

# ***TR 2005/5 - 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***

⚠ This cover sheet is provided for information only. It does not form part of *TR 2005/5 - 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*

⚠ This ruling contains references to repealed provisions, some of which may have been re-enacted or remade. The ruling has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *16 March 2005*



## Taxation Ruling

# 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

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### *Preamble*

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVA** of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. *Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.**

## What this Ruling is about

### **Class of persons/arrangement**

1. This Ruling applies to residents of the United States and the United Kingdom that are classified as financial institutions for the purposes of either the Australia – United States Taxation Convention, as amended by the Protocol, (the US Convention) or the Australia – United Kingdom Taxation Convention (the UK Convention) (collectively referred to as 'the Conventions').
2. This Ruling applies to those arrangements where interest arises in Australia, within the meaning of Article 11(7) of the Conventions, and is derived by United States (US) or United Kingdom (UK) residents that are financial institutions for the purposes of the Conventions. The US and UK residents must beneficially own, or be beneficially entitled to this interest.

### **Issues discussed in Ruling**

3. The Ruling discusses the circumstances under which the US or UK resident will not be subject to tax in Australia under the Conventions on interest income arising in Australia.
4. This Ruling focuses on the definition of 'financial institution' contained in Article 11(3)(b) of the Conventions. The definition of 'financial institution' distinguishes two types of entities; those that are 'banks' and those that are 'other enterprises'.

5. The definition also contains a number of undefined terms. Given these undefined terms, there has been some uncertainty as to whether a US or UK resident will be considered to be a 'financial institution' for the purposes of the Convention and subsequently whether it will be subject to Australian tax on interest income arising in Australia.

6. The Ruling and Explanation sections of this Ruling are presented in two parts:

- A. ascertaining whether the US or UK resident is classified as a financial institution under Article 11(3)(b) of the Conventions; and
- B. other requirements that a US or UK resident financial institution must satisfy if it is not to be subject to tax on its interest income arising in Australia, namely:
  - the financial institution is unrelated to and dealing wholly independently with the payer of the interest (Article 11(3)(b));
  - the interest is not effectively connected with a permanent establishment in Australia of the US or UK resident (Article 11(6)); and
  - the interest is not paid as part of an arrangement involving 'back to back' loans (Article 11(4)).

7. This Ruling is intended to assist residents of the US and the UK in receipt of interest arising in Australia to establish their income tax liability, and also assist payers of interest of this type determine their withholding tax obligations.<sup>1</sup>

8. Unless specifically addressed, for the purposes of this Ruling, a reference to a US or UK resident does not include the permanent establishment in Australia of the US or UK resident.

## **Date of effect**

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9. This Ruling applies in respect of withholding taxes from the date of effect of the Conventions. The US Protocol that amended the US Double Taxation Convention took effect for withholding taxes on 1 July 2003. The UK Convention took effect for withholding taxes on 1 July 2004. However, the 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 Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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<sup>1</sup> Interest withholding tax obligations may arise in respect of interest paid by both residents of Australia and non-residents in accordance with Division 11A of Part III of the *Income Tax Assessment Act 1936*.

## Ruling

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10. Where a US or UK resident:

- satisfies the definition of 'financial institution';
- is beneficially entitled to, or beneficially owns the interest; and
- is unrelated to, and dealing wholly independently with the payer of the interest,

and the interest arising in Australia is not:

- effectively connected with a permanent establishment in Australia of the US or UK resident; nor
- paid as part of an arrangement involving 'back to back' loans,

Australia has no taxing rights under Article 11(2) of the Conventions in respect of interest paid to the US or UK resident. Accordingly, payers of interest of this type have no obligation under section 128B of the *Income Tax Assessment Act 1936* (ITAA 1936) to withhold tax from such payments made to these US or UK residents.

### **PART A: ascertaining whether the US or UK resident is classified as a financial institution under Article 11(3)(b) of the Conventions**

11. The definition of a 'financial institution' is contained in Article 11(3)(b) of the Conventions and categorises US and UK residents into those that are 'banks' and those that are 'other enterprises'.

#### **Banks**

12. For the purposes of the Conventions, the Commissioner considers that a bank means a US or UK resident that is authorised or licensed to carry on a banking business (that is, to take deposits and make advances) in the US or the UK, and satisfies the capital adequacy requirements to be classified as a bank, as distinct from other categories of deposit taking institutions.

13. Where a US or UK resident satisfies these requirements, it will constitute a financial institution and does not need to satisfy the other elements of the definition of what is a financial institution.

14. The Commissioner considers that UK residents that appear on the list of banks published by the UK Financial Services Authority<sup>2</sup> will constitute a bank for the purposes of Article 11(3)(b) of the UK Convention.

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<sup>2</sup> 'FSA – Banks', [www.fsa.gov.uk/list\\_banks/](http://www.fsa.gov.uk/list_banks/).

**Other enterprises**

15. 'Other enterprises' are those residents of the US or UK that are not classified as banks. This means that these enterprises must 'substantially derive their profits' by 'raising debt finance in the financial markets' or by 'taking deposits at interest' and 'using those funds in carrying on a business of providing finance'. Collectively, these activities are referred to as 'spread activities' in this Ruling.

16. While US or UK residents that operate as credit unions, building societies, savings banks or saving and loans institutions, are unlikely to satisfy the meaning of the term 'bank' for the purposes of the Conventions, the Commissioner considers that these US or UK residents would still meet the definition of financial institution as they would satisfy the requirements for 'other enterprises'.

***Raising debt finance in the financial markets***

17. The meaning of the term 'debt finance' has regard to the approach applied in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) of analysing the economic substance of the rights and obligations arising under a financing arrangement rather than the mere legal form. This recognises that the basic indicator of the economic character of the debt is the non-contingent nature of the returns. Applied in the context of the Conventions, a US or UK resident is raising debt finance where the funds obtained result in an 'effectively non-contingent obligation' to return an amount at least equal to the amount received. The term 'effectively non-contingent obligation' takes its meaning from section 974-135 of the ITAA 1997.

