


TR 2006/D3 - Income tax: withholding on payments to foreign residents for works and related activities

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Draft Taxation Ruling

Income tax: withholding on payments to foreign residents for works and related activities

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① This Ruling provides you with the following level of protection:

This publication is a draft for industry and professional comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation 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.

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What this Ruling is about

1. This Ruling considers what constitutes a 'payment under a contract for works or related activities' for the purpose of Regulation 44C of Taxation Administration Regulations 1976 (TAR 1976).
2. Sections 12-315 and 12-317 of Subdivision 12-FB – 'Payments to foreign residents etc' of Part 2-5 of Schedule 1 to the *Taxation Administration Act 1953* (TAA) impose an obligation on certain payers to withhold an amount from certain payments made to foreign entities or received for foreign entities (called 'payees' in this Ruling). This Ruling provides guidance as to when an obligation to withhold an amount arises under sections 12-315 and 12-317.
3. This Ruling is only concerned with payments to which sections 12-315 and 12-317 of Schedule 1 to the TAA apply. In this Ruling a reference to sections 12-315 and 12-317 is a reference to those sections in the TAA.

Ruling

4. For the purpose of paragraph 12-315(1)(b) a prescribed payment pursuant to regulation 44C of the TAR 1976, is a payment made under a contract entered into after 30 June 2004 for works or related activities.

How to determine if a contract is one for works or related activities

5. A contract for works, takes on its ordinary meaning as understood in the construction, infrastructure and resource sectors and specifically includes contracts for the construction, installation and upgrading of buildings, plant and fixtures. A contract for related activities includes any activities associated with the works including activities associated with the construction, installation and upgrading of buildings plant and fixtures whether or not provided by the same contractor who performs the contract for works.
6. Regulation 44C of the TAR 1976 requires a contract to be characterised as one for works or related activities, rather than as one for something else (such as the acquisition of goods), in order for a payment under the contract to be subject to Foreign Resident Withholding (FRW).
7. Where a contract is exclusively for works or related activities, the contract will clearly be one falling within regulation 44C of the TAR 1976. However, where a contract provides for the payee to provide both works/related activities and something else (such as to supply goods), it will be more difficult to characterise the contract. This will require an examination of all the things to be done under the contract to determine if its essential character is for works or related activities. Whilst value is an important factor in characterising a contract the question is whether there is in substance a contract which produces an outcome of a works nature. If any works or related activities to be provided by the payee under the contract are merely incidental to other things to be provided under that contract, it will not be one covered by regulation 44C.
8. An amount of 5% from each payment made under a contract for works or related activities is to be withheld pursuant to subregulation 44C(2) of the TAR 1976.

Variations to the withholding rate

9. The Commissioner will grant a variation to the withholding rate, including to nil, where in the Commissioner's view the foreign entity is not required to pay tax in Australia through the operation of a tax treaty or where the tax on the expected profits is less than the amount of withholding. The Commissioner may also grant the foreign entity an exemption for the purposes of paragraphs 12-315(1)(d) and 12-317(1)(d) of the TAA where the foreign entity has established a history of compliance with its obligations under Australian taxation laws and in the Commissioner's opinion the entity will continue to comply with those obligations.
10. The Commissioner may also in special circumstances vary the amount required to be withheld from a class of payments, including varying that amount to nil, section 15-15 of the TAA.

11. The following are examples of some of the activities that fall within the scope of the legislation.

Example 1 – chimney construction

12. Chimeree Ltd a foreign resident chimney construction expert is contracted by Bricked Ltd, to demolish an industrial chimney and construct a new one at Bricked's premises in Australia. Chimeree is required to supply all the necessary goods, equipment and personnel to carry out the contracted work. The total value of the contract is \$3 million with construction over a period of 4 months.

13. Entities are required to withhold from prescribed payments made to foreign residents. Bricked is making a payment to Chimeree, a foreign resident. Payments under contracts for works and related activities are prescribed by subregulation 44C(1) of the TAR 1976. The demolition and construction of the chimney is a contract for works within the meaning of 'works' in subregulation 44C(3). Therefore all payments by Bricked under the contract are subject to a 5% rate of withholding.

Example 2 – pipeline installation

14. Drillco an Australian resident is developing an off shore oil and gas reserve. It has installed a platform and is connecting the wellhead to onshore receivable facilities. Drillco contracts a foreign resident, SeaSub to supply remote operated submarines, diving equipment and related services to monitor and assist Pipes R-U's (an Australian resident) who is laying the pipeline on the sea bed. SeaSub supplies the equipment under one contract for \$5 million and personnel under another contract for \$7.9 million.

