


TD 2008/D15 - Income tax: (a) are credits for United Kingdom interest withholding tax paid allowable under Article 22.1(a) of the 2003 United Kingdom Convention to an Australian resident financial institution which enters into an arrangement of the kind described in Taxpayer Alert TA 2007/3; and (b) would the Commissioner consider the application of Part IVA of the Income Tax Assessment Act 1936 to the arrangement?

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Draft Taxation Determination

Income tax:

- (a) are credits for United Kingdom interest withholding tax paid allowable under Article 22.1(a) of the 2003 United Kingdom Convention to an Australian resident financial institution which enters into an arrangement of the kind described in Taxpayer Alert TA 2007/3; and
- (b) would the Commissioner consider the application of Part IVA of the *Income Tax Assessment Act 1936* to the arrangement?

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Ruling

1. (a) No. Credits for the United Kingdom interest withholding tax (UK IWT) paid in connection with such an arrangement are not allowable under Article 22.1(a) of the 2003 United Kingdom Convention (UK Convention)¹ to an Australian resident financial institution which enters into such an arrangement because the UK IWT paid is not paid 'in accordance with this Convention' within the meaning of Article 22.1(a).

¹ This tax treaty, as set out in Schedule 1 of the *International Tax Agreements Act 1953* (the Agreement Act), is an agreement that is given the force of law in Australia by section 5 of that Act.

(b) Yes. The Commissioner would consider the application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) to the arrangement if the financial institution is entitled to a foreign tax credit or foreign income tax offset under Division 18 of Part III of the ITAA 1936 or Division 770 of the *Income Tax Assessment Act 1997* (ITAA 1997) respectively. Part IVA of the ITAA 1936 may apply to such an arrangement if it is reasonable to conclude under section 177D of the ITAA 1936, based upon the facts of a particular arrangement, that there was a scheme entered into for the sole or dominant purpose of obtaining a tax benefit of the kind specified in paragraph 177C(1)(bb) of the ITAA 1936 (the tax benefit being the foreign tax credit or foreign income tax offset). If it does apply, the Commissioner may determine that the foreign tax credits or foreign income tax offsets are not allowable to the taxpayer.

2. Taxpayer Alert TA 2007/3 (the Alert) describes an arrangement where an Australian resident taxpayer seeks to enhance its return on a bond investment by way of claiming foreign tax credits² or foreign income tax offsets,³ as the case may be, for withholding tax claimed to be payable under the arrangement. The effect of the entire arrangement is that neither the bond issuer's group, nor the participating Australian resident taxpayer, bears the economic cost of the tax withheld.

3. Arrangements of the kind described in the Alert are marketed to financial institutions and exhibit some or all of the following elements:

- An Australian resident company (the taxpayer) establishes a wholly owned limited liability company (LLC) in an offshore jurisdiction (other than the UK).
- The LLC is treated on a flow-through basis for the purposes of tax in the foreign jurisdiction and is a foreign hybrid company for Australian tax purposes pursuant to Division 830 of the ITAA 1997.
- The LLC acquires bonds (or similar securities or financial instruments) issued by a financial institution resident in the United Kingdom (UK) (the UK Issuer).
- The bonds or similar securities or financial instruments are offered on the basis that they produce an enhanced return compared to those of a similar grade of issue. For example, the taxpayer is offered the bonds or similar securities or financial instruments on the basis that they produce a return of 5.5% per annum notwithstanding that the interest paid by the UK Issuer is at the London Inter-Bank Offered Rate (LIBOR) rate of 4.4% per annum.
- The payment of interest on the bonds or similar securities or financial instruments is claimed by the UK Issuer to attract UK withholding tax at the rate applicable for the LLC (on the assumption a tax treaty does not apply to reduce or eliminate the withholding tax payable).
- The bonds or similar securities or financial instruments are transferred between members of the UK Issuer's group under a securities lending arrangement immediately before the LLC acquires them. As a result, a member of the Issuer's group claims a tax credit in the UK for a 'reverse charge' tax that is deemed to arise under the securities lending arrangement (even though no 'reverse charge' tax is actually payable).

