


TR 2006/9 - Income tax: interest withholding tax - cross-border interbranch funds transfers within resident authorised deposit-taking institutions

 This cover sheet is provided for information only. It does not form part of *TR 2006/9 - Income tax: interest withholding tax - cross-border interbranch funds transfers within resident authorised deposit-taking institutions*



Taxation Ruling

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

Contents	Para
LEGALLY BINDING SECTION:	
What this Ruling is about	1
Ruling	8
Date of effect	34
NOT LEGALLY BINDING SECTION:	
Appendix 1:	
Explanation	35
Appendix 2:	
Detailed contents list	63

📌 This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner’s opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling addresses the withholding tax liability of a non-resident that is paid interest by an authorised deposit-taking institution (ADI) that is an Australian resident. It contains the Commissioner’s opinion on the way in which section 128B of Division 11A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) applies to interest paid to non-residents by resident ADIs. In particular, this Ruling focuses on the application of subparagraph (i) of paragraph 128B(2)(b).
2. This Ruling applies to non-residents who are paid interest by an ADI that is an Australian resident with an offshore permanent establishment (PE) for Australian taxation purposes.
3. For the purposes of this Ruling:
 - an ADI is a body corporate that has been granted a banking licence to operate a banking business in Australia under the *Banking Act 1959*; and
 - an offshore PE is a PE of the ADI in a country outside Australia at or through which the ADI carries on business.

4. This Ruling does not discuss whether there is a PE in existence.¹ Generally, a PE is a fixed place of business through which business is wholly or partly carried on.
5. This Ruling does not affect the application of any interest withholding tax (IWT) exemption available to the non-resident where the interest income of the non-resident satisfies the requirements for exemption,² or non-inclusion for interest withholding tax purposes.³
6. This Ruling does not alter the application of Taxation Ruling TR 2005/11⁴ to determine the allocation of an ADI's income, expense or profit.
7. This Ruling does not prevent the application of the general anti-avoidance provisions.⁵ They apply where a scheme is entered into or carried out for the dominant purpose that a taxpayer is not liable to pay withholding tax on an amount that they would have, or could reasonably have been expected to have, been liable to pay withholding tax on, if the scheme had not been entered into or carried out. Where an amount of tax benefit has been identified and the above requirement is satisfied, it is open to the Commissioner to determine that the taxpayer is liable to withholding tax and to take such action as is necessary to give effect to that determination.

Ruling

8. A non-resident is liable to pay income tax by way of interest withholding tax under subsection 128B(5) and subparagraph 128B(2)(b)(i) of the ITAA 1936 where interest is paid to it by a resident ADI and the interest is not wholly incurred by the ADI in carrying on business in a country outside Australia at or through an offshore PE.
9. Subsection 128B(8) determines for the purposes of subparagraph 128B(2)(b)(i) when interest is not an outgoing wholly incurred by the ADI in carrying on business in a country outside Australia at or through an offshore PE. The interest outgoing is not incurred in carrying on an overseas business if the interest is incurred in gaining or producing income or is reasonably attributable to income

¹ See Taxation Ruling TR 2002/5 Income tax: Permanent establishment - What is 'a place at or through which [a] person carries on any business' in the definition of permanent establishment in subsection 6(1) of the Income Tax Assessment Act 1936?

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

³ For example, subparagraph (ii) of paragraph 128B(3)(h) provides that section 128B does not apply to interest income derived by the non-resident in carrying on business in Australia at or through a PE of the non-resident in Australia (except interest derived by a limited partner in a VCLP or AFOF as such partner).

⁴ Taxation Ruling TR 2005/11 Income tax: branch funding for multinational banks

⁵ See Part IVA of the ITAA 1936, in particular section 177CA covering withholding tax avoidance.

derived otherwise than in carrying on business at or through the offshore PE.