18. The term 'financial markets' in the expression 'raising debt finance in the financial markets' takes on its ordinary commercial meaning. It means a facility through which:

- offers to acquire or dispose of debt finance products are regularly made or accepted (including offering loans); or
- offers and invitations are regularly made to acquire or dispose of debt finance products that are intended to result or may reasonably be expected to result in the making (or acceptance) of offers to acquire or dispose of such debt finance products (including offering loans).

The linkage between the meaning of debt finance above, and the requirement that the enterprise obtains its debt finance in the financial markets, means that these funds must be raised on normal commercial terms.

***Taking deposits at interest***

19. The term 'taking deposits at interest' takes on its ordinary meaning. The CCH Macquarie Business Dictionary defines 'deposit' as:

a sum of money placed into an account with a financial institution. Deposits can range in maturity from a deposit in a passbook account, able to be withdrawn on demand (or on call), to a deposit made for a fixed period of time.<sup>3</sup>

20. As such, the term, 'taking of deposits at interest' refers to the receipt of a sum of money into an account by a financial institution which pays interest thereon. In the above dictionary definition the term 'financial institution' is used in its ordinary sense, as an institution authorised under a regulatory regime to take deposits, rather than in the defined sense used in the Conventions. For the purposes of this Ruling, the enterprise must be authorised under the regulatory regime of either the US or the UK, to take sums of money to be placed in an account.

21. Where a US or UK resident is authorised to take deposits, it can take deposits at interest from any source, including from a related party (on commercial terms).

***Using those funds in carrying on a business of providing finance***

22. The term 'providing finance' takes on its ordinary meaning and in the Macquarie Dictionary is defined as:

3. to supply with means of payment; provide capital for; obtain or furnish credit for.<sup>4</sup>

23. The meaning of *finance* in 'providing finance' is broader than 'debt finance'. While it includes those financial instruments that meet the meaning of debt finance, it is not limited to the provision of funds for which the lender receives a return that is non-contingent in nature. Rather, a provision of finance entails the supply or provision of funds or assets with an obligation (either contingent or non-contingent) on the recipient to return these funds or assets in the future.

24. While various financing arrangements may constitute the provision of finance within the meaning of the term, such financing arrangements must generate income in the form of interest (within the meaning of Article 11(5)) for the enterprise to be entitled to an exemption under Article 11(3)(b) of the Conventions.

25. The activities of providing finance must also be undertaken in such manner that a US or UK resident is considered to be carrying on a business.

<sup>3</sup> *The CCH Macquarie Business Dictionary*, CCH Australia Limited, Sydney, 1993, p 168.

<sup>4</sup> *The Macquarie Dictionary*, Second Edition, The Macquarie Library, New South Wales, 1992, p 649.

***Substantially deriving its profits***

26. The term 'substantially deriving its profits' means that the activities of raising debt finance in the financial markets or taking deposits at interest and using those funds in carrying on a business of providing finance, needs to comprise the US or UK resident's main business activity.

27. These activities constitute the main business activity of the US or UK resident if such activity is the main contributor to the overall profit of the US or UK resident. 'Profit' in this context can be measured according to a range of acceptable accounting indicators, including gross profit, net operating income or operating profit. It should also be measured on the same accounting basis over a reasonable period to ascertain whether the spread activity is consistently the main activity of the enterprise.

28. Where financial institutions, resident in the US or UK, provide finance to an Australian resident through a permanent establishment in a third country it would be necessary to consider the entire activities of the US or UK resident, rather than only the activities undertaken through the permanent establishment, to determine whether it is substantially deriving its profits from its spread activities.

**PART B: additional conditions for a financial institution to meet to determine whether it will be subject to tax on its interest income arising in Australia*****Whether the US or UK financial institution is unrelated to, and dealing wholly independently with the payer of the interest***

29. For the purposes of Article 11(3)(b), the US or UK resident must be both unrelated to, and dealing wholly independently with the Australian payer.

30. The term 'unrelated' means that there is no ownership or control based relationship between the payer of the interest and the financial institution, under which one party is able to exert sufficient influence over the activities of the other party. In this regard, the term 'sufficient influence' takes its meaning from section 318 of the ITAA 1936. Essentially, an entity will be sufficiently influenced by another entity where that entity has 'influence, because of obligation or custom, over a company or its directors to direct the actions of the company either directly or through interposed entities'.<sup>5</sup>

31. In determining whether the parties will be regarded as dealing wholly independently with each other, an arm's length test is applied to ascertain whether the transaction has taken place on normal, open market, commercial terms. In relation to the arm's length requirements, paragraphs 4, 23 and 24 of TR 2002/2 provide guidance.

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<sup>5</sup> Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990, page 205. In addition refer to the meaning of 'sufficiently influenced' in paragraph 318(6)(b) ITAA 1936.

***The interest is effectively connected with a permanent establishment in Australia of the US or UK resident***

32. In cases where interest is paid by an Australian borrower to a permanent establishment in Australia of the financial institution, and the indebtedness in respect of which the interest is paid is effectively connected with that permanent establishment, Article 11(6) of the Conventions specifies that the provisions of Article 7 (Business Profits) will apply. Notwithstanding that the US or UK resident may be a financial institution, the interest arising in Australia will be taxable in Australia under Article 7 of the Conventions.

***Whether the interest is paid as part of an arrangement involving 'back to back' loans***

33. The effect of Article 11(4) is that where a back-to-back loan arrangement involving related party or other debt is structured through a US or UK financial institution, Article 11(3) will not apply.

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## **Explanation**

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### **Background**

34. Australia has a taxing right under Article 11(2) of the Conventions in respect of interest payments that arise in Australia to which a US or UK resident is beneficially entitled to, or beneficially owns.

35. Australia, however, will not tax interest payments made to US or UK residents that are:

- financial institutions;
- unrelated to the interest payer; or
- dealing wholly independently with the payer of the interest,

and the interest received is:

- not paid as part of a 'back to back' arrangement; and
- is not effectively connected with a permanent establishment in Australia of the US or UK resident.

36. It is the US or UK resident that is beneficially entitled to the interest that must meet the requirements of the Article. The term 'resident' in Article 11 derives its meaning from Articles 1, 3 and 4 of the Conventions. The effect of the definition of 'resident' in the Conventions in the case of corporate groups is that it refers to a particular company within the company group. As a corporate group is not a resident for the purposes of Article 11, the attributes of that Article cannot apply to it. Rather, it is the particular company that is



beneficially entitled to the interest that must meet the requirements of Article 11(3), including the requirement to be a financial institution.

