IT 2515 - Income tax : interest withholding tax - exemption under section 128F of the Income Tax Assessment Act

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TAXATION RULING NO. IT 2515

INCOME TAX : INTEREST WITHHOLDING TAX - EXEMPTION UNDER SECTION 128F OF THE INCOME TAX ASSESSMENT ACT

F.O.I. EMBARGO: May be released

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F.O.I. INDEX DETAIL

REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1010993	INTEREST WITHHOLDING TAX OVERSEAS DEBENTURE ISSUE ISSUE OUTSIDE AUSTRALIA RAISING OF A LOAN OUTSIDE AUSTRALIA INTEREST PAID OUTSIDE AUSTRALIA	128F 128F(1)

PREAMBLE Advice was recently sought from this Office concerning the exemption from withholding tax provided by section 128F of the Income Tax Assessment Act in respect of interest paid by a company on debentures issued and widely distributed overseas. In particular, advice was sought about whether the exemption applied in respect of bonds or notes issued on the international capital market where the principal amount raised by the company and the interest due by the company to bond holders were payable in Australian dollars.

FACTS 2. A company proposed to issue bonds bearing a stated rate of interest with the terms of the issue ensuring wide distribution of the bonds on the Euromarket and prohibiting their sale to residents of Australia. Any application for payment of principal or interest by a bondholder had to be made to an office of a paying agent located outside Australia. The principal amount of the loan raised by the company through the issue of the bonds was to be payable to the company in Australian dollars. The interest on the bonds was also payable in Australian dollars.

3. Interest payments were to be made utilising the facilities of the Euro-clear system. Euro-clear is one of two major clearance systems for internationally traded securities. The other system is Centrale de Livraison de Valeurs Mobilieres (Cedel). Both systems operate in a similar manner and are linked electronically. Euro-clear was established in 1968 to provide a means of settling transactions in internationally traded securities. Settlements take place by way of book entry in a number of different currencies irrespective of the location of the parties to the trade or the securities involved. Related services provided by Euro-clear include custody services, services for the closing and initial distribution of new issues, and a program for securities borrowing and lending. Euro-clear

is owned (through an interposed holding company and licensing arrangements) by over 120 banks, financial institutions and dealers, all of which are Euro-clear participants. Since its establishment in 1968 by Morgan Guaranty, Euro-clear has operated in Brussels under an agreement between Morgan Guaranty and (through the interposed ownership structure) the owners of Euro-clear. The contractual arrangements applicable between Morgan Guaranty and the Euro-clear participants (of whom there are over 2,000) are in turn governed by terms and conditions which are subject to periodical revision. Euro-clear accepts for deposit securities which are, or are expected to be, actively traded in the international markets or held in quantity by Euro-clear participants. In connection with such securities, Euro-clear arranges the collection of subscription payments, remittance of funds to the issuer, and paying agency services.

4. There are three common methods of payment of interest applicable to Australian dollar denominated and deliverable bonds and notes held in Euro-clear. These may be summarised as follows:

First Method

> Each payment of interest is made by the issuer to the fiscal and paying agent at an account maintained with a bank in Australia. The agent immediately makes payment to Morgan Guaranty, as sub-paying agent, to a bank account maintained in Australia. Morgan Guaranty then by book entry credits that payment in favour of Euro-clear for account of the individual Euro-clear participants who may then draw upon that credit to pay interest to the note-holders outside Australia. This is the most common method of payment.

Second Method

> This method is essentially the same as the first except that the sub-paying agent is not Morgan Guaranty. Accordingly, interest will be paid by the issuer to the fiscal and paying agent who in turn will pay a sub-paying agent at a bank account maintained in Australia. The sub-paying agent pays to Morgan Guaranty an Australian dollar payment in a bank account in Australia and Morgan Guaranty credits such amounts to the account of a member of Euro-clear who then draws on it to pay the bond holders outside Australia.

Third Method

> Morgan Guaranty as a sub-paying agent for the issue, on being presented with an interest coupon by a bond holder in Brussels, makes payment against that coupon either in cash or by cheque drawn on its account maintained with a bank in Australia.

5. Prior to the amendment effected by paragraph 26(a) of Taxation Laws Amendment Act (No. 3) of 1986, applicable to interest paid after 4 November 1986, section 128F required that both the relevant loan and the interest be paid in a currency

other than the currency of Australia. That requirement has now been removed. While the section, as amended, clearly envisages the payment of loan moneys and of interest in Australian dollars, it still requires that the loan be raised, and the interest be paid, outside Australia.

6. The question arises whether the requirements of subsection 128F(1) are satisfied where banking procedures require amounts of interest payable to a non-resident, and loan moneys received by a resident bond issuer, to be cleared through a bank account maintained in Australia. In these circumstances, given that the payments are in Australian dollars, the place of payment may be construed as being Australia.

RULING

7. The requirements contained in subsection 128F(1) are directed not at banking procedures but towards ensuring that debentures which are widely distributed and traded in the international capital markets are only available to non-residents of Australia and that payments are made outside Australia.

8. Adoption of the strict view - viz., that where payments of principal and interest are cleared through a bank account in Australia, they are made in Australia - would frustrate the operation of section 128F. Accordingly, where interest is transferred by the issuer to an account maintained in Australia and the account is maintained by financial institutions solely as a step in the clearance of funds, and such interest is promptly credited to an account maintained outside Australia for such financial institutions or for persons for whom the financial institution has collected such interest, the interest is considered to be paid 'outside Australia' for the purposes of subsection 128F(1). The funds held in the account maintained in Australia, prior to being remitted to the appropriate non-resident, are not to be utilised in any way by the paying or sub-paying agent in the interim period. The length of the interim period will depend on the relevant banking procedures. However, it is not envisaged to be greater than a few days. It is clear that payment by a paying agent or clearance system from an Australian bank account to a bondholder by direct credit to a bondholder's bank account maintained in Australia would not comply with the requirement in paragraph 128F(1)(d) that the interest be paid outside Australia.

9. On the other hand, if the funds have been credited to the bondholder's overseas account and subsequently the bondholder redirects the funds to be transferred to another account held by him in Australia, then paragraph 128F(1)(d) is satisfied. The bondholder is in absolute control of the funds once they are credited to his overseas account and, without a separate and specific instruction from the bondholder, no funds can be transferred from his overseas account to another bank account located in Australia. Any interest accruing on the Australian account of the bondholder would, of course, be subject to withholding tax.

10. Similarly, the use of banking procedures requiring loan

moneys received by an Australian issuer from non-resident debenture holders to be cleared through a bank account maintained in Australia will not of itself cause the debentures to be considered not to have been issued by the company outside Australia for the purposes of subsection 128F(1).

COMMISSIONER OF TAXATION
19 January 1989