TR 2001/D13 - Income tax: taxation implications of the Century Yuasa Batteries decision

This document has been finalised by TR 2002/4.

Draft Taxation Ruling
Income tax: taxation implications of the Century Yuasa Batteries decision

Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling considers the implications of the decision of the Full Federal Court in *FCT v. Century Yuasa Batteries* 98 ATC 4380; (1998) 38 ATR 442 ("CYB"). The Full Federal Court in CYB ruled (at ATC 4384; ATR 445) that the amounts paid to a lender by a borrower under an indemnification of tax clause were "neither interest nor in the nature of interest but were an indemnity against [the lender's] liability for income tax".

2. Interest, said the Court, (at ATC 4383, ATR 444) "is the return, consideration, or compensation for the use or retention by one person of a sum of money belonging to, or owed to, another, and that interest must be referable to a principal". [1]

3. The Full Federal Court in CYB concluded that an indemnification amount paid by the borrower to the lender against the lender's liability for Australian interest withholding tax does not fit the common law description of interest (or the statutory extension as it then was). A number of taxation consequences flow from the approach adopted by the Court.

Class of persons

4. This ruling applies to all borrowers and lenders under loan contracts which contain an indemnification of tax clause where the lender is liable for interest withholding tax under subsection 128B(5) of the *Income Tax Assessment Act 1936* (ITAA 1936). References

[1] In CYB the indemnification amount was not interest even though the payment appeared (at least mathematically) to be related to the loan amount.

throughout this ruling to the lender are references to the person liable under subsection 128B(5) to interest withholding tax. References to the borrower are references to the person liable to deduct and remit amounts under Division 4 of Part VI of the ITAA 1936 or Subdivision 12-F of Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953).[2]

Class of arrangements

5. This ruling applies to amounts paid as an indemnification of tax under an indemnification of tax clause in a cross-border loan agreement or associated with a cross-border loan agreement.

Ruling

Indemnification payments are income

6. Each case will need to be examined on its particular facts. Where the lender carries on a business of lending and the loan is made in the course of the lender's business the Commissioner is of the view that indemnification amounts paid to a lender under an indemnification of tax clause will be ordinary income in the hands of the lender under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) or subsection 25(1) of the ITAA 1936. (See paragraphs 16 and 17 of this Ruling).

7. Where the loan is not made in the ordinary course of the lender's business, the indemnification amount may still be income according to ordinary concepts. This would be the case where the intention or purpose of the lender in entering into the indemnification arrangement was to make a profit or gain and the indemnification arrangement was entered into, and the profit was made, in carrying out a business-like operation or commercial transaction. (See paragraphs 18 to 22 and paragraphs 23 to 29 of this Ruling).

8. Where a treaty applies, if the payment is business income in the hands of the lender, it will be considered to be business profits for the purposes of the relevant treaty. If the indemnification amount is income but not business profits it will be considered under the other provisions of the treaty, including the Other Income article, if one exists. (See paragraphs 32 to 38 of this Ruling).

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[2] The reference to a borrower does not include intermediaries required to deduct an amount from interest, for example, under subsection 221YL(2B) of the ITAA 1936 or section 12-250 of Schedule 1 to the TAA 1953.

Source of the income

9. The circumstances of each case will determine if the indemnification amount has an Australian source. If it does have an Australian source and is income, it will be included in assessable income under paragraph 6-5(3)(a) of the ITAA 1997 or paragraph 25(1)(b) of the ITAA 1936.

10. Factors which are relevant in determining source include the place at which the contract containing the indemnification clause is negotiated and signed, where it is performed, where the indemnification payment flowing from the loan is made, the location of the funds out of which the indemnification payment is made, the event occasioning the indemnification payment (i.e., the liability to Australian withholding tax) and the residence of the payer. (See paragraphs 30 and 31 of this Ruling.)

Indemnification amount deductible

11. Assuming the indemnification amount has the necessary connection with the borrower's income earning activities, it is deductible to the borrower under section 8-1 of ITAA 1997 or subsection 51(1) of ITAA 1936. It is not a capital amount in these circumstances. (See paragraphs 39 to 47 of this Ruling.)

