonably attributable' to income derived by the offshore PE – paragraph 128B(8)(b)(ii)

22. In determining the interest that is reasonably attributable to a PE under paragraph 128B(8)(b)(ii), regard should be had to the principles set out in Taxation Ruling TR 2001/11. Broadly, 'to the extent that funds borrowed by an entity are used in connection with the business carried on through its PE, the interest expense incurred by the entity on those borrowings is attributable to the PE.'⁵

Tracing of funds within the ADI

23. It is necessary to use a tracing approach to determine the attribution of the interest outgoing to an offshore PE. The tracing approach seeks to trace the funds used by a PE in carrying on its business with the original provision of funds by a third party. The associated interest outgoing may then be attributed accordingly.

24. The starting point for determining the use of the borrowed funds is to trace the funds to their end use. A rigid tracing of the borrowings is not always possible. Where tracing is not possible, borrowed funds are attributable to the ADI carrying on business at or through its offshore PE to the extent that the funds were originally borrowed for that purpose and that purpose can still be seen at the time the interest is paid to the non-resident.

25. Where the ADI borrows funds through its head office from a non-resident and uses those funds in carrying on business at or through its offshore PE, the interest outgoing associated with those funds is attributable to the PE. In these circumstances the non-resident does not have a liability for interest withholding tax.

26. Conversely, where the ADI borrows funds from a non-resident through its offshore PE and its Australian head office uses those funds, the interest outgoing is attributable to the head office, not the PE. In these circumstances, the non-resident has an interest withholding tax liability.

27. As an ADI is a single legal entity, no interest withholding tax liability arises in respect of the interest expense associated with the internal transfer of funds from the PE to the head office. This is because an entity cannot in a legal sense, lend to itself.⁶ Therefore, amounts representing interest on funds transferred internally are notional only and are not interest under subsection 128A(1AB) of the ITAA 1936 and do not create a liability for interest withholding tax.

⁵ Taxation Ruling TR 2001/11 paragraph 3.42.

⁶ *Max Factor and Co. v. FC of T* 84 ATC 4060; (1984) 15 ATR 231. In the case of foreign banks with branches in Australia, Part IIIB of the ITAA 1936 can lead to a withholding tax liability on interbranch interest because of the special deeming in Part IIIB.

TR 2005/D18

28. To the extent that interest income derived by a non-resident is an outgoing partly incurred by the ADI in carrying on a business in a country outside Australia at or through the ADI's offshore PE in that country, subsection 128B(5) of the ITAA 1936 does not apply to the part of the interest attributable to the PE, but does apply to the part of the interest that is not attributable to the PE.⁷

29. Where the purpose or the use to which the borrowings are put changes, the associated interest outgoing may no longer be attributable to the offshore PE in carrying on its business. For example this may occur if the PE ceases to carry on a business for the purpose of gaining or producing income. The non-resident is liable to interest withholding tax to the extent that the associated interest outgoing:

- is no longer attributable to the PE carrying on its business; and
- is not attributable to another offshore PE,

even if an interest withholding tax liability did not exist previously.

Pool of funds

30. The nature of the business of banks means that it is not ordinarily practicable or possible to trace either the source or end use of funds transferred between branches such that the entity's actual third party interest outgoing associated with those funds can be attributed between branches.⁸ This is because, generally, third party borrowings are placed into a pool of funds that is used to support the bank as a whole.

31. However, where a bank raises third party borrowings through its offshore PE and:

- the funds are raised for the purpose of funding the Australian head office;
- the funds raised by the offshore PE approximate the value to funds provided to the Australian head office; or
- funds provided to the Australian head office by the PE are from sources other than the PE's pool of funds,

the borrowings can be traced to their end use and the associated interest expense is not attributable to the PE. In these circumstances, an interest withholding tax liability arises for the non-resident.

⁷ Subsection 128B(6) of the ITAA 1936.

⁸ Taxation Ruling TR 2005/11 paragraph 18.

32. Similarly, to the extent that the use of non-resident third party funds borrowed by the ADI through its head office can be traced to PEs of the ADI, the associated interest outgoing is not attributable to the head office. The non-resident is not liable to interest withholding tax on interest the non-resident derives to the extent the corresponding interest outgoing of the ADI is attributable to the ADI's offshore PE.

33. As discussed in paragraph 27, an interest withholding tax liability does not arise in respect of notional interest charges on internal funds transfers. This includes, the Australian head office 'transferring' funds to a PE in respect of interest owing on the head office's nostro account⁹ and interest attributed by the head office to a vostro account of a PE where it is in credit.

Non-assessable non-exempt income

34. Generally, interest income derived by a non-resident that is subject to withholding tax is excluded from assessable income under section 128D.¹⁰ Interest income derived by a non-resident on or after 30 June 2003 that is subject to withholding tax is non-assessable non-exempt income of the non-resident. Non-assessable non-exempt income is defined at section 6-23 of the ITAA 1997. It includes an amount of ordinary or statutory income if a provision of the ITAA 1997 or of another Commonwealth law, states that it is not assessable income and is not exempt income.¹¹

Example

Tracing of funds

35. Aus Bank, an ADI incorporated in Australia, carries on banking business through a PE in the UK.

36. On the 1 June 2005, Aus Bank borrows \$1million through its PE from Foreign Lender at a rate of 6.5% payable monthly in advance for a term of 5 years. The following day, the PE transfers the funds to the head office on the same terms for internal accounting purposes. The head office uses the funds in its Australian activities.

