Taxation Ruling
Income tax: obligations of borrowers who pay withholding tax on behalf of foreign lenders

other Rulings on this topic

CITCM 499 CITCM 858

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What this Ruling is about

1. This Ruling explains:

   (a) how interest withholding tax on interest payable to a foreign lender is calculated if an Australian borrower agrees to:
   - pay to the lender an amount equivalent to the lender's withholding tax liability;
   - indemnify the lender against the withholding tax; or
   - pay the withholding tax on the lender's behalf;

   and

   (b) the situations in which, and when an obligation falls on the borrower:
   - to withhold the tax; and
   - to pay the tax to the Australian Taxation Office ("ATO").

2. Interest income, including amounts in the nature of interest, derived from Australia by:

   - a person who is not a resident of Australia, (excluding interest income derived by a non-resident in carrying on business through a permanent establishment in Australia); or
   - a resident of Australia, but only if the interest income is derived in carrying on business through a permanent establishment outside Australia,

   is generally subject to a 10% flat rate of withholding tax (Division 11A of Part III of the *Income Tax Assessment Act 1936*). In these circumstances, the withholding tax deducted from the payment represents the final liability of the foreign lender to Australian income tax on the interest income.

3. Although withholding tax is usually deducted by borrowers at the rate of 10% of the interest payable to a foreign lender, a borrowing agreement may require the borrower to pay to the lender an amount equivalent to the lender's withholding tax liability. In other words, the borrower may be required to pay to the lender:

(a) interest at the rate specified in the agreement; and

(b) a sum equivalent to the amount of the lender's withholding tax liability on the interest.

Similarly, a borrowing agreement may require the borrower to indemnify the lender against withholding tax on the interest or, in broad effect, to meet the lender's liability by actually paying the withholding tax.

Ruling

(a) Calculating withholding tax paid by a borrower on behalf of a lender

4. A borrower may undertake, as a written or implied term of a loan agreement:

- to pay to the lender an amount equivalent to the Australian withholding tax for which the foreign lender is liable;
- to indemnify the lender against the withholding tax; or
- to meet the lender's liability by actually paying the withholding tax.

In each situation, the borrower must pay an amount of withholding tax calculated as follows:

$$\text{interest withholding tax} = 10\% \text{ of } \frac{10}{9} \times [\text{interest payment}]$$

5. This formula is based on the reasoning that the after-tax return required by the lender can only be achieved if interest withholding tax is deducted from a gross amount of interest one-ninth greater than the amount of interest actually paid by the borrower to the lender.

(b) Borrower's obligation to deduct withholding tax

6. A borrower is required to:
   - deduct withholding tax either before or at the time interest is paid or (as explained at paragraph 8 of this Ruling) is deemed to have been paid; and
   - pay the tax to the ATO within 21 days after the end of the month in which the tax is deducted,

in each of three situations.

7. These situations are:
   (i) if the interest is payable to a person who, in relation to the borrowing, is shown in the borrower's records as having an address outside Australia; or
   (ii) if the interest is payable, either to the lender or to another person, outside Australia; or
   (iii) if the lender has notified the borrower that withholding tax must be deducted, even though the interest is paid in Australia.

8. Interest is deemed for withholding tax purposes to be paid to a person if it is reinvested, accumulated, carried to any reserve sinking fund or insurance fund however designated, or is otherwise dealt with on behalf of the person or as the person directs.

Date of effect

9. This Ruling sets out the current practice of the ATO. It applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued.

Explanations

(a) Calculating withholding tax paid by a borrower on behalf of a lender

- **Grossing-up clauses**

10. A loan agreement may contain a clause which (in the absence of a withholding tax exemption applying) requires the borrower to pay an additional amount so that the amount of interest paid to the lender effectively is the same as if there were no withholding tax. Under a so-called "grossing -up clause", the borrower undertakes to pay to the lender the equivalent of a before-tax amount of interest. The fact remains, however, that a foreign lender remains liable for the tax.