Refunds

12. Excess amounts of "interest withholding tax" which have been withheld in accordance with IT 2683 prior to 1 July 2000 and remitted to the ATO will be refunded where the borrower and lender make a joint application for a refund to the ATO nominating one of the parties as the person to whom the refund should be made. (See paragraphs 48 to 61 of this Ruling.)

Date of effect

13. This ruling, when finalised, will apply to years commencing both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Indemnification clauses and escalation of interest clauses

14. Payments made under clauses similar to that found in CYB are indemnification of tax payments and not interest. The indemnification clause in CYB read (at 98 ATC 4382):

> Taxes
>
> All sums by the Borrower under this Agreement shall be paid in full without set off or counterclaim and free and clear of and without any deduction or withholding for or on account of any tax. If the Borrower or any other person is required by any law or regulation to make any deduction or withholding from any payment the Borrower shall together with such payment pay an additional amount so that the Lender receives free and clear of any tax the full amount it would have received if no such deduction or withholding had been required. The Borrower shall pay to the relevant taxing authority the full amount of the deduction or other withholding…

15. Clauses which escalate interest are not indemnification of tax clauses. A clause commonly used over the years to increase the interest payable is to the following effect:

> Interest = 10/9 x (LIBOR + Interest Margin).

(See, for example, JA Dunstan "Eurocurrency Lending and Note Issue" in Austin and Vann (eds) *The Law of Public Company Finance* (Law Book Company Sydney 1986) 324 at 333.) This clause increases the interest to take account of a liability to interest withholding tax. The final amount under the formula is interest for the purposes of Division 11A of Part III of the ITAA 1936.

Not interest, but income

16. If an indemnification of tax amount is not interest, what is it? It is the view of the Commissioner that an amount paid under an indemnification of tax clause in a loan agreement may be income in the hands of the lender. A starting point for this analysis is *FCT v. Myer Emporium* 87 ATC 4363; (1987) 18 ATR 693. The High Court said (at 87 ATC 4366-4367; 18 ATR 697):

> Although it is well settled that a profit or gain made in the ordinary course of carrying on a business constitutes income, it does not follow that a profit or gain made in a transaction entered into otherwise than in the ordinary course of carrying

> on the taxpayer's business is not income. Because a business is carried on with a view to profit, a gain made in the ordinary course of carrying on the business is invested with the profit-making purpose, thereby stamping the profit with the character of income. But a gain made otherwise than in the ordinary course of carrying on the business which nevertheless arises from a transaction entered into by the taxpayer with the intention or purpose of making a profit or gain may well constitute income. Whether it does depends very much on the circumstances of the case. Generally speaking, however, it may be said that if the circumstances are such as to give rise to the inference that the taxpayer's intention or purpose in entering into the transaction was to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary judged by reference to the ordinary course of the taxpayer's business. Nor does the fact that a profit or gain is made as the result of an isolated venture or a "one-off" transaction preclude it from being properly characterised as income (*F.C.T. v. Whitfords Beach Pty Ltd* 82 ATC 4031 at pp 4036-4037, 4042; (1982) 150 CLR 355 at pp 366-7, 376). The authorities establish that a profit or gain so made will constitute income if the property generating the profit or gain was acquired in a business operation or commercial transaction for the purpose of profit-making by the means giving rise to the profit.

Ordinary business income

17. The lender will in many cases be a bank or similar financial institution in the business of making loans. Where the lender is in the business of lending and the loan is in the ordinary course of the lender's business, the indemnification amount received by the lender is ordinary business income. It is, to use the words of the High Court in Myer Emporium quoted at paragraph 16 above, " a gain made in the ordinary course of carrying on the business. [It is] invested with the profit making purpose, thereby stamping the profit with the character of income".

Extraordinary business income

18. Even where the loan is not made in the ordinary course of the lender's business, the reasoning of the High Court in *Myer Emporium* indicates that the indemnification amount may still be income in the hands of the lender. It will be necessary to look at the circumstances of each case, but the inference prima facie will be that the taxpayer's intention or purpose in requiring the borrower to indemnify the

liability of the lender to withholding tax was to make a profit or gain of the amount of that indemnification.