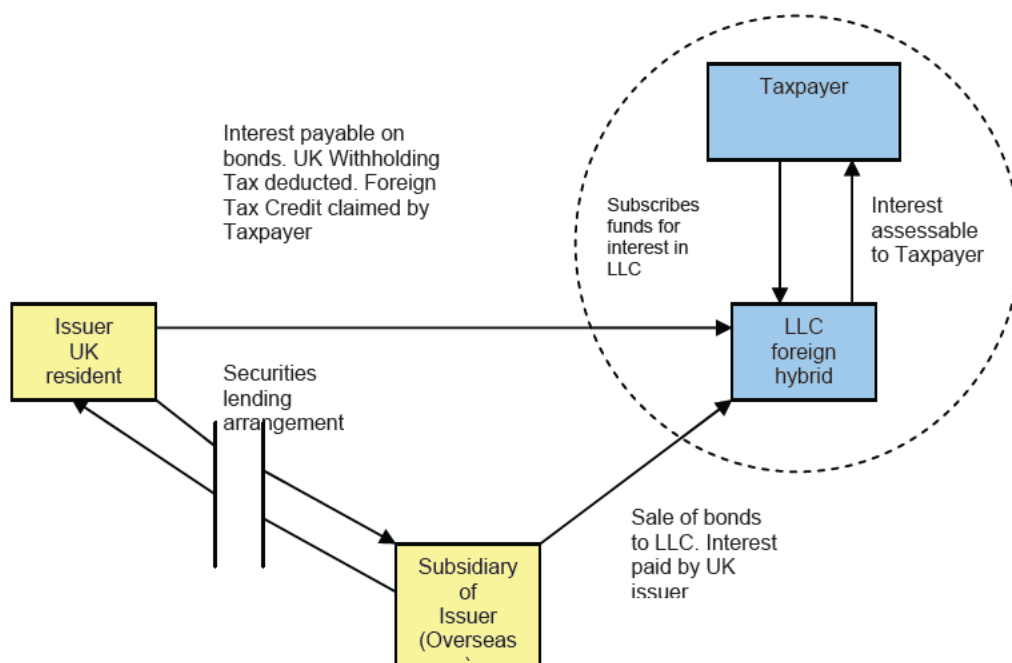
² Division 18 of Part III of the ITAA 1936 regarding foreign tax credits continues to deal with applicable matters before the repeal of the Division as from, generally, 1 July 2008 (see Part 6 of Schedule 1 to the *Taxation Laws Amendment (2007 Measures No. 4) Act 2007*).

³ See Division 770 of the ITAA 1997 dealing with foreign income tax offsets applicable to income years and statutory or notional accounting periods commencing on or after 1 July 2008.

That UK credit (claimed by the member of the UK Issuer's group) is equal to the amount of the UK withholding tax liable to be paid under UK tax law.

- A foreign tax credit or foreign income tax offset is claimed by the taxpayer for the amount of UK withholding tax paid.
- The amount of the foreign tax credit or the foreign income tax offset claimed by the taxpayer exceeds the Australian income tax payable on the net interest income derived under the arrangement. The amount of the excess is then claimed to reduce Australian tax payable on other foreign source income of the taxpayer.

Diagram



Date of effect

4. It is proposed that when the final Determination is issued, it will apply both before and after its date of issue. However, the Determination 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 Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

Application of the UK Convention to the taxpayer and to the interest

5. The LLC referred to in the arrangement outlined in paragraph 3 is treated as if it were a partnership for Australian income tax purposes⁴ because it satisfies the requirements under section 830-15 of the ITAA 1997.