11. The formula in paragraph 4 of this Ruling recognises that the two elements of a grossed-up payment (that is, the interest payment

and an amount equivalent to the lender's withholding tax liability) both accrue to the benefit of the lender.

12. As defined in subsection 128A(1), the term 'interest' includes 'an amount in the nature of interest'.

13. The grossed-up amount is the amount paid as interest, or in the nature of interest, which yields the (after-tax) amount required by the lender. The grossed-up amount represents 'interest' or 'an amount in the nature of interest' because it has the character of a sum paid by the borrower for the use of the money borrowed (i.e., the principal). It follows that when a borrower pays interest in accordance with a grossing-up clause the withholding tax must be calculated on the grossed-up basis specified in paragraph 4 of this Ruling.

- **Grossing-up clause legally invalid in certain circumstances but lender's withholding tax paid voluntarily**

14. If a borrowing is secured by a mortgage (as defined by subsection 261(5), a grossing-up clause in the borrowing agreement or in any related agreement could be legally void (section 261). Payment of an amount additional to interest in order to satisfy the lender's Australian tax liability could not, in these circumstances, be enforced against the borrower.

15. Even though a borrower in a situation where the borrowing is secured by a mortgage may not be legally compelled to comply with a grossing-up clause, an additional amount to satisfy the lender's withholding tax liability may still be paid voluntarily. Withholding tax needs to be calculated in this situation in accordance with paragraph 4 and to be deducted and paid in accordance with paragraph 6.

(b) Borrower's obligation to deduct interest withholding tax

16. There are three situations where a statutory obligation is imposed on a borrower to deduct withholding tax from interest and to pay the deducted amount to the ATO:

(1) If the interest is payable to a person who, in relation to the borrowing, is shown in the borrower's records as having an address outside Australia (paragraph 221YL(2A)(a), section 221YN).

(2) If the interest is payable, either to the lender or to another person, outside Australia (paragraph 221YL(2A)(b), section 221YN).

(3) If:

- the interest is paid in Australia to a lender who is an Australian resident, but the loan originated from a foreign branch of the lender; and
- the lender has notified the borrower that withholding tax must be deducted (subsections 221YL(2E),(2F), section 221YN).

17. The borrower is not obliged to deduct withholding tax if interest is paid to a person in Australia who receives the payment on behalf of the foreign lender. In this situation, the person receiving the payment is obliged to deduct withholding tax at the time the payment is received (subsection 221YL(2B), section 221YN).

18. Paragraph 221YK(3)(a) deems interest to have been paid in the circumstances stated in paragraph 8 of this Ruling.

19. A person who refuses or fails to deduct withholding tax is personally liable to pay to the Commissioner an amount equal to the withholding tax due on the interest together with a penalty for late payment (subsection 221YQ(1)). If such a payment is made, the person making the payment is empowered by subsection 221YQ(2) to recover an amount equal to the withholding tax, but not any additional tax for late payment, from the foreign lender.

Example

20.
- On 1 July 1990, Australian Borrower obtained a AUD40 million term loan from a syndicate of Singaporean financial institutions.
- Interest is payable quarterly at the nominal annual rate of 13.5%. No exemption from interest withholding tax applies.
- The loan agreement provides for Australian Borrower to pay:

"...such additional amounts as may be necessary in order that the net amounts of interest received by the Lenders after withholding or deduction for, or on account of, Australian taxes shall equal the amounts of interest which would have been receivable by the Lenders in the absence of such withholding or deduction."

21. On 30 September 1990, interest paid to the lenders totals $1.35 million.

22. On or before 21 October 1990, Australian Borrower is required to pay withholding tax to the Commissioner of Taxation calculated as follows:

$$10\% \text{ of } \frac{10}{9} \times \$1.35 \text{ million}$$

$$= \$150\,000.$$

Commissioner of Taxation

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