19. Similarly, it may be, to use the words of point (ii) of paragraph 32 of TR 92/3 in commenting on the *Myer Emporium* decision, that the indemnification amount is "a profit or gain arising from a transaction which is an ordinary incident of the business activity of the taxpayer, although not a transaction entered into directly in its main business activity…".

20. Although, as the Full Federal Court said in CYB at 98 ATC 4383, 38 ATR 445, quoting Cooper J, the judge at first instance, the "purpose of the clauses was not to enable [the lender] to earn an additional profit or return **on the loan**"[3], the purpose of the lender in requiring an indemnification of tax clause was still to make a profit or gain. As the Full Federal Court put it at 98 ATC 4383, 38 ATR 445, the purpose of the lender in CYB was, again quoting the words of Cooper J, " to ensure that the effective rate of interest earned … was not reduced by [the lender] having to pay or bear these additional costs". As Cooper J said, and the Full Federal Court agreed at 98 ATC 4384, 38 ATR 445, "the fact of their payment [i.e., of the indemnification amounts] undoubtedly enabled [the lender] to better enjoy the interest earned". It is difficult to see in these circumstances any other purpose or intention in relation to indemnification of tax clauses than one of making a profit or gain, with the quantum of the profit or gain being the amount of the indemnification.

21. In the Federal Court case of *FCT v. Cooling* (1990) 90 ATC 4472; 21 ATR 13 and the High Court decision in *FCT v. Montgomery* (1999) 99 ATC 4749; 42 ATR 475 lease incentive payments received by a firm of solicitors, although extraordinary in the context of the business, were held to be income in the hands of the solicitors. These cases support the view advanced in this part of the ruling.

22. Where the indemnification gain or profit is made as an incident of the business of the lender and is income of the lender, it will be regarded as business income even though it is extraordinary in the context of the particular business.

Non business loans

23. Where the loan is not made as an incident of business of the lender, a profit or gain made as part of an isolated venture or one-off transaction can still be income. (See *Myer Emporium*, quoted at paragraph 16 above).

24. If the loan is not made as an incident of the business of the lender, the indemnification clause may show that the intention of the

[3] Emphasis added.

lender is to make a profit or gain. According to paragraph 16 of TR 92/3 if a taxpayer not carrying on a business makes a profit, that profit is income if:

(a) the intention or purpose of the taxpayer in entering into the profit-making transaction or operation was to make a profit or gain; and

(b) the transaction or operation was entered into, and the profit was made, in carrying out a business operation or commercial transaction.

25. The profit-making transaction in this regard is the indemnification clause and the quantum of the profit or gain is the amount of the indemnification.

26. Non-business loans which contain an indemnification clause may fit within this description, depending on the facts of the case. (See *Myer Emporium,* quoted at paragraph 16 above.)

27. Another approach is based on the comments of Fullagar J in *FCT v. Dixon* (1952) 86 CLR 540. In that case the High Court held that voluntary payments made by a former employer to top up a former employee's army salary and wages were income. Fullagar J said, at CLR 567-568:

> It seems to me that the appellant's receipts from Macdonald, Hamilton & Co. must be regarded as having the character of income. They were regular periodical payments - a matter which has been regarded in the cases as having some importance in determining whether particular receipts possess the character of income or capital in the hands of the recipient, see e.g., *Seymour v. Reed* (1927) AC 554 , at p 570 and *Atkinson v. Federal Commissioner of Taxation* (1951) 84 CLR 298. This consideration, while not unimportant, is not decisive. What is, to my mind, decisive is that the expressed object and the actual effect of the payments made was to make an addition to the earnings, the undoubted income of the respondent. What the employing firm decided to do, and what it really did, in relation to the respondent and others in the same position, was "to make up the difference between their present rate of wages and the amount they will receive". What is paid is not salary or remuneration, and it is not paid in respect of or in relation to any employment of the recipient. But it is intended to be, and is in fact, a substitute for - the equivalent pro tanto of - the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily and there is not even a moral obligation to continue making the payments. It acquires the character of that for which it is substituted and that to which it is added.