37. This Ruling focuses on whether the US or UK resident will be classified as a financial institution and addresses the additional conditions that this US or UK resident must meet if it is not to be subject to tax on interest payments arising in Australia. These aspects are addressed in Parts A and B of this Ruling respectively.

**PART A: ascertaining whether the US or UK resident will be classified as a financial institution under Article 11(3)(b) of the Conventions**

38. The definition of 'financial institution' has been defined in Article 11(3)(b) of the Conventions as follows:

...For the purposes of this Article, the term 'financial institution' means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.<sup>6</sup>

***The meaning of undefined terms within the definition of Financial Institution***

39. The definition of a 'financial institution' contains a number of terms that are not defined in the Conventions. These include:

- 'bank';
- 'raising debt finance in the financial markets';
- 'taking deposits at interest';
- 'providing finance'; and
- 'substantially deriving its profits'.

40. Article 3(3) of the UK Convention states:

As regards the application of this Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the laws of that State for the purposes of the taxes to which this Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

41. Article 3(2) of the US Convention similarly provides that where a term is not defined in the Convention it takes on the meaning it has under the domestic tax law of the country applying the Convention unless the context otherwise requires.

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<sup>6</sup> *International Tax Agreements Act 1953*, Schedule 1, Article 11(3)(b); Schedule 2, Article 11(3)(b).

42. Notwithstanding the different wording in Article 3(2) of the US Convention compared with Article 3(3) of the UK Convention, it is considered that there is no substantive difference in the application and operation of the General Definitions Article in both Conventions as it relates to undefined terms.

43. Taxation Ruling 2001/13 sets out the Commissioner's approach to the interpretation of undefined terms in a treaty (see paragraphs 63 to 76 of TR 2001/13). This approach is relied upon in this Ruling to provide meaning to the undefined terms referred to in paragraph 39.

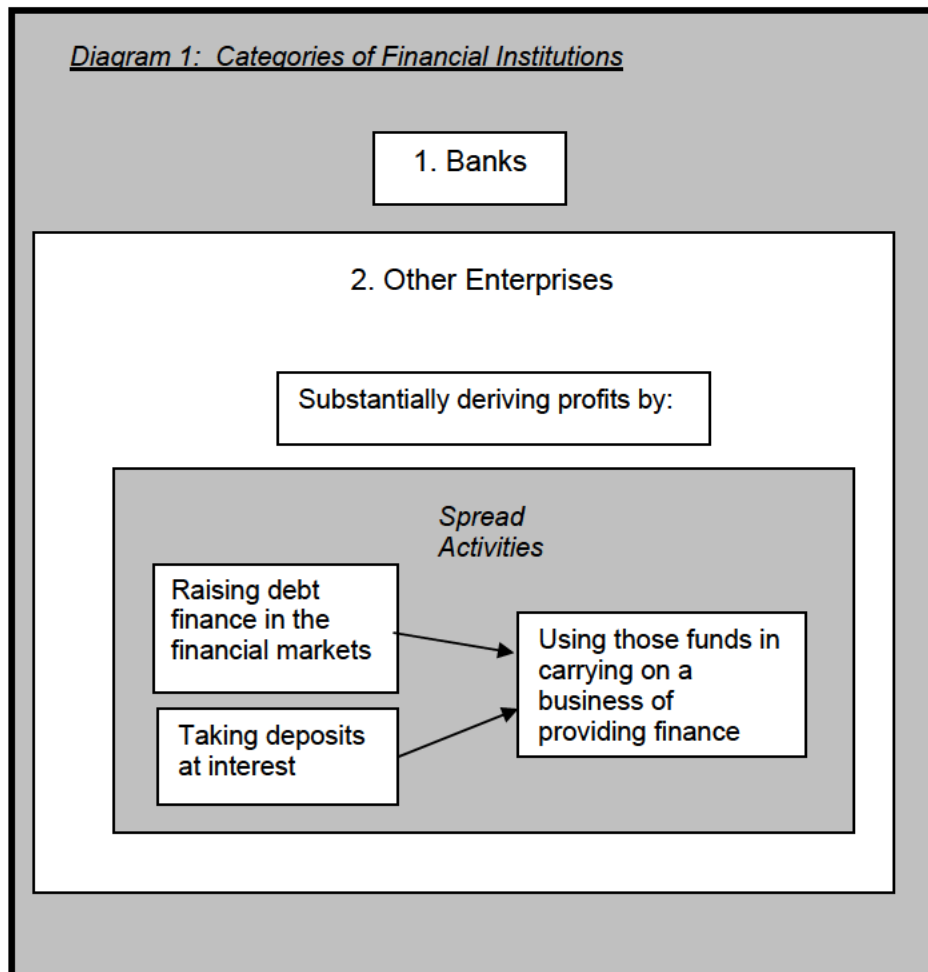
### **Banks**

44. Some uncertainty has arisen as to whether the definition requires a 'bank' to meet all the elements of the definition in order to be a financial institution.

45. The drafting of the definition could allow two interpretations. A literal interpretation may suggest that both 'banks' and 'other enterprises' must substantially derive their profits by either taking deposits at interest or raising debt finance in the financial markets, and using these funds to carry on a business of providing finance in order to qualify as a financial institution.

46. Alternatively, the word 'bank' may be read in isolation from the rest of the definition such that a 'bank', as defined, qualifies as a financial institution.

47. The specific reference to banks within the definition allows these entities to be distinguished from other enterprises that are not banks. The Commissioner therefore considers the latter to be the better view. Accordingly, there are two categories of financial institutions: US or UK residents that are banks, and US or UK residents that are other enterprises. This is represented in Diagram 1.



48. As such, the requirements of substantially deriving profits, raising funds and carrying on a business of providing finance are only applicable to US or UK residents that are 'other enterprises'.

### ***The meaning of the term 'Bank'***

49. Article 11 of the Conventions does not define the word 'bank', nor is it defined elsewhere in the Conventions.

50. Article 3(2) of the US Convention and Article 3(3) of the UK Convention indicate that Australia's domestic law meaning of the term bank should apply unless the context requires otherwise.