6. The LLC is not a resident of Australia or the United Kingdom for the purposes of Article 4.1 of the UK Convention and is therefore not entitled to the benefits of the UK Convention.

7. The taxpayer is an Australian resident company. Therefore, the taxpayer is:

- a 'person' within the definition of that term in Article 3.1(f) of the UK Convention; and
- a 'resident of Australia' for the purposes of the UK Convention pursuant to Article 4.1(b) of the UK Convention.

As a result, the taxpayer is a person to whom the UK Convention applies for the purposes of Article 1 of the UK Convention.

8. As the taxpayer is the sole shareholder of the offshore LLC, the taxpayer:

- is treated as the partner in the partnership (referred to at paragraph 5 of this draft Determination) pursuant to section 830-25 of the ITAA 1997; and
- is treated as having an individual interest in all the distributions of the net income of the partnership pursuant to section 830-30 of the ITAA 1997.

9. Article 11.3(b) of the UK Convention provides:

Notwithstanding paragraph 2, 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:

- (a) ...
- (b) the interest is derived by a financial institution which is unrelated to and dealing wholly independently with the payer.⁵

10. Taxation Ruling TR 2001/13 Income tax: interpreting Australia's Double Tax Agreements sets out the Commissioner's approach to:

- the use of the Commentary to the OECD Model Tax Convention on Income and on Capital (OECD Model);⁶ and
- the interpretation of undefined terms in a treaty.⁷

⁴ See section 830-20 of the ITAA 1997 and the definition of 'foreign hybrid tax provisions' in subsection 995-1(1) of the ITAA 1997.

⁵ Article 11.3(b) is also subject to the application of other paragraphs of Article 11 of the UK Convention.

⁶ Paragraphs 101 to 108 of TR 2001/13.

⁷ Paragraphs 63 to 76 of TR 2001/13.

11. The Commissioner's approach in TR 2001/13 and the Commentary to the OECD Model are relevant in:

- determining whether the taxpayer is entitled to the benefits of the UK Convention; and
- interpreting Article 11.3(b) and Article 22.1(a) of the UK Convention.

12. Paragraph 6.3 of the Commentary on Article 1 of the OECD Model⁸ refers to the principle:

... that the State of source should take into account, as part of the factual context in which the treaty is to be applied, the way in which an item of income, arising in its jurisdiction is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. ...

13. In applying the UK Convention in accordance with this principle, the United Kingdom should recognise that Australia's flow-through tax treatment of the LLC under Division 830 of the ITAA 1997 operates. The relevant part of the income derived by the LLC is included in the assessable income of the taxpayer.

14. Accordingly, the Commissioner considers that:

- the taxpayer would be in the position to claim the benefit of the UK Convention in respect of the UK IWT payable on its UK sourced interest income;
- the interest income on the bonds or similar securities or financial instruments may be treated as satisfying the requirements of Article 11.3(b) of the UK Convention where the taxpayer is a 'financial institution' for the purposes of the Convention; and
- subject to the taxpayer meeting the other relevant requirements of Article 11, the United Kingdom should recognise that it cannot, by reason of Article 11.3(b) of the UK Convention, impose withholding tax on the interest on the bonds or similar securities or financial instruments.

The application of the Elimination of Double Taxation Article to the UK IWT.

15. Article 22.1(a) of the UK Convention provides:

Subject to the provisions of the laws of Australia from time to time in force which relate to the allowance of a credit against Australian tax of tax paid in a country outside Australia (which shall not affect the general principle of this Article):

- (a) United Kingdom tax paid under the laws of the United Kingdom and in accordance with this Convention, whether directly or by deduction, in respect of income or gains derived by a person who is a resident of Australia from sources in the United Kingdom shall be allowed as a credit against Australian tax payable in respect of that income; ...

16. The United Kingdom does not have any taxing rights over the interest under the UK Convention where Article 11.3(b) of the UK Convention applies to the interest on the bonds or similar securities or financial instruments. In such a case, any UK IWT paid is not United Kingdom tax paid 'in accordance with this Convention' for the purposes of Article 22.1(a) of the UK Convention.