28. This reasoning can also apply to indemnification of tax amounts. They are not interest. However, as the Full Federal Court in CYB recognised, at 98 ATC 4383, 38 ATR 445, adopting the words of the judge at first instance, the purpose of the indemnification and other cost covering clauses "was to ensure that the effective rate of interest earned … was not reduced by [the lender] having to pay or bear these additional costs".

29. The indemnification amount is a regular periodical payment which, in light of the Full Federal Court's comments in CYB mentioned in paragraph 28 above, can be considered as "an addition to the earnings, the undoubted income of [the lender]" as Fullagar J puts it. Adopting Fullagar J's approach outlined at paragraph 27 above the indemnification amount acquires the character of that to which it is added, i.e., it is income.

Source of indemnification income

30. Under paragraph 25(1)(b) of the ITAA 1936 and subsection 6-5(3) of the ITAA 1997 the assessable income of a non-resident includes income from sources in Australia. The source of income is a practical, hard matter of fact. It is something which a practical person would regard as the real source of income (*Nathan v. FCT* (1918) 25 CLR 183 at 189-190, per Isaacs J).[4]

31. Factors which are relevant here include the place at which the contract containing the indemnification clause is negotiated and made, where it is performed, where the indemnification payment flowing from the loan is made, the location of the funds out of which the indemnification payment is made, the event occasioning the indemnification payment (i.e., the liability to Australian withholding tax) and the residence of the payer.

Treaty considerations

32. If a tax treaty applies, a number of further issues need to be considered.

Interest

33. While the application of a Double Tax Agreement (DTA) depends on its terms and the particular circumstances of the borrower and lender, Australia's DTAs, in defining interest, refer to the meaning of interest under the domestic law of the contracting state.

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[4] See also *FCT v. Mitchum* (1965) 113 CLR 401 at 406 per Barwick CJ, Menzies and Owen JJ and *FCT v. Efstathakis* 79 ATC 4256 at 4258; (1979) 9 ATR 867 at 869 per Bowen CJ.

This means that, in terms of Australia applying the relevant DTA, interest has the meaning it has under the laws of Australia, including the common law and the definition contained in subsection 128A(1AB) of the ITAA 1936. The Federal Court decided in CYB that the common law meaning of interest and the definition of interest in subsection 128A(1AB) did not include a tax indemnification amount. Despite changes to the definition since the decision, that remains the case.

34. This means that the interest article in our DTAs will not apply to indemnification of tax payments because they are not interest. It is necessary then to look at the business profits article (normally article 7) to see if it applies.

Business profits

35. Australia will only have taxing rights over an indemnification of tax payment under a business profits article if the income is business profits, the enterprise is carrying on business in Australia at or through a permanent establishment and the profits made are attributable to that permanent establishment.

36. Where the indemnification amount is business income,[5] the Commissioner's view is that that income is business profits for the purposes of our treaties. However even if the indemnification amount is business profits within the relevant article, there still needs to be a PE in Australia at or through which the enterprise carries on business before the provision can operate. In CYB the indemnification payment was made to a resident of a treaty country through an intermediary Australian bank. The non-resident lender did not have a PE in Australia (indicated by the fact that the interest was subject to IWT) so that Australia could not have taxing rights in those circumstances over any indemnification payment under the relevant business profits article.

37. If the lender is not a resident of a treaty country the indemnification amount, if it is assessable income, will be included in the assessable income of the lender under subsection 25(1) of the ITAA 1936 or section 6-5 of the ITAA 1997 where the indemnification income has a source in Australia.

Section 255

38. Where Australia does have taxing rights over an indemnification amount, section 255 of the ITAA 1936 applies to the

[5] See Paragraphs 16 and 17, and 18 to 22 of this Ruling.

indemnification income. The Commissioner will follow IT 2544 in this regard.

Deductibility

39. Is the indemnification amount paid by the borrower to the lender deductible under section 8-1 of the ITAA 1997 or subsection 51(1) of the ITAA 1936?