51. For a bank to operate in Australia it must comply with the *Banking Act 1959*.<sup>7</sup> Although this Act establishes the legal framework for banks operating in Australia, it does not contain a definition of a bank. The term 'authorised deposit taking institution' (ADI) is used instead.

<sup>7</sup> *Banking Act 1959* section 8.

52. An ADI is defined as a body corporate that has been granted an authority to carry on a 'banking business' in Australia.<sup>8</sup> This authority is granted by the Australian Prudential Regulatory Authority (APRA).<sup>9</sup> A 'banking business' consists of 'both taking deposits (other than as part-payment for identified goods or services) and making advances'.<sup>10</sup>

53. While all banks are required to be ADIs, ADIs also include building societies and credit unions. For an ADI to use the word 'bank' in its title it must meet certain capital adequacy requirements as specified by APRA.<sup>11</sup> APRA Guidelines stipulate that these institutions must have a minimum of \$50 million in Tier 1 Capital.<sup>12</sup> It is only these entities that are considered to be banks under Australian law.

54. In summary, the meaning of a bank for Australian domestic law purposes is a body corporate that has an authority to carry on a banking business in Australia and has at least \$50 million in Tier 1 Capital.

55. It is apparent from the above analysis, that when determining the liability for Australian tax, a meaning of the term bank that is limited to Australia's domestic law meaning<sup>13</sup> will not be directly applicable to US or UK residents that operate from the US or the UK respectively. Rather, as the Article is intended to apply to residents of the US or the UK, the context requires that the term bank must allow these US or UK residents to undertake their banking business in their country of tax residence.

56. While there are differences between the jurisdictions, US or UK residents classified as banks in the US and the UK have similar regulatory requirements to Australian banks.

57. The banks in these jurisdictions must comply with their domestic regulatory requirements and, where applicable, satisfy any capital adequacy standards that distinguish them from other types of financial institutions. For example, both banks and building societies may be authorised to take deposits. However, to be classified as a bank, the US or UK resident may have to satisfy higher capital adequacy requirements.

58. Having regard to both Australia's domestic law meaning and the treaties' context in paragraph 55, it is the Commissioner's view that the term 'bank' means residents of the US or UK that:

- are authorised or licensed to carry on a banking business (that is, to take deposits and make advances) in either the US or the UK where they are resident respectively; and

<sup>8</sup> *Banking Act 1959* section 5, subsection 9(3).

<sup>9</sup> APRA is the prudential regulator of banks, insurance companies, superannuation funds, credit unions, building societies and friendly societies in Australia.

<sup>10</sup> *Banking Act 1959* section 5.

<sup>11</sup> *Banking Act 1959* section 66.

<sup>12</sup> 'Guidelines on Authorisation of ADIs', paragraph 13, [www.apra.gov.au](http://www.apra.gov.au).

<sup>13</sup> See paragraph 49.

- where there are higher capital adequacy requirements in either the US or UK that distinguish banks from other categories of deposit taking institutions, then these higher requirements must be satisfied.

59. US or UK residents that operate as credit unions, building societies, savings banks or saving and loans institutions in the US and UK have lower capital adequacy requirements than those required of commercial banks. Accordingly, these US or UK residents are unlikely to satisfy the meaning of the term 'bank' for the purposes of the Conventions.<sup>14</sup>

60. Where a US or UK resident is part of a corporate group, and another company in this group meets the requirements in paragraph 58, the US or UK resident will not be considered to be a bank for the purposes of the Convention unless it also satisfies these requirements.

61. The Commissioner considers that UK residents that appear on the list of banks published by the UK Financial Services Authority<sup>15</sup> will constitute a bank for the purposes of Article 11(3)(b) of the UK Convention.

### **Other enterprises**

62. The second part of the definition of financial institution relates to other enterprises and contains a number of undefined terms.

63. Other enterprises are required to substantially derive their profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of the provision of finance. For convenience, the Ruling refers to the undertaking of these activities as the enterprise's 'spread activities'.

64. As noted in paragraph 59, while US or UK residents that operate as credit unions, building societies, savings banks or saving and loans institutions, are unlikely to satisfy the meaning of the term 'bank' for the purposes of the Conventions, the Commissioner however, considers that these US or UK residents would still meet the definition of financial institution as they would satisfy the requirements for 'other enterprises'.

### ***The meaning of 'raising debt-finance in the financial markets'***

65. In examining the meaning of 'raising debt finance in the financial markets', it is clear that the inclusion of the word 'debt' refers to a particular type of finance raising. Therefore, a traditional loan of funds from the financial markets would be a form of raising debt finance, while the raising of finance through an issue of ordinary shares to the public, being a form of equity financing, would not.

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<sup>14</sup> Refer to paragraph 64 as these US or UK residents will still be treated as financial institutions.

<sup>15</sup> 'FSA – Banks', [www.fsa.gov.uk/list\\_banks/](http://www.fsa.gov.uk/list_banks/).

66. It will not always be apparent from the nature of modern financing arrangements whether certain arrangements constitute one of raising debt or equity finance. With the development of innovative financial products as a means of raising finance, the traditional legal boundaries to distinguish 'debt' from 'equity' are no longer appropriate in this context.

67. There is no definition of the term 'debt finance' in the Conventions, nor is the term specifically used in Australia's tax law. Division 974 of the ITAA 1997 does, however, distinguish debt from equity. An object of this Division is to establish a test to determine whether an arrangement gives rise to a debt interest or an equity interest in order to discern what amounts are deductible from amounts that may be frankable.<sup>16</sup> This approach has regard to the economic substance of the rights and obligations arising under a financing arrangement, rather than the mere legal form.<sup>17</sup> It recognises that the basic indicator of the economic character of a debt is the non-contingent nature of the returns.<sup>18</sup> The Division distinguishes debt from equity interests by focusing on the single organising principle – the effective obligation of an issuer to return to the investor an amount at least equal to the amount invested.<sup>19</sup> In applying the test the Division requires an 'effectively non-contingent obligation', a term defined in section 974-135.

68. It is considered that the approach used in Division 974 to distinguish between debt and equity, based on the economic substance of the rights and obligations in question, should be applied to the meaning to be given to 'debt finance' in the Conventions.