10. Where funds are borrowed from a non-resident by the ADI through its offshore PE and the funds are used in the Australian business of the ADI, the interest outgoing is reasonably attributable to the head office's income. In accordance with subparagraph 128B(8)(b)(ii) the interest outgoing is not an outgoing incurred in carrying on business at or through an offshore PE. Subsection 128B(2) applies to the interest paid and subsection 128B(5) will impose an income tax liability (by way of interest withholding tax) on the non-resident.

11. However, where funds are borrowed from a non-resident by the ADI through its offshore PE for the repatriation to head office of equity in the offshore PE, no interest withholding tax liability arises, even though the source of the funds can be traced to a non-resident. For subparagraph 128B(8)(b)(ii) purposes, it is not reasonable to attribute the interest incurred to income derived otherwise than in carrying on the business of the offshore PE. Subsection 128B(2) does not apply to the interest paid to the non-resident as the associated interest outgoing is incurred by the resident ADI in carrying on business at or through its offshore PE.

12. Where the ADI, through its head office borrows from a non resident and uses the funds in carrying on business at or through an offshore PE to derive income in accordance with paragraph 128B(8)(b), provided the interest outgoing is incurred in carrying on business through a PE, then the exemption in subparagraph 128B(2)(b)(i) applies and no interest withholding tax liability arises. If the interest outgoing is incurred by the ADI in its head office operations then an interest withholding tax liability will arise under subsection 128B(5).

13. Where interest is, in part only, not an outgoing incurred by the ADI in carrying on business at or through an offshore PE, as defined in subsection 128B(8), then subsection 128B(6) operates to ensure that subsection 128B(5) only applies to that part of the interest.

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

15. Where it is not possible to trace the end use of borrowings and the income derived, because the borrowings have been placed in a pool of funds, the interest outgoing is, subject to paragraph 16 of this Ruling, reasonably attributable to income derived by that part of the ADI (for example, offshore PE or Australian head office) through which the funds were borrowed. Where the interest outgoing is so attributable to the offshore PE of the ADI, the non-resident is not liable for interest withholding tax under subsection 128B(5). Where the interest outgoing is reasonably attributable to income derived by

the ADI's Australian head office, an interest withholding tax liability arises under subsection 128B(5).

16. Where a bank raises third party borrowings through its offshore PE and:

- the funds are raised for the purpose of funding the Australian head office or a PE of the bank located in Australia;
- the funds raised by the offshore PE approximate the value of funds provided to the Australian head office or a PE of the bank located in Australia and there is a nexus⁶ between the raising and the providing of the funds; or
- funds provided to the Australian head office or a PE of the bank located in Australia, by the offshore PE are from sources other than the PE's pool of funds

the borrowings can be traced to their end use. In such circumstances, it would be reasonable to attribute the interest incurred to income derived by the ADI at or through its head office or its PE located in Australia, as required by subsection 128B(8). This means the interest incurred is treated for the purposes of subparagraph 128B(2)(b)(i) and paragraph 128B(6)(b) as not being interest incurred in carrying on a business at or through an offshore PE. In these circumstances, an interest withholding tax liability arises for the non-resident lender.

17. Where the offshore PE's excess or surplus pool of funds is on-lent to be used in the ADI's Australian business, no withholding tax liability arises for the non-resident lender because it is not reasonable to attribute any interest outgoings to income derived otherwise than through the PE, provided paragraph 16 of this Ruling is satisfied. Where the PE lends funds out of its pool including to the Australian head office and subsequently borrows from non-residents, funds to replenish its pool, no withholding tax liability would arise. Again, this is subject to paragraph 16 of this Ruling.

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

19. For interest payments made to non-residents who are residents of countries with a tax treaty with Australia, the extent of liability to Australian tax is consistent with the treatment of such interest amounts under section 128B of the ITAA 1936. That is, similar principles to those referred to in paragraphs 9 to 17 of this Ruling are found in the OECD Model Tax Convention;⁷ Article 11(5)

⁶ That is, something more than simply an approximation of funds must exist.