40. In the ordinary case where the borrowed funds are used for business purposes by the Australian borrower the interest will be deductible under the first or second limb of section 8-1 of the ITAA 1997 or subsection 51(1) of the ITAA 1936 and the indemnification amount will likewise be deductible unless it is properly regarded as a payment of capital.

41. The classic decisions on the distinction between capital and income are well known. (See for example Dixon J's judgement in *Sun Newspapers v. FCT* (1938) 61 CLR 337 at 363, the High Court decision in *G P International Pipe Coaters v. FCT* (1990) 170 CLR 124 at 137; 90 ATC 4413 at 4419; 21 ATR 1 at 7, and the Full Federal Court decision in *FCT v. Email* (1999) 99 ATC 4868 at 4873; 42 ATR 698 at 704). It is clear that it is the character of the advantage sought which provides the best guidance as to the nature of the expenditure because it tells us most about the essential character of the expenditure itself.

42. The payment of the indemnification amount is an additional payment made by the borrower for the use of the money for the relevant period. In respect of each period of the loan the amount of interest originally contracted for is payable, and the indemnification amount is payable, and both those represent the cost to the borrower of the use of the money for that period. The character of the advantage sought is the use of the money for that interest period, typically three or six months. The payment is repeated each quarter or half year during the course of the loan as the cost to the borrower of obtaining the use of the money in its business in each of those periods. Therefore, according to the *Sun Newspapers* description, the advantage has no lasting qualities, and the use of the money is secured by a periodical outlay to cover its use and enjoyment for periods commensurate with the payment. The character of the advantage sought is simply the use of the money for the interest period.

43. The Full High Court in *Steele v. DC of T* (1999) 99 ATC 4242; 41 ATR 139 considered the nature of interest. The Court said, at ATC 4248; ATR 148, that:

> ... interest is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but, rather, the use of borrowed money during the term of the loan. According to the criteria noted by Dixon J in *Sun Newspapers Ltd and*

Associated Newspapers Ltd v. FC of T it is therefore ordinarily a revenue item.

44. The Commissioner views indemnification payments to be similar to interest outgoings by a borrower in that they are periodic payments made by the borrower to secure the use of the borrowed money during the term of the loan. The payment of an indemnification amount is therefore a payment of a revenue nature. In addition the payments are contingent on the imposition of IWT. This contingency further supports the view that the payments are on revenue account.

Alternative View

45. An argument has been made that the payment by the borrower of an indemnification amount is capital in nature and thus should be dealt with under section 25-25 of the ITAA 1997 or section 67 of the ITAA 1936. These arguments are based on comments in CYB (1998) 98 ATC 4380 at 4383-4384; 38 ATR 442 at 445 where the Full Federal Court agreed with Cooper J, the judge at first instance, that "the additional payments were a cost to the applicant of obtaining the use of the funds". This is not the same as the cost of obtaining the loan. The Commissioner takes the view that the indemnification amount is a price for the use of the funds and not an amount paid for the purpose of obtaining the loan.

46. Statements in the judgment of Deane and Sheppard JJ in *Ure v. FCT* (1981) 81 ATC 4100 at 4112-4113; 11 ATR 484 at 496-499 could also arguably support the capital payment approach. However *Ure* dealt with guarantee fees which enabled the applicant to obtain the loan. As CYB makes clear indemnification amounts are for obtaining the use of the loan, not the loan. *Ure* therefore does not apply.

47. For the reasons outlined above the indemnification amounts payable under an indemnity of the type the subject of the decision in CYB are, where one of the positive limbs of section 8-1 of the ITAA 1997 or subsection 51(1) of the ITAA 1936 has been satisfied, deductible under those provisions, as the case may be. They are not outgoings of capital or of a capital nature.

Refunds

48. If, pre-3 May 2000,[6] a borrower has followed IT 2683, and there is an indemnification of tax clause, then the borrower has deducted and remitted an excess amount of "IWT" to the ATO. The

[6] IT 2683 was withdrawn on 2 May 2000.

excess will be 1/10th of the amount deducted and remitted by the Australian company in accordance with IT 2683. IT 2683 came into effect on 21 May 1992. It adopted the following gross-up formula:

IWT = 10% of 10/9 x [interest payment].