69. The Commissioner does not require the US or UK resident to satisfy all of the requirements of Division 974 (for example, there is no requirement that the scheme is a financing arrangement under section 974-130). Rather it is consistent with the context of the Conventions to utilise the economic principle underpinning that Division in interpreting this term. Therefore, where it can be concluded that the raising of funds results in an effectively non-contingent obligation, as defined in section 974-135 of the ITAA 1997, to provide an amount at least equal to the amount received, this will constitute 'raising debt finance' for the purposes of the Conventions.

70. For example, under security lending arrangements and repurchase agreements an enterprise may sell securities with an effectively non-contingent obligation to purchase those securities back at a later date at a higher price reflecting an imputed interest rate. A so-called buy-sell agreement (being a form of a repurchase agreement) has the same economic effect. Similarly, an enterprise which receives cash collateral under a securities lending transaction is obliged to repay the cash amount at a later date.

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<sup>16</sup> ITAA 1997 subsection 974-10(1), Note.

<sup>17</sup> ITAA 1997 subsection 974-10(2).

<sup>18</sup> ITAA 1997 subsection 974-10(2), Note 1.

<sup>19</sup> Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001, paragraph 1.9.

71. The Commissioner considers that such means of financing are within the meaning of raising debt finance. These activities are consistent with the context of Article 11(3)(b) which is to include within the definition of raising debt finance those arrangements that in economic substance are akin to a loan.

72. The meaning of 'debt finance' also needs to be viewed in the context of it being raised in the 'financial markets'. The term 'financial markets' in the composite expression 'raising debt finance in the financial markets' takes on its ordinary commercial meaning. It means a facility through which:

- offers to acquire or dispose of debt finance products are regularly made or accepted (including offering loans); or
- offers and invitations are regularly made to acquire or dispose of debt finance products that are intended to result or may reasonably be expected to result in the making (or acceptance) of offers to acquire or dispose of such debt finance products (including offering loans).

73. This definition includes all forms of loan financing through recognised entities that form part of the retail financial market (that is, depository institutions and finance companies). It also includes the raising of debt finance in the wholesale financial markets through which debt finance products such as notes and bonds are issued.

#### *Corporate groups*

74. An issue that has arisen is whether the enterprise that raises its debt finance from a related party within a corporate group is considered to be raising 'debt finance in the financial markets'. The key question here is whether the related party forms part of the 'financial markets'. If so, the related party borrowing will still qualify as raising debt finance in the financial markets.

75. For the related party lender to form part of the financial markets it needs to show that it regularly provides finance to the public as a financier. Where the enterprise raises funds from a related party that regularly provides finance to the public as a financier, the enterprise will be taken to have raised its debt finance in the financial markets if it raises such funds on normal commercial terms.

76. On the other hand, where the enterprise raises its debt finance from a corporate treasury or group financier that does not regularly provide finance to the public, the enterprise will not be taken to have raised its debt finance in the financial markets.

*The use of special purpose vehicles*

77. Another issue is whether an enterprise that provides finance (and therefore is the beneficial owner of the interest) and indirectly raises its debt finance by using a special purpose vehicle, is considered to be raising its debt finance in the financial markets.

78. In these circumstances, it could be argued that the enterprise, to which the definition is being applied, is not raising debt finance in the financial markets because it raises its finance from the special purpose vehicle, not the financial markets.

79. However, where it can be shown that the special purpose vehicle that is used by the enterprise to raise debt finance in the financial markets:

- is established for the sole or principal purpose of acquiring the debt finance in the financial markets on behalf of the enterprise; and
- is, in substance, merely a conduit for the financing transaction between the enterprise and the financial markets (for the special purpose subsidiary to be treated as a mere conduit, it must be shown that the full economic effect of the financing arrangement flows through to the enterprise),

then the enterprise will be taken to have 'raised debt finance in the financial markets'.

80. This approach reflects the context, object and purpose of Article 11(3) which is to exclude US and UK financial institutions from being subject to Australian tax on interest arising in Australia where they can show that they are substantially operating on the profit margin between the cost of funds and the income from the use of such funds in providing finance. This will substantively be the case where the financial institution uses a conduit that it fully owns and controls to raise the debt finance on its behalf in the financial markets.

81. An enterprise that raises its debt finance from the corporate treasury in its group is unlikely to satisfy the requirements in paragraph 79 as a corporate treasury is not considered to be a mere conduit.

***The meaning of the term 'taking deposits at interest'***

82. The phrase, 'taking deposits at interest' is not defined in the Conventions.

83. The term 'interest' is defined in Article 11(5). While the term has a wide meaning, its scope is more limited when used in the context of taking deposits at interest.



84. The Macquarie Business Dictionary defines 'deposit' as:  
a sum of money placed into an account with a financial institution. Deposits can range in maturity from a deposit in a passbook account, able to be withdrawn on demand (or on call), to a deposit made for a fixed period of time.<sup>20</sup>
85. The definition indicates that to take deposits at interest a sum of money must be placed in an account with an enterprise that is authorised under a regulatory regime (such as APRA in the case of Australia) to take deposits at interest. This distinguishes a deposit from a mere loan.
86. Therefore, where the enterprise accepts funds placed with it from a related party within a company group, such funds will not be considered to be 'taking deposits at interest', unless the enterprise is authorised as a depository institution. Once an enterprise is so authorised to take deposits, it is accepted that the deposits can be received from any source, including from a related party (on commercial terms).
87. This interpretation is consistent with the intent of the Convention which recognises that enterprises other than banks, such as building societies and saving and loan associations, may also raise their funds by taking deposits at interest from the public.

***The meaning of the term 'Using those funds in carrying on a business of providing finance'***

88. The Convention requires that the funds raised by debt finance or by taking deposits must be *used* to carry on a business of providing finance. This indicates that there must be a connection between the provision of finance and the raising of funds in the required manner. The requirement of *using those funds* will be satisfied where these activities are undertaken concurrently in carrying on a business.
89. The term 'providing finance' in the definition of financial institution is not qualified by stating whether this must be undertaken through debt or equity. The ordinary meaning of the term 'finance' as defined in Macquarie Dictionary is quite wide. It relevantly states:
3. to supply with means of payment; provide capital for; obtain or furnish credit for.<sup>21</sup>
90. The Commissioner considers that the non-resident may provide both debt finance and equity finance. Accordingly, the provision of finance entails the supply or provision of funds or assets with an obligation (either contingent or non-contingent) on the recipient to return the funds or assets in the future.