⁷ OECD Committee on Fiscal Affairs for the Organisation for Economic Co-operation and Development, Model Tax Convention on Income and Capital, Paris, Condensed Version 15 July 2005

(which forms the basis of equivalent provisions in Australia's tax treaties). Australia's tax treaty provisions based on Article 11(5) determine whether the interest arises in Australia and hence whether Australia is allocated a right to tax the interest under the Interest Article (usually Article 11) of the relevant tax treaty.

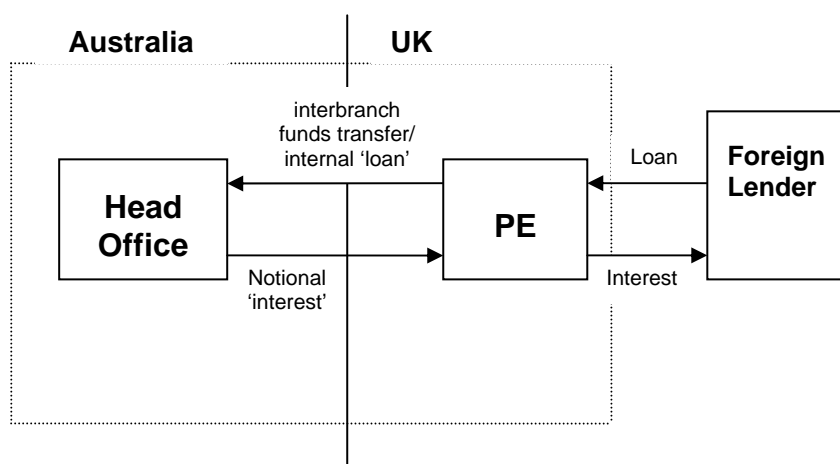
Examples⁸

Example 1 – tracing of funds possible

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

21. On 1 June 2005, Aus Bank borrows \$1 million through its PE from Foreign Lender at a rate of 6.5% payable monthly in advance for a term of 5 years. The following day, the PE transfers the funds to the head office at a slightly higher notional interest rate.⁹ The head office uses the funds in its Australian activities.

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



Interbranch funds transfer – internal 'loan'

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

⁸ In each of the following examples, it is assumed that Foreign Lender provides the loan funds other than in carrying on the business in Australia at or through a PE of the non resident in Australia (see subparagraph 128B(3)(h)(ii)).

⁹ The notional interest rate is higher as the increase reflects a reward to the UK PE for providing funds to the head office.

Foreign loan

24. The use of the funds advanced by Foreign Lender can be traced to its use by the head office of Aus Bank. The interest paid by Aus Bank to Foreign Lender is reasonably attributable to income that is derived by Aus Bank otherwise than in carrying on business at or through an offshore PE. For the purposes of subparagraph 128B(2)(b)(i) the interest is not an outgoing wholly incurred by Aus Bank in carrying on business at or through an offshore PE. Consequently, an interest withholding tax liability arises for Foreign Lender.

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

Example 2 – tracing of funds is not possible

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

27. On 2 June 2005, the UK PE transfers \$1 million to the Australian head office at an arm's length interest charge. The funds are provided out of the PE's pool of funds. The PE's pool of funds constitutes funds from numerous sources, including interest bearing loans from non-residents. Loans out of the pool of funds, including transfers to head office, cannot be traced to any particular source and paragraph 16 of this Ruling does not apply.

Interbranch funds transfer – internal 'loan'

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

Foreign loans

29. Interest payments by Aus Bank to foreign lenders on untraceable funds that originally formed part of the UK PE's pool of funds, are not reasonably attributable to income derived by Aus Bank otherwise than in carrying on a business at or through an offshore PE. For the purposes of subparagraph 128B(2)(b)(i) the interest is an outgoing wholly incurred by Aus Bank in carrying on business at or through an offshore PE. Consequently, no interest withholding tax liability arises for Foreign Lender.

Example 3 – borrowing to repatriate branch equity

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

31. On 1 June 2005, Aus Bank borrows \$1 million through its PE from Foreign Lender. The PE transfers the \$1 million to the head office. In its books of account the ADI records the \$1 million as a repatriation of branch equity of UK PE to the head office.