49. IT 2683 is based on the view that an indemnification of IWT is itself interest. Following CYB it is accepted that this is incorrect and the formula therefore does not apply in relation to an indemnification of tax payment under an indemnification of tax clause in a loan agreement.

50. Australian borrowers have requested refunds of the excess amount of "IWT" deducted and remitted. If the amount is in fact an indemnification of tax paid under an indemnification of tax clause and the formula in IT 2683 was used, there are differing views as to whether the borrower or the lender is entitled to a refund.

Is it the lender who is entitled to a refund?

51. For payments made prior to 1 July 2000 the main refund provisions are found in sections 221YS and 221YT of the ITAA 1936. In relation to such payments made under IT 2683, sections 221YS and 221YT arguably operate to give a credit to the lender for the amount deducted by the borrower. It should be noted that under section 221YT and/or the *Taxation Administration Act 1953* the Commissioner can apply that credit in discharge of any tax liability of the lender to the Commonwealth.

52. Section 221YS was the gateway provision into the application of withholding tax credits. It gave a credit to a person whose income included interest from which a deduction had been made or purported to have been made. The amount of the credit corresponded to the amount of the deduction borne by the person. One view is that a lender receiving an indemnification of IWT payment satisfies these requirements.

53. First, the lender has interest income from which a deduction has purported to have been made where the borrower has followed IT 2683. Secondly arguably the phrase "the deduction borne by that person" in the section refers to the legal liabilityto interest withholding tax of the lender.

54. Further, the Explanatory Memorandum on the *Income Tax Assessment Act (No 4) 1967* (which introduced these provisions) says:

> Although a non-resident will not receive a notice of assessment for withholding tax, he will be entitled under section 221YS of the Principal Act to a credit for the tax withheld from dividends or interest. If he considers the amount withheld to be in excess of the withholding tax imposed by the law, it will

be open to him, under section 221YT of the Principal Act, to take action, if necessary, in the courts for the allowance of the appropriate credit and the making of a refund.

55. For these reasons it is argued that where there is an excess of payments made in accordance with IT 2683 and of credits under section 221YS, the person who is entitled to the credit – the lender – is entitled to a refund of the excess (after offsetting where appropriate against other tax liabilities).

56. It should be noted that Cooper J at first instance in CYB ((1997) 97 ATC 4299 at 4316; 35 ATR 394 at 412) rejected the borrower's claim for a refund of the total or part of the IWT and penalties in dispute (including an amount paid under IT 2683) where the only ground offered in support of the refund request was section 5 of the *Administrative Decisions (Judicial Review) Act 1977*.

57. In addition it is argued, based on the comments in the Explanatory Memorandum set out at paragraph 54, that sections 221YS and 221YT comprise an exhaustive and exclusive withholding tax refund regime which extinguishes any common law rights which may have existed. (See for example *Chippendale Printing Company Pty Ltd v. FCT* 96 ATC 4175; (1996) 32 ATR 128.) If these sections do form a comprehensive statutory refund regime, because there is no legislative ability for the ATO to pay interest on the excess IWT amounts refunded, no interest is payable. (See *Chippendale Printing Company Pty Ltd v. FCT* per Sheppard J at 96 ATC 4176; 32 ATR 129.)

Alternative View

58. An alternative view is that, in relation to the indemnification amount, no credit for the lender arises under subsection 221YS because the indemnification amount is not interest and that in any event the indemnification clause means that it is the borrower who bears the deduction. This means there is no debt due and payable to the lender by the Commissioner.

59. This alternative view then argues that sections 221YS and 221YT are not a complete statutory code for refunds. The borrower could possibly in those circumstances have a common law right to a refund from the Commonwealth.