<sup>20</sup> *The CCH Macquarie Business Dictionary*, CCH Australia Limited, Sydney, 1993, p 168.

<sup>21</sup> *The Macquarie Dictionary*, Second Edition, The Macquarie Library, New South Wales, 1992, p 649.

91. The definition of 'providing finance' is broader than the traditional lending of funds. For example, providing cash collateral under a securities lending arrangement, the purchase of securities under a repurchase agreement (where the seller of the securities has a non-contingent obligation to repurchase them, or identical securities, at a later date at a higher price reflecting an imputed interest rate) or the purchase of redeemable preference shares would all constitute the provision of finance.

92. Furthermore, the leasing of an asset under a finance lease, or the lending of a security under a security lending arrangement may also constitute the provision of finance under the Convention where there is an obligation to return those assets or securities at a later date.

93. On the other hand, a US or UK resident share trader who may sell securities to an Australian resident would not be providing finance as there is no obligation on the recipient to return these shares. Furthermore, underwriting activities or financial advisory services, provided by an enterprise would not constitute the provision of finance as no funds or assets are provided by the enterprise.

94. It should be noted that while certain financing transactions may constitute the 'provision of finance', for the enterprise to benefit from Article 11, these financing transactions must generate payments in the form of interest under Article 11(5) of the Conventions.

95. The definition also requires the enterprise to use these funds in *carrying on a business* of providing finance. Whether an enterprise is 'carrying on a business of providing finance' is a question of fact and would need to be considered in the light of the general principles relevant to this question. The courts have held that a range of factors or indicators are relevant in determining whether a business is carried on. These factors are discussed in Taxation Ruling TR 97/11 and should be relied upon to determine whether the US or UK resident is carrying on the business of providing finance.

### ***The meaning of the term 'substantially deriving its profits'***

96. An enterprise is required to be substantially deriving its profits from carrying on a business of 'spread activities' (see paragraph 63).

97. In *Commissioner of Superannuation v. Scott* (1987) 71 ALR 408, the meaning of 'substantially' was interpreted when the Court decided whether the respondent was wholly or substantially dependent upon her husband at the time of his death. In this case, the juxtaposition of the word 'wholly' influenced the Courts' decision that:

the meaning, in relation to a person in the expression 'wholly or substantially dependent', [is] that that person is primarily, essentially or in the main dependent upon another person.<sup>22</sup>

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<sup>22</sup> (1987) 71 ALR 408 at 413.

98. In the case of *Commissioner of Taxation v. Comcorp* (1996) 70 FCR 356 at 395, the Federal Court examined the issue of whether a person substantially complied with a provision of a deed. Justice Carr decided that in this instance 'substantially' involved a degree of compliance and was used in a relative sense rather than in an absolute sense.<sup>23</sup> The meaning of 'substantially' is therefore different to what may be considered 'substantial'.

99. In considering these cases, the Commissioner is of the view that when the word 'substantially' is used in the context of an enterprise substantially deriving its profits from its 'spread activities', it is also used in a relative sense. The relevant term 'substantially' when used in conjunction with 'deriving profits', requires that the main source of the enterprise's profits be derived from its business of undertaking 'spread activities'.

100. This means that while the spread activities need not be the sole activity of the enterprise, it will need to constitute its main activity when compared to any other activity that it undertakes in terms of its contribution to the enterprise's overall profits.

101. 'Profits' in this context takes on its accounting meaning. Thus, 'profits' can be measured according to a range of acceptable accounting indicators of profits, including gross profit, net operating income or operating profit.

102. The Commissioner also recognises that the amount of profits that an enterprise generates will fluctuate from year to year. As such, the enterprise's profits should be evaluated on the same accounting basis over a reasonable period of time in relation to each business activity to ascertain whether the main source is from its 'spread activities'.

103. For example, a merchant bank that obtains its profits from both fees and from its spread activities will need to demonstrate that the profits from its spread activities are the main contributor to the enterprise's profits. It is accepted that in a particular year its spread activities may suffer a downturn in profitability. However, despite the profit result in that particular year, if its main source of profits over time is from its spread activities, it will constitute a financial institution.

104. It has been suggested that the view adopted in this Ruling may differ from that provided by the United States in their Technical Explanation.<sup>24</sup> The United States Technical Explanation notes that where investment banks, brokers and commercial finance companies obtain their funds by borrowing from the public, they will be considered to be financial institutions.<sup>25</sup>

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<sup>23</sup> 70 FCR 356 at 395.

<sup>24</sup> See discussion of the interpretative value of Technical Explanations in TR 2001/13, paragraph 125.

<sup>25</sup> Department of the Treasury Technical Explanation of the Protocol between the Government of the United States of America and the Government of Australia signed at Canberra on September 27, 2001, Amending the Convention between the United States of America and the Government of Australia with respect to taxes on income signed at Sydney on August 6, 1982, Article 7 paragraph 3.

105. The Commissioner notes that these types of entities may be classified as financial institutions where they meet the requirements of the definition. However, for this to occur, it is necessary that these entities substantially derive their profits from their spread activities.

106. Where financial institutions, resident in the US or UK, provide finance to an Australian resident through a permanent establishment in a third country, it is necessary to consider the entire activities of the US or UK resident, rather than just the activities undertaken through the permanent establishment, to determine whether it is substantially deriving its profits from its spread activities.

**PART B: additional conditions for a financial institution to meet to determine whether it will be subject to tax on its interest income arising in Australia**

***Whether the US or UK financial institution is unrelated to, and dealing wholly independently with the payer of the interest***

107. Article 11(3)(b) requires that the US or UK financial institution must be unrelated to and dealing wholly independently with the Australian payer if the interest is not to be subject to Australian tax.

108. This requirement has two elements, both of which must be satisfied. The financial institution must be unrelated to the payer, and must deal wholly independently with the payer. These elements are both undefined in the Conventions.