Interbranch funds transfer – no ‘loan’

32. The transfer of funds from the UK PE to the head office is not recorded as a loan. The head office does not record or claim any amount as ‘interest’ on the \$1m transferred. The UK PE does not record or return income on the funds transferred.

Foreign loans

33. Even though the source of the \$1m can be traced to a non-resident lender, the interest payments by Aus Bank to Foreign Lender are not reasonably attributable to income derived by Aus Bank otherwise than in carrying on business at or through the offshore PE. For the purposes of subparagraph 128B(2)(b)(i), the interest is an outgoing wholly incurred by Aus Bank in carrying on business at or through an offshore PE because the borrowing has replaced equity that was already being used in the UK PE. Consequently, no interest withholding tax liability arises for Foreign Lender. Paragraph 16 of this Ruling does not apply.

Date of effect

34. This Ruling applies from 27 September 2006. However, this Ruling does 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 before this Ruling.

Commissioner of Taxation27 September 2006

Appendix 1 – Explanation

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

General liability to interest withholding tax

35. Under Division 11A of Part III of the ITAA 1936, a non-resident is liable to interest withholding tax on certain interest income that it derives. Pursuant to subsection 128B(5) of the ITAA 1936, income tax by way of interest withholding tax is payable on interest income to which section 128B applies. One requirement for section 128B to apply to interest derived by a non-resident is that the interest must be paid to the non-resident.¹⁰

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

Interest to which section 128B of the ITAA 1936 applies

37. Interest is defined for the purposes of Division 11A in subsection 128A(1AB). It includes amounts in the nature of interest, amounts paid in substitution for interest, amounts received in exchange for interest in connection with a washing arrangement and dividends paid in respect of non-equity shares. Interest does not include an amount to the extent to which it is a return on an equity interest in a company.

38. As an ADI is a single legal entity, no interest withholding tax liability arises in respect of the interest outgoing associated with the internal transfer of funds from the PE to the head office. This is because an entity cannot in a legal sense, lend to itself.¹¹

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

¹⁰ Paragraph 128B(2)(b) of the ITAA 1936.

¹¹ *Max Factor and Co. v. FC of T* 84 ATC 4060; (1984) 15 ATR 231. In the case of foreign banks with branches in Australia, Part IIIB of the ITAA 1936 can lead to a withholding tax liability on interbranch interest because of the special deeming in Part IIIB.

40. Subsection 128B(8) provides that interest is not an outgoing incurred in carrying on business at or through an offshore PE if the interest is incurred in gaining or producing, or is reasonably attributable to, income that is or may be derived otherwise than in carrying on business at or through the PE. To the extent that an interest outgoing meets these requirements, it is subject to interest withholding tax in accordance with subparagraph 128B(2)(b)(i) and subsection 128B(5).

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

41. Subsection 128B(8) sets out when interest paid to a person by another person is not an interest outgoing incurred, by that other person, in carrying on business in a country outside Australia at or through a PE in that country. Like subsections 128B(2) and 128B(6), it refers to an interest outgoing being 'incurred'.

42. Broadly, for general income tax purposes, an interest outgoing is incurred if there is a presently existing obligation to pay the interest and interest need not be paid to be incurred.¹² However in the interest withholding tax context, paragraph 128B(8)(a) makes it clear that subsection 128B(8) only applies to interest that has been paid¹³, in which case, it is clear that the amount has been incurred by the resident ADI. Therefore, for paragraph 128B(8)(b) purposes, the key issue is not whether the interest has been incurred, but the nexus between the interest outgoing and the income derived by the ADI.

43. Paragraph 128B(8)(b) means that if an ADI has incurred interest to derive income, or interest is reasonably attributable to income, derived otherwise than in carrying on business at or through an offshore PE, then the interest is not an outgoing incurred by the ADI in carrying on business at or through an offshore PE for the purposes of subparagraph 128B(2)(b)(i) and subsection 128B(6). Interest will be treated as not being incurred in carrying on a business through an offshore PE if it can be linked to income derived by the ADI otherwise than through the offshore PE or is reasonably attributable to income derived by the ADI otherwise than through the carrying on business of the offshore PE.