⁸ OECD Committee on Fiscal Affairs, Model Income Tax Convention on Income and on Capital, Condensed version, 17 July 2008, 46.

17. Accordingly, Australia would have no obligation under Article 22.1(a) of the UK Convention to provide credit to the taxpayer against Australian tax payable for the UK IWT paid.

Foreign income tax

18. As a consequence of any UK IWT not being paid in accordance with the UK Convention, there is an impact under the foreign income tax offsets provisions in Division 770 of the ITAA 1997. Relevantly, foreign income tax means tax that is imposed by a law other than an Australian law⁹ and is tax on income (paragraph 770-15(1)(a) and subparagraph 770-15(1)(b)(i) of the ITAA 1997 respectively).¹⁰

19. The Commissioner considers that it is implicit in the term ‘imposed by a law other than an Australian law’ that the tax is imposed in accordance with the laws of the foreign jurisdiction. The laws of the foreign jurisdiction extend to taking into account obligations arising from tax treaties. Where tax has been paid in a foreign jurisdiction but that tax is not paid ‘in accordance with this Convention’ for the purposes of Article 22.1(a) of the UK Convention, the tax paid has not been correctly ‘imposed by a law’ of the foreign jurisdiction and, therefore, is not ‘foreign income tax’ for the purposes of subsection 770-15(1) of the ITAA 1997.

20. This position is consistent with paragraph 1.87 of the Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007 which states that such a law ‘... must be validly made by or under an authority recognisable by the Commonwealth ...’.

Part IVA

21. The application of Part IVA of the ITAA 1936 to a scheme depends on a careful weighing of all eight matters specified in section 177D of the ITAA 1936.¹¹ Therefore, in the absence of all relevant information, it is not possible to state definitively whether a particular scheme will attract Part IVA of the ITAA 1936.¹²

22. The Commissioner considers that the whole or some part of the arrangement described in paragraphs 2 and 3 of this draft Determination constitutes a scheme under section 177A of the ITAA 1936. This scheme would be expected to give rise to a tax benefit of the kind specified in paragraph 177C(1)(bb) of the ITAA 1936 if the taxpayer was entitled to foreign tax credits or foreign income tax offsets for the UK IWT claimed to be payable under the arrangement. This is because, but for the scheme, the taxpayer would or might reasonably have been expected:

- to have acquired the bonds or similar securities or financial instruments directly from the UK Issuer; or
- made no bond investment at all.

⁹ As defined in subsection 995-1(1) of the ITAA 1997 to include a Commonwealth, State or a Territory law.

¹⁰ In the context of these arrangements, there is no relevant difference between the meaning of ‘foreign income tax’ under Division 770 of the ITAA 1997 and ‘foreign tax’ in subsection 6AB(2) of the ITAA 1936 for the purposes of the former foreign tax credit provisions in Division 18 of Part III of the ITAA 1936.

¹¹ Refer to Practice Statement PS LA 2005/24 in relation to how the Commissioner applies Part IVA of the ITAA 1936 and other general anti-avoidance provisions.

¹² There have been a number of decisions of the High Court and Federal Court concerning the operation of Part IVA of the ITAA 1936. A useful summation of the principles emerging from these decisions can be found in the judgement of Hill J in *Commissioner of Taxation v. Sleight* (2004) 136 FCR 211; 2004 ATC 4477; (2004) 55 ATR 555.

In such instances, the result would have been that the taxpayer would not have been entitled to the foreign tax credits or foreign income tax offsets.