*Unrelated*

109. Given that the term 'unrelated' is not defined in the Conventions, it takes its meaning from the context in which it appears in the Conventions. As the term 'unrelated' is used in conjunction with the additional requirement for the financial institution to deal wholly independently with the payer, this suggests that the meaning of the term 'unrelated' is influenced by these other words in the Article. It is therefore not limited to a literal interpretation whereby even a minimal ownership interest would connote that the parties are related. Furthermore, the Explanatory Memoranda to the Conventions indicate that the intention of the Article is to align the treatment of interest paid to US and UK financial institutions with the domestic interest withholding tax exemption currently available under section 128F of the ITAA 1936.<sup>26</sup>

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<sup>26</sup> Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.131.

110. The section 128F exemption from interest withholding tax does not rely on the term 'unrelated' in determining its application. Rather, it precludes interest paid to associates pursuant to subsection 128F(6) from being subject to the withholding tax exemption. The term 'associate' is defined in subsection 128F(9) and has the meaning given by section 318, subject to certain modifications. In relation to section 318, an entity will be an associate of a company where, amongst other things, the company is 'sufficiently influenced'<sup>27</sup> by that other entity.

111. In this regard, as indicated in the Explanatory Memorandum introducing section 318, an entity will be sufficiently influenced by another entity where that entity has 'influence, because of obligation or custom, over a company or its directors to direct the actions of the company either directly or through interposed entities'.<sup>28</sup>

112. Therefore, the requirement of being 'unrelated' is contextually similar to a non-associate relationship whereby the relationship is not capable of affecting the dealings between the financial institution and the payer. Taking this factor into account, the Commissioner considers that a financial institution will be unrelated to the interest payer where, in considering the level of participation in the ownership or control of either the financial institution or the Australian payer by the other party, it can be concluded that neither party is able to exert sufficient influence over the other party. As such, this test is aligned with the approach adopted in section 128F that excludes from the exemption, debentures acquired by an associate.<sup>29</sup>

113. For example, Company A that has a portfolio interest in the shareholding of Company B (and no other means of controlling Company B) will be treated as being unrelated for the purposes of the Article 11. The ownership interest is such that Company A will not be able to sufficiently influence the activities of Company B.

114. In a similar manner, redeemable preference shares (RPS) usually contain restricted voting and profit participation rights and are often used as a form of finance, being in substance economically similar to a loan. In such cases, where the holder of the RPS ordinarily has limited power to direct the activities of the company in general meetings and no other factors exist affecting the relationship, it would be reasonable to conclude that the RPS holder does not sufficiently influence the issuing entity so that the parties are treated as being unrelated.

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<sup>27</sup> Refer subparagraph 318(1)(e)(i) of the ITAA 1936.

<sup>28</sup> Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990, p205. In addition refer to the meaning of 'sufficiently influenced' in paragraph 318(6)(b) of the ITAA 1936.

<sup>29</sup> ITAA 1936, subsections 128F(6) and 128F(9).

*Dealing wholly independently with the payer*

115. Even if the parties are unrelated to each other it is still necessary that the parties are dealing with each other wholly independently. As noted at paragraph 108, the term, 'dealing wholly independently with the payer' is undefined in the Conventions. The term, however, is used within Article 9 of both Conventions to determine whether enterprises are associated enterprises.

116. The Explanatory Memorandum for Article 9 of the UK Convention states the following:

Consistent with Australia's modern treaty practice, the inclusion of the expression 'dealing wholly independently with one another' in paragraph 1 recognises dealings on a truly independent basis as the appropriate benchmark for determining whether the transactions have taken place on normal, open market commercial terms.<sup>30</sup>

117. In determining whether a transaction has taken place on normal, open market commercial terms, an arm's length test is applied. The Commissioner is of the view that for the purposes of Article 11 it is also necessary to examine whether the Australian payer and the financial institution operate on an arm's length basis.

118. Taxation Ruling TR 2002/2 examines the meaning of 'arm's length' for the purpose of subsection 47A(7) of the ITAA 1936. Paragraph 4 of that Ruling states that:

Whether a loan satisfies the arm's length test will ultimately be determined by reference to the facts of each particular case and the outcome that might have been expected to arise between independent parties in comparable circumstances.

119. The Commissioner is of the view that Taxation Ruling TR 2002/2, in particular paragraphs 4, 23 and 24, may be relied upon to determine whether parties are acting independently with each other for the purposes of Article 11.

120. If a financial institution is unrelated to the payer of interest, but is not dealing wholly independently with the payer then the exemption from interest withholding tax will not apply. For example, if enterprises enter into two or more transactions that in total may reflect an arm's length dealing, but are not individually arm's length transactions, then the parties would not be regarded as dealing with each other wholly independently.<sup>31</sup>

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<sup>30</sup> Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.102.

<sup>31</sup> Refer to *Collis v. FCT* 96 ATC 4831; (1996) 33 ATR 438.

121. In some circumstances Australian resident entities will be borrowing from a UK or US financial institution and may also receive financial or credit support from their foreign parent entity (for example, parent guarantees in relation to the loan). In the context of the Conventions the mere existence of credit support, does not, of itself, mean that the financial institution and the Australian borrower are not dealing wholly independently with each other. Rather, having regard to the totality of the arrangement, credit support, or other forms of parent guarantees, are simply some of the factors that are taken into account in ascertaining whether the loan is one which would arise between parties dealing wholly independently with each other.

***Whether the interest is effectively connected with a permanent establishment of the beneficial owner in the country in which the interest arises***

122. The Explanatory Memorandum to the UK Convention states that:

Interest derived by a resident of one country which is paid in respect of an indebtedness which is effectively connected with a permanent establishment of that person in the other country, will form part of the business profits of that permanent establishment and be subject to the provisions of Article 7 (Business profits). Accordingly, the rate of limitation of 10% and the exemption for financial institutions do not apply to such interest in the country in which the interest is sourced.<sup>32</sup>

123. In cases where interest is paid by an Australian borrower to a permanent establishment in Australia of the financial institution, and the indebtedness in respect of which the interest is paid is effectively connected with that permanent establishment, Article 11(6) of the Conventions specifies that the provisions of Article 7 (Business Profits) will apply. This interest will be taxable in Australia.

124. However, where US or UK residents provide finance, through a permanent establishment in a third country, to an Australian resident, the interest will not be taxable in Australia, providing they meet the definition of financial institution and satisfy the other conditions in the Article 11.