¹² *Nilsen Development Laboratories Pty Ltd & Ors v. FC of T* (1981) 144 CLR 616 at 627; 81 ATC 4031 at 4037; (1981) 11 ATR 505 at 514, *FC of T v. James Flood Pty Ltd* (1953) 88 CLR 492 at 506-7, *New Zealand Flax Investments v. FC of T* (1938) 61 CLR 179, Taxation Ruling TR 94/26 and Taxation Ruling TR 97/7.

¹³ Paragraph 36 discusses when interest is paid.

44. The Explanatory Memorandum inserting subsection 128B(8) into the ITAA 1936 confirms that the location where the borrowed funds are used within the resident entity to derive income forms the basis for attributing the associated third party interest outgoing within the resident entity. The Explanatory Memorandum states¹⁴ that:

Proposed sub-section (8) contains a rule to clarify (for the purposes of sections 128B(2)(b)(i), 128B(2A)(b)(i), and 128B(6)(b)) the geographic location of interest paid by a resident who carries on business outside Australia.

...The technical background to proposed sub-section (8) is that the present law, in referring to interest being an outgoing wholly incurred in carrying on business outside Australia, may not be confined to interest that is a charge against income of that business, but could, for example, extend to cases where the general arrangements for the loan and payment of interest are made at an overseas branch, even though the interest is a charge against the income of the Australian business.

The objective of sub-section (8) is to firmly link the location of the outgoing interest with the location of the income resulting from the use of the funds. If interest paid is not incurred in gaining income of an overseas branch (e.g., the funds are used in Australia), the effect of the sub-section will be to preclude any argument that the interest was an outgoing wholly incurred in carrying on the branch business outside Australia, and thus not subject to withholding tax.

[emphasis added]

PE profit attribution rules¹⁵

45. While the above approach is required to determine the IWT liability of a non-resident, the PE profit attribution principles in Taxation Ruling TR 2005/11 remain valid for determining the income, expense and profit allocation within the resident ADI for general income tax purposes. There is no provision that limits the general meaning of 'incurred by a person in carrying on business at or through an offshore PE' for PE profit attribution purposes in a manner similar to subsection 128B(8). These two areas of tax law operate independently of each other to determine the respective tax liabilities of different taxpayers.

Tracing of funds within the ADI

46. It is appropriate, where possible to use a tracing approach to determine the nexus between the interest outlay and the derivation of income by the ADI for the purposes of section 128B. The tracing approach seeks to trace the funds used by the ADI to the income gained or produced or is reasonably attributable to such income. The associated interest outgoing may then be treated accordingly.

¹⁴ See the Introductory Note to clause 9 of the *Income Tax Assessment Bill 1974*.

¹⁵ See Division 13 of the ITAA 1936 and the business profits article (generally article 7) of Australia's international tax treaties.

47. The starting point for determining the use of the borrowed funds is to trace the funds to their end use. A rigid tracing of the borrowings is not always possible. For example, funds might be borrowed by an offshore PE and placed in its pool of funds. Where tracing is not possible, for the purposes of section 128B interest is incurred by the ADI in carrying on business at or through its offshore PE:

- where but for subsection 128B(8) the interest is incurred by the ADI in carrying on business at or through the offshore PE; and
- it is not the case, absent tracing, that the interest incurred has gained or produced income, or could be reasonably attributed to income, derived otherwise than in carrying on business through that PE.

48. Where the ADI borrows funds through its head office from a non-resident and uses the whole of those funds in carrying on business at or through a PE to derive income, the interest outgoing is reasonably attributable to that income. If the interest is also incurred in carrying on business at or through the offshore PE, subparagraph 128B(8)(b)(ii) operates to ensure the non-resident does not have a liability for interest withholding tax.