23. It is likely that the Commissioner would consider it reasonable to conclude, having regard to the eight matters set out in section 177D of the ITAA 1936, that the sole or dominant purpose of the taxpayer or another person in entering into or carrying out the scheme was for the taxpayer to obtain the tax benefit.¹³ In this context, the following general observations can be made:

- the manner in which the scheme was entered into and carried out exhibits some degree of contrivance, including the use of the interposed LLC to seek to ensure that UK withholding tax is paid (without obtaining the exemption under the UK Convention);
- the form of the scheme involves a bond investment with an enhanced return paid by the Issuer. The LLC is legally liable to pay the withholding tax on the return. However, the substance of the scheme is that the UK Issuer's group does not bear the cost of the withholding tax the Issuer withholds on interest payments to the LLC since the effect of the reverse charge credit is to 'refund' to another member of the UK Issuer group the amount remitted to the UK Revenue. In substance, neither the UK bond Issuer's group nor the taxpayer bear the economic cost of the tax for which the Australian taxpayer claims the foreign tax credits or the foreign income tax offsets; and
- Furthermore, whereas the taxpayer is obtaining a return of 5.5% on its investment (after including the value of the tax benefit obtained by the taxpayer by claiming an Australian foreign tax credit or foreign income tax offset), in substance the return paid by the UK Issuer is at the London Inter-Bank Offered Rate (LIBOR) rate of 4.4%.

24. It would therefore be expected that the Commissioner would be in a position to exercise his power under section 177F of the ITAA 1936 to cancel the tax benefit obtained under the scheme and disallow any foreign income tax offsets (or foreign tax credits) to which the taxpayer may be entitled under the arrangement.

¹³ The question posed by section 177D of the ITAA 1936 concerning purpose is one that is objectively determined and does not depend on why the taxpayer or any of its agents acted as they did (see *Federal Commissioner of Taxation v. Hart* (2004) 217 CLR 216; 2004 ATC 4599; (2004) 55 ATR 712).

Appendix 2 – Your comments

25. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

26. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2001/13; TR 2006/10

Subject references:

- double tax agreements
- double tax relief
- foreign income
- foreign income tax offsets
- foreign tax credits
- interest income
- international tax
- schemes & shams
- tax benefits under tax avoidance schemes
- tax planning, avoidance & evasion
- treaties
- United Kingdom

Legislative references:

- ITAA 1936 6AB(2)
- ITAA 1936 Pt III Div 18
- ITAA 1936 Pt IVA
- ITAA 1936 177A
- ITAA 1936 177C(1)(bb)
- ITAA 1936 177D
- ITAA 1936 177F
- ITAA 1997 Div 770
- ITAA 1997 770-15(1)
- ITAA 1997 770-15(1)(a)
- ITAA 1997 770-15(1)(b)(i)
- ITAA 1997 Div 830
- ITAA 1997 830-15

- ITAA 1997 830-20
- ITAA 1997 830-25
- ITAA 1997 830-30
- ITAA 1997 995-1(1)
- ITAA 1953 5
- ITAA 1953 Sch 1
- ITAA 1953 Sch 1 Art 1
- ITAA 1953 Sch 1 Art 3.1(f)
- ITAA 1953 Sch 1 Art 4.1
- ITAA 1953 Sch 1 Art 4.1(b)
- ITAA 1953 Sch 1 Art 11
- ITAA 1953 Sch 1 Art 11.3(b)
- ITAA 1953 Sch 1 Art 22.1(a)
- Taxation Laws Amendment (2007 Measures No. 4) Act 2007 Sch 1 Pt 6

Case references:

- Commissioner of Taxation v. Sleight (2004) 136 FCR 211; 2004 ATC 4477; (2004) 55 ATR 555
- Federal Commissioner of Taxation v. Hart (2004) 217 CLR 216; 2004 ATC 4599; (2004) 55 ATR 712

Other references:

- PS LA 2005/24
- Taxpayer Alert TA 2007/3
- Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007
- OECD Committee on Fiscal Affairs, Model Income Tax Convention on Income and on Capital, Condensed version, 17 July 2008

ATO references

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