125. It is important to note that the permanent establishment is not a separate legal entity but rather the fixed place of business through which the enterprise carries on its business in the other jurisdiction. Consequently, the activities undertaken through the permanent establishment are being undertaken by the US or UK resident. It is therefore necessary to consider the entire activities of the US or UK resident against the criteria in Article 11 of the Conventions, including the activities undertaken through the permanent establishment, to determine whether the resident is a financial institution and whether the interest is taxable in Australia.

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<sup>32</sup> Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.139.

***Whether the interest is paid as part of an arrangement involving 'back to back' loans***

126. Article 11(4) states that:

Notwithstanding paragraph 3, interest referred to in subparagraph (b) of that paragraph may be taxed in the State in which it arises at a rate not exceeding 10 per cent of the gross amount of the interest if the interest is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans.

127. The aim of this provision is to prevent related party and other debt being structured through a financial institution to gain access to the withholding tax exemption. Due to the range of arrangements which may arise, it will be necessary to determine whether 'back to back' loans exist on a case by case basis.

128. This intent is reflected in the Australian Explanatory Memorandum for the UK Convention which states the following:

The exemption will not be available for interest paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and structured to have a similar effect. The denial of the exemption for these back-to-back loan type arrangements is directed at preventing related party and other debt from being structured through financial institutions to gain access to a withholding tax exemption. The exemption will only be denied for interest paid on the component of a loan that is considered to be back-to-back.<sup>33</sup>

## **Examples**

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### **Banks**

#### ***Example 1***

129. Company A is a resident of the US under the US Convention. It has been granted its principal banking licence from the US Federal Depository Insurance Corporation to undertake banking activities in the US. In obtaining this licence, the company has satisfied the US capital adequacy requirements to be classified as a bank in the US.

130. As Company A, has been granted its banking licence in the US and satisfies the United States' capital adequacy requirements to operate as a bank, it is considered to be a bank for the purposes of Article 11(3)(b) of the US Convention and as a consequence is a financial institution (see paragraphs 12 and 58).

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<sup>33</sup> Explanatory Memorandum to the International Tax Agreements Amendment Bill 2003, Chapter 1: The 2003 United Kingdom Convention, paragraph 1.133.



## **Other enterprises**

### ***Example 2***

131. Company D is a resident of the UK. It raises its funds by issuing promissory notes and commercial bills to the public. It then uses these funds to provide finance leases.

132. These methods of raising funds are arrangements that are entered into that result in an effectively non-contingent obligation to provide an amount at least equal to the amount received. The issuing of promissory notes and commercial bills therefore constitute raising debt finance (see paragraphs 17 and 69).

133. A finance lease is considered to be providing finance (see paragraphs 23 and 92).

134. Company D would constitute a financial institution under the UK Convention.

## **Substantially deriving profits**

### ***Example 3***

135. Company G is a resident of the US and is a subsidiary of a parent company that is a bank. Company G conducts an insurance business and does not hold a banking licence. Over a period of three years Company G, on average, derives 90% of its profits from insurance activities and 10% from the carrying on of spread activities.

136. Company G is not a financial institution as its main business activity does not involve undertaking spread activities but rather insurance activities (see paragraphs 26 to 27 and 99 to 102). Although a subsidiary of a parent company that is a bank, Company G itself is not a bank, as defined.

### ***Example 4***

137. Over a period of three years, Company I has derived 40% of its profit from its spread activities, 30% of its profit from the provision of financial advice and 30% of its profit from underwriting activities.

138. When compared to Company I's other activities over a reasonable time, its main business is from its spread activities and, as such, it is substantially deriving its profits from its spread activities. It does not matter that the spread activities do not amount to the majority of its overall profits (see paragraphs 26 to 27 and 99 to 102).

**Permanent establishment*****Example 5***

139. Company L is a US resident and is classified as a financial institution under the US Convention and has a permanent establishment in Australia. Company L is beneficially entitled to interest that arises in Australia which relates to an indebtedness that is effectively connected to its permanent establishment in Australia.

140. Although Company L is beneficially entitled to the interest, the interest will be taxable in Australia on a net basis under the Business Profits Article (see paragraphs 32 and 123).

***Example 6***

141. Company F is a US Bank for the purposes of the US Convention and has a branch in Japan. The Japanese branch provides finance to an unrelated Australian company. The terms of the loan are considered to be at arm's length and the loan is not considered to be part of a back to back arrangement.

142. The interest paid to the Japanese branch by the Australian company will not be subject to tax in Australia as Company F is beneficially entitled to this interest and is a financial institution for purposes of the US Convention (see paragraph 124).

**Unrelated*****Example 7***

143. Company X is a resident of the UK and is a Financial Institution under the UK Convention. Company X makes a loan to its wholly owned subsidiary, Company Y, in Australia.

144. Given Company X's ownership interests in Company Y, Company X is in a position to sufficiently influence the activities of Company Y. Company X and Company Y are therefore not unrelated for the purposes of the UK Convention (see paragraphs 30 and 112). The interest paid by Company Y to Company X will be subject to tax in Australia.

***Example 8***

145. Company M is an Australian resident that borrows funds from public Company N that is a resident of the UK (and a financial institution for the purposes of the UK Convention). Company M has a small portfolio shareholding in Company N.

146. Company M's participation in Company N's ownership will not sufficiently influence the activities of Company N. It is therefore treated as being unrelated for the purpose of the UK Convention (see paragraphs 30, 112 and 113).

**Back to back arrangements****Example 9**

147. Company K is a resident of Australia and is wholly owned by Company J, a resident of the UK. Company J wishes to lend funds to Company K to assist its Australian operations. Company J decides that, rather than providing funds directly to Company K (which would be subject to withholding tax), it makes an arrangement with a financial institution in the UK to avoid interest withholding tax. The arrangement involves providing funds to the financial institution, with the financial institution in turn on-lending these funds to Company K. As a result of this arrangement, Company K pays interest to the UK financial institution.

148. The interest that the financial institution receives from Company K will not be entitled to the treaty benefit under Article 11(3) as the arrangement is considered to be 'back to back' (see paragraphs 33 and 127).

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**Commissioner of Taxation**

16 March 2005

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