49. Conversely, where the ADI borrows funds from a non-resident through its offshore PE for purposes other than repatriation of head office equity in the offshore PE and its Australian head office uses those funds to carry on business, the interest outgoing is reasonably attributable to the gaining or producing of the income derived by the ADI at or through the head office. Regardless of where the interest expense is incurred for PE profit attribution purposes, for the purpose of subparagraph 128B(2)(b)(i) as determined by paragraph 128B(8)(b), the interest is not an outgoing incurred by the ADI in carrying on business at or through an offshore PE. In these circumstances, the non-resident has an interest withholding tax liability.

50. Where the ADI borrows through its offshore PE from a non-resident and transfers the borrowed funds to its head office as a repatriation of head office equity in the offshore PE, the interest outgoing incurred by the PE in repatriating branch equity is appropriately a charge against income of the PE, despite the fact that the source of the funds transferred from the PE to the head office can be traced to the non-resident. For subparagraph 128B(8)(b)(ii) purposes, it is not reasonable to attribute the interest incurred to income derived otherwise than in carrying on the business of the offshore PE.¹⁶ Subsection 128B(2) does not apply to the interest paid to the non-resident as the associated interest outgoing is incurred by the resident ADI in carrying on business at or through its offshore PE.

¹⁶ Taxation Ruling TR 2005/11 Part II deals with the attribution of equity capital to a PE of a bank.

51. Subsection 128B(6) 'is designed to meet the case of where interest is paid by a resident to a non-resident on moneys some of which are used in carrying on a business through a permanent establishment of the resident in another country.'¹⁷ Subsection 128B(6) ensures that for the purpose of subsection 128B(5) only that part of the interest incurred that is not an outgoing incurred in carrying on business at or through an offshore PE is subject to interest withholding tax. Subsection 128B(8) applies to determine when the part interest is not an outgoing incurred by the ADI in carrying on business at or through an offshore PE. That is, the part of the interest incurred must be incurred in deriving income, or be reasonably attributed to income, derived otherwise than in carrying on business at or through an offshore PE.

52. Where the use of the borrowed funds changes, the associated interest outgoing may no longer be interest incurred by the ADI in carrying on business at or through an offshore PE for the purposes of section 128B. For example, this may occur if the PE ceases to carry on a business for the purpose of gaining or producing income. The non-resident is liable to interest withholding tax to the extent that the associated interest outgoing:

- is no longer incurred in carrying on business at or through the offshore PE as defined in subsection 128B(8); and
- is not incurred in carrying on business at or through another offshore PE as defined in subsection 128B(8),

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

Pool of funds

53. The nature of the business of banks means that it is not ordinarily practicable or possible to trace either the source or end use of funds transferred between branches such that the entity's actual third party interest outgoing associated with those funds can be allocated between branches.¹⁸ This is because, generally, third party borrowings are placed into a pool of funds that is used to support the bank as a whole. However, where it is possible to trace funds used by parts of the entity back to their source, this forms the basis for allocating the associated interest outgoing to parts of the bank for IWT purposes.

¹⁷ Page 31 of the Explanatory Memorandum inserting subsection 128B(6) into the ITAA 1936, Income Tax Assessment Bill (No. 4) 1967.

¹⁸ Taxation Ruling TR 2005/11 paragraph 18.

54. Where a bank raises third party borrowings through its offshore PE and:

- the funds are raised for the purpose of funding the Australian operations or a PE of the bank located in Australia;
- the funds raised by the offshore PE approximate the value of funds provided to the Australian head office or a PE of the bank located in Australia and there is a nexus¹⁹ between the raising and the providing of the funds; or
- funds provided to the Australian head office or a PE of the bank located in Australia, by the offshore PE are from sources other than the PE's pool of funds

the borrowings can be traced to their end use. In such circumstances, it would be reasonable to attribute the interest incurred to income derived by the ADI at or through its head office or its PE located in Australia, as required by subsection 128B(8). This means the interest incurred is treated for the purposes of subparagraph 128B(2)(b)(i) and paragraph 128B(6)(b) as not being interest incurred in carrying on a business at or through an offshore PE. In these circumstances, an interest withholding tax liability arises for the non-resident lender.