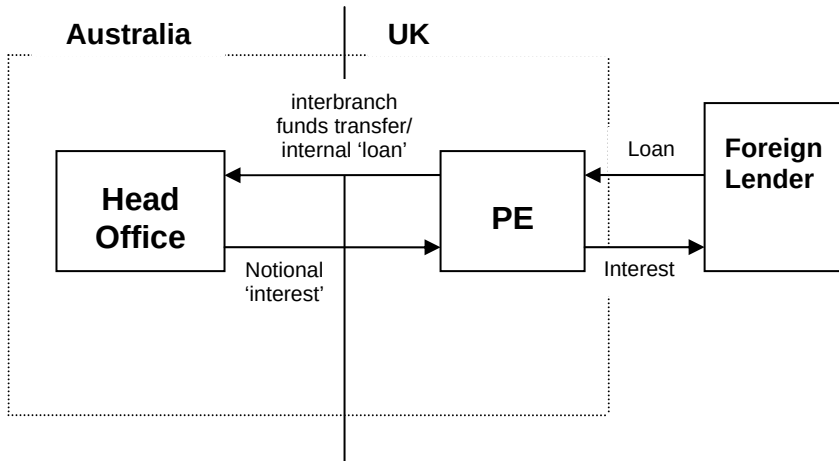
⁹ Subsection 128A(1) of the ITAA 1936 defines a nostro account for the purposes of Division 11A.

¹⁰ In some unusual cases, it is possible that interest withholding tax will not apply. In such cases, section 128D will not apply but as the income is sourced in Australia, tax by way of ordinary assessment would arise (subject to any applicable international tax treaty).

¹¹ Section 11-55 in Subdivision 11-B of Part 1-4 of the ITAA 1997 specifically includes interest income falling within section 128D of the ITAA 1936 in the list of non-assessable non-exempt items.

TR 2005/D18

37. The transfer of funds is illustrated on the following diagram.



Interbranch funds transfer – internal ‘loan’

38. As Aus Bank is a single legal entity, no interest withholding tax is payable in respect of notional interest amounts paid by the head office to the PE in relation to the interbranch funds transfer (that is, the internal ‘loan’) (see paragraph 27).

Foreign loan

39. The use of the funds advanced by Foreign Lender can be traced to its use by the head office of Aus Bank. Therefore, the interest paid by Aus Bank to Foreign Lender is attributable to Aus Bank’s head office and is not incurred in carrying on business through Aus Bank’s offshore PE. Consequently, an interest withholding tax liability arises for Foreign Lender under section 128B of the ITAA 1936 in respect of the funds advanced to Aus Bank.

40. The interest derived by Foreign Lender is non-assessable non-exempt income under section 128D. Even if Foreign Lender is required to lodge Australian income tax returns for the income years in which it derives interest income from Aus Bank, Foreign Lender does not include its non-assessable non-exempt income in assessable income.

Your comments

41. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 17 February 2006

Contact officer: Naomi Lindoy

E-mail address: Naomi.Lindoy@ato.gov.au

Telephone: (07) 4753 7129

Facsimile: (07) 4753 7275

Address: International Strategy & Operations
Australian Taxation Office
PO Box 9990
TOWNSVILLE QLD 4810

Detailed contents list

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

	Paragraph
What this Ruling is about	1
Class of Persons/Arrangement	1
Date of effect	6
Ruling	7
Explanation	15
General liability to interest withholding tax	15
Interest to which section 128B of the ITAA 1936 applies	17
<i>Interest outgoing not incurred in carrying on business at or through an offshore PE – subsection 128B(8) of the ITAA 1936</i>	20
<i>Whether interest is 'reasonably attributable' to income derived by the offshore PE – paragraph 128B(8)(b)(ii)</i>	22
<i>Tracing of funds within the ADI</i>	23
<i>Pool of funds</i>	30
Non-assessable non-exempt income	34

TR 2005/D18

Example	35
Tracing of funds	35
<i>Interbranch funds transfer – internal ‘loan’</i>	38
<i>Foreign loan</i>	39
Your comments	41
Detailed contents list	42

Commissioner of Taxation

21 December 2005

<i>Previous draft:</i>	- ITAA 1936 128B
Not previously issued as a draft	- ITAA 1936 128B(2)
	- ITAA 1936 128B(2)(b)(i)
<i>Related Rulings/Determinations:</i>	- ITAA 1936 128B(5)
TR 92/20; TR 94/26; TR 97/7;	- ITAA 1936 128B(6)
TR 2001/11; TR 2002/5;	- ITAA 1936 128B(8)
TR 2005/11	- ITAA 1936 128B(8)(a)
	- ITAA 1936 128B(8)(b)(ii)
<i>Subject references:</i>	- ITAA 1936 128D
- foreign branches of Australian companies	- ITAA 1936 128F
- international tax	- ITAA 1936 Pt IIIB
- non-resident interest withholding tax	- Banking Act 1959
- withholding taxes	
<i>Legislative references:</i>	<i>Case references:</i>
- TAA 1953 Pt IVA	- FC of T v. James Flood Pty Ltd (1953) 88 CLR 492
- ITAA 1997 6-23	- Max Factor and Co. v. FC of T 84 ATC 4060; (1984) 15 ATR 231
- ITAA 1997 Subdiv 11-B	- New Zealand Flax Investments v. FC of T (1938) 61 CLR 179
- ITAA 1997 11-55	- Nilsen Development Laboratories Pty Ltd & Ors v. FC of T (1981) 144 CLR 616; 81 ATC 4031; (1981) 11 ATR 505
- ITAA 1936 Pt III Div 11A	
- ITAA 1936 128A(1)	
- ITAA 1936 128A(1AB)	
- ITAA 1936 128A(2)	

ATO references

NO: 2005/10938
 ISSN: 1039-0731
 ATOLaw topic: Income Tax ~~ Withholding Tax ~~ dividends, interest and royalties
 Income Tax ~~ Withholding Tax ~~ international