Doubts

60. Because of the doubts about who if anyone is entitled to a refund in these circumstances, and until that doubt is resolved by judicial decision, borrowers and lenders may make joint refund applications to the ATO nominating one of the parties as the person to

whom the refund should be made. As part of the refund process in these circumstances the parties involved will be required to enter into a binding release in which they agree not to pursue further action against the Commonwealth or the Commissioner in relation to any excess amount if a refund is made to one of the parties as a result of a joint application. Before any refund is made the Commissioner will examine the circumstances to see if the non-resident lender has any liability to Australian tax (including an income tax liability that may arise in relation to the indemnification amount) and whether the excess IWT can be used as a credit against that liability. If a liability to Australian tax on the indemnification amount does exist, then unless shown otherwise, the Commissioner will assess the lender to tax on the indemnification amount equivalent to the amount of the credit. In those circumstances no amount will be available for refund. Where a refund is made (because Australia does not have taxing rights over the indemnification amount) the Commissioner will advise the Australian borrower that if they receive any amount of the refund either directly (e.g., through the refund process) or indirectly (e.g., from the lender under the loan agreement) it should be included in their assessable income.[7]

61. Given that IT 2683 was withdrawn on 3 May 2000, it is unlikely borrowers with indemnification of tax clauses would follow that ruling and withhold excess amounts after that date. If in fact that does occur after 30 June 2000, the person concerned should contact the ATO to discuss the issue.

Interest on overpayments

62. Nothing in the *Taxation (Interest on Overpayments and Early Payments) Act 1953* allows the payment of interest on the refund of excess IWT.

Examples

Example 1

63. HK Company is a resident of Hong Kong. It is in the business of lending. It does not have a permanent establishment in Australia. On 1 July as part of its lending business it lends an amount of $1m to Ausco, an Australian resident company. Interest is 7.5%, payable

[7] See the High Court decision of *H.R. Sinclair & Son Pty Ltd v. FCT* (1966) 114 CLR 5370 and the Federal Court decision of *Warner Music Australia Pty Ltd v. FCT* 96 ATC 5046; (1996) 34 ATR 171. See also Division 20 of the ITAA 1997. It should also be kept in mind that the relevant State or Territory Statute of Limitations would need to be examined to determine their application in the circumstances of each refund application.

annually. The loan agreement contains an indemnification of tax clause similar to that in paragraph 14.

64. On 30 June Ausco pays HK Company $75,000. That payment is made up of two amounts - $67,500, being net interest after deduction of 10% IWT and an indemnification of IWT amount being $7,500.

65. This $7,500 indemnification amount is income in the hands of the lender. This means the indemnification amount will be included in assessable income in accordance with paragraph 25(1)(b) of the ITAA 1936 or paragraph 6-5(3)(a) of the ITAA 1997 where its source is Australia.

Example 2

66. Ausco borrows from Usco the same amount at the same rate as mentioned in example 1. Usco is a resident of the United States and does not have a PE in Australia. Usco is not in the business of lending, but has excess short-term cash reserves from its business activities. The loan contains an indemnification of tax clause.

67. The amount of the indemnification payment is $7,500. This amount will be income in the hands of Usco because it arises from a transaction entered into by Usco with the intention or purpose of making a profit or gain. The fact that Usco requires Ausco to agree to an indemnification of tax clause indicates on its face an intention or purpose on the part of Usco to make a profit or gain of the amount of the indemnification.

68. Further it is the Commissioner's view that the indemnification amount in these circumstances is business profits and falls for consideration under article 7 of the US DTA (see paragraphs 18-22 above). Because Usco does not have a permanent establishment in Australia, Australia does not have taxing rights under the treaty over the indemnification amount.

Detailed contents list

69. Below is a detailed contents list for this draft Ruling:

Your comments

70. If you wish to comment on this draft Ruling, please send your comments promptly by **30 November 2001** to

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Commissioner of Taxation
17 October 2001

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
IT 2544; TR 92/20; TR 92/3

Subject references:
- interest
- interest withholding tax
- income
- deductions
- permanent establishment
- business profits

Legislative references:
- *Administrative Decisions (Judicial Review) Act 1977* 5
- ITAA 1936 25(1)
- ITAA 1936 25(1)(b)
- ITAA 1936 51(1)
- ITAA 1936 67
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- ITAA 1936 128A(1AB)
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ISSN: 1039-0731