Surpluses and replenishments

55. Where an offshore PE's excess or surplus pool of funds is on-lent to be used in the Australian head office, no withholding tax liability would arise because it is not reasonable to attribute any interest outgoings to income derived otherwise than through the PE, provided paragraph 54 of this Ruling is satisfied. For example, if the funds were borrowed with the intention of creating a surplus of funds that is to be lent to Australia then the question of IWT liability arises.

56. Where an offshore PE lends funds out of its pool including to the Australian head office and the PE subsequently borrows from non-residents, funds to replenish its pool, no withholding tax liability would arise, subject to paragraph 54 of this Ruling. For example, if a large or unusual amount is provided out of the pool and a similar amount is subsequently borrowed by the PE and there is a nexus between the amounts, the question arises whether the interest incurred is reasonably attributable to income derived otherwise than in carrying on business through the PE.

¹⁹ That is, something more than simply an approximation of funds must exist.

57. Similarly, to the extent that the use of non-resident funds borrowed by the ADI through its head office can be traced to its end use in offshore PEs of the ADI, the associated interest incurred is not reasonably attributed to income derived otherwise than by the PEs under paragraph 128B(8)(b). Provided the interest is also incurred by the ADI in carrying on business at or through the offshore PE to gain or produce income, the exemption in subparagraph 128B(2)(b)(i) will apply.

58. As discussed in paragraph 38 of this Ruling, an interest withholding tax liability does not arise in respect of notional interest charges on internal funds transfers. This includes, the Australian head office 'transferring' funds to a PE in respect of interest owing on the head office's nostro account²⁰ and interest attributed by the head office to a vostro account of a PE where it is in credit.

Non-assessable non-exempt income

59. Generally, interest income derived by a non-resident that is subject to withholding tax is excluded from assessable income under section 128D.²¹ Interest income derived by a non-resident on or after 30 June 2003 that is subject to withholding tax is non-assessable non-exempt income of the non-resident. Non-assessable non-exempt income is defined at section 6-23 of the ITAA 1997. It includes an amount of ordinary or statutory income if a provision of the ITAA 1997 or of another Commonwealth law, states that it is not assessable income and is not exempt income.²²

Tax treaty implications of interest payments made to non-residents

60. Under the Interest Article (Article 11) in the OECD Model Tax Convention (and equivalent Articles in Australia's tax treaties), the Contracting State in which interest arises may tax interest derived by a resident of the other Contracting State. OECD Model Article 11(5) (which forms the basis of equivalent provisions in Australian tax treaties) deals with the situation where the Australian payer of the interest has a PE in the treaty partner country 'in connection with which the indebtedness on which the interest is paid was incurred and the interest is borne by that PE.' In such situations, Article 11(5) (or the equivalent provision of the relevant Australian tax treaty) would deem the interest to arise in the treaty partner country in which the PE is located, thus preventing Australia from exercising a source taxing right under the Interest Article, or the equivalent provision of the relevant tax treaty.

²⁰ Subsection 128A(1) of the ITAA 1936 defines a nostro account for the purposes of Division 11A.

²¹ In some unusual cases, it is possible that interest withholding tax will not apply. In such cases, section 128D will not apply but as the income is sourced in Australia, tax by way of ordinary assessment would arise (subject to any applicable international tax treaty).

²² Section 11-55 in Subdivision 11-B of Part 1-4 of the ITAA 1997 specifically includes interest income falling within section 128D of the ITAA 1936 in the list of non-assessable non-exempt items.

61. The OECD Commentary²³ on Article 11(5) explains, at paragraphs 26 and 27, that the interest will have a source in the PE host country rather than the payer country where the interest bearing loan has an 'obvious economic link' with the offshore PE of the payer. Essentially, it explains that this will be the case where 'the loan is contracted for the requirements of the PE and the interest is borne by the PE'.

62. From the examples provided in the OECD Commentary²⁴, it is clear that what is important is whether the PE 'uses' the loaned funds for its specific purposes/requirements and the interest is ultimately borne by the PE, irrespective of whether the Head Office actually contracts for the loan or services the loan. Thus, Article 11(5) of the OECD Model (and the equivalent provisions in Australia's tax treaties) relies on a similar principle to that set out in paragraphs 9-17 of the Ruling to determine when interest is not an outgoing incurred by the ADI in carrying on business in a country outside Australia at or through an offshore PE for the purposes of subparagraph 128B(8)(b)(ii) of the ITAA 1936.

²³ Commentary on the 2005 OECD Model Tax Convention - condensed version, page 173.

²⁴ Commentary on the 2005 OECD Model Tax Convention – condensed version, page 173 – 174.

Appendix 2 – Detailed contents list

63. The following is a detailed contents list for this Ruling:

	Paragraph
What this Ruling is about	1
Ruling	8
Examples	20
<i>Example 1 – tracing of funds possible</i>	20
<i>Interbranch funds transfer – internal ‘loan’</i>	23
<i>Foreign loan</i>	24
<i>Example 2 – tracing of funds is not possible</i>	26
<i>Interbranch funds transfer – internal ‘loan’</i>	28
<i>Foreign loan</i>	29
<i>Example 3 – borrowing to repatriate branch equity</i>	30
<i>Interbranch funds transfer – no ‘loan’</i>	32
<i>Foreign loan</i>	33
Date of effect	34
Appendix 1 – Explanation	35
General liability to interest withholding tax	35
Interest to which section 128B of the ITAA 1936 applies	37
Interest outgoing not incurred in carrying on business at or through an offshore PE – subsection 128B(8) of the ITAA 1936	41
PE profit attribution rules	45
Tracing of funds within the ADI	46
<i>Pool of funds</i>	53
<i>Surpluses and replenishments</i>	55
Non-assessable non-exempt income	59
Tax treaty implications of interest payments made to non-residents	60
Appendix 2 – Detailed contents list	63

References

Previous draft:

TR 2005/D18

Related Rulings/Determinations:

TR 94/26; TR 97/7; TR 2002/5;
TR 2005/11

Subject references:

- foreign branches of Australian companies
- international tax
- non-resident interest withholding tax
- withholding taxes

Legislative references:

- TAA 1953
- ITAA 1997 6-23
- ITAA 1997 Subdiv 11-B
- ITAA 1997 11-55
- ITAA 1936 Pt III Div 11A
- ITAA 1936 128A(1)
- ITAA 1936 128A(1AB)
- ITAA 1936 128A(2)
- ITAA 1936 128B
- ITAA 1936 128B(2)
- ITAA 1936 128B(2)(b)
- ITAA 1936 128B(2)(b)(i)
- ITAA 1936 128B(2A)(b)(i)
- ITAA 1936 128B(3)(h)(ii)
- ITAA 1936 128B(5)
- ITAA 1936 128B(6)
- ITAA 1936 128B(6)(b)
- ITAA 1936 128B(8)
- ITAA 1936 128B(8)(a)

- ITAA 1936 128B(8)(b)
- ITAA 1936 128B(8)(b)(ii)
- ITAA 1936 128D
- ITAA 1936 128F
- ITAA 1936 Div 13
- ITAA 1936 Pt IIIB
- ITAA 1936 Pt IVA
- ITAA 1936 177C
- Banking Act 1959

Case references:

- FC of T v. James Flood Pty Ltd (1953) 88 CLR 492
- Max Factor and Co. v. FC of T 84 ATC 4060; (1984) 15 ATR 231
- New Zealand Flax Investments v. FC of T (1938) 61 CLR 179
- Nilsen Development Laboratories Pty Ltd & Ors v. FC of T (1981) 144 CLR 616; 81 ATC 4031; (1981) 11 ATR 505

Other references:

- Explanatory Memorandum to the Income Tax Assessment Bill 1974
- Explanatory Memorandum to the Income Tax Assessment Bill (No. 4) 1967
- OECD Committee on Fiscal Affairs for the Organisation for Co-operation and Development, Model Tax Convention on Income and Capital, Paris, Condensed Version 15 July 2005

ATO references

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