15. The pipeline construction is works as defined and assistance with and monitoring of that construction is a related activity. Consequently all payments made under both contracts, for \$5 million and \$7.9 million, are a prescribed payment and therefore subject to 5% withholding.

Example 3 – smelter construction

16. MineCo has decided to undertake down stream processing of its ore. It contracts with an Australian project manager SmelCo to construct a smelter. The contract requires separate payments for goods, equipment, construction and commissioning. SmelCo enters into a contract to purchase a furnace from a German supplier – a purchase of goods. SmelCo then imports and installs the furnace into the works.

17. The smelter construction is works as defined at regulation 44C of the TAR 1976 and the purchase of goods is part of those works. However, the payment by MineCo is to an Australian Resident and therefore no withholding obligation arises under section 12-315 of the TAA.

18. Note – the payment by SmelCo to the foreign resident for the mere supply of the furnace in the way described above is not made under a contract for works. It is a contract between the two entities for the purchase of goods or equipment and is therefore not a prescribed payment. SmelCo, an Australian resident, undertakes the installation of the furnace.

Example 4 – acquisition of major equipment with foreign involvement

19. MillCo a resident company contracts with an Indian firm to supply a brake press for their metal fabrication business. The contract is for one inclusive amount of \$500,000. The brake press is shipped in 3 modules which are assembled on site by MillCo. The Indian firm provides two technical specialists who travel to Australia to supervise the installation and commissioning of the equipment. They provide technical advice where needed. The two specialists spend four weeks on site before returning home.

20. The contract is to acquire goods in an undissected contract with incidental assembly and assistance in installation. As it is not a works contract there is no withholding obligation.

Example 5 – upgraded maintenance facilities

21. OreCo is upgrading its mine site maintenance facility for its dump trucks. A new computer diagnostic unit for engines is purchased and imported from an American supplier. As part of the \$600,000 purchase price the American supplier sends an employee to OreCo's premises for 1 week to supervise the installation and commissioning of the diagnostic unit.

22. The supervision of the installation of the diagnostic unit is minor and incidental to the purchase of goods. The supervision of the installation by the American supplier does not change the character of the contract. The contract is not for works or related activities and therefore no withholding obligations apply.

Example 6 – dragline installation with foreign involvement and variation of withholding rate

23. BauxCo is expanding its ore stock pile facilities. It purchases from Draggers Co, an American firm, a new 300 tonne dragline to be supplied and commissioned for \$5 million. The contract stipulates that \$1.5 million is for the erection and installation of the Dragline in Australia with the machine costing \$3.5 million. The dragline, due to its scale and nature, is shipped to Australia as several separate pieces. On arrival the dragline is assembled and commissioned by Draggers using local labour and equipment.

24. The contract for \$5 million is a contract for works and related activities because its essential character is for the assembly and commissioning of the dragline. Therefore all payments under the contract to the foreign resident Draggers are prescribed payments and would be subject to withholding at 5% (\$5 million @ 5% = \$250,000).

25. During the tendering process prior to being engaged by BauxCo, Draggers Co determines that its taxable income on the project will be \$500,000. The withholding amount of \$250,000 for the contract will exceed the estimated tax liability of Draggers Pty Ltd for the project by \$100,000, that is, the corporate tax rate of 30% is applied to the taxable income of \$500,000 resulting in \$150,000 tax payable. Draggers Co could apply to the Tax Office during the tendering period for a variation of the withholding rate to 3%. Alternatively Draggers Co, after lodgement of an Australian income tax return, would receive a refund of any excess amounts withheld.

Example 7 – fit out of aero bridges

26. Tarmac Ltd is constructing aero bridges at its new international terminal in Alice Springs. Tarmac contracts with a French design company LessEstMore Ltd (LEM) to purchase and install the interior fit out of the aerobridges. The fit out components are to be shipped in containers and installed over a period of 16 months on site. LEM have senior technicians with specialised knowledge who have an office on site which is equipped with machinery to modify and fabricate the fit out modules as required.

27. The contract is a contract for works and related activities and consequently all payments under the contract are prescribed and a withholding amount of 5% of each payment is required. However, LEM asks Tarmac Ltd to apply to the tax office for a variation to a nil withholding amount on the basis that there is not a permanent establishment in Australia and therefore any profit is taxable in France. The tax office refuses the variation request, on the basis that a permanent establishment exists in Australia and as a result Australia can tax the profits.

Example 8 – road design

28. RoadCo Ltd is constructing a new highway to the resort NoWhere for \$250 million. RoadCo engages RevHead Ltd, an Australian firm, to supply the engineering design and supervision work for \$12 million. RevHead sub contracts a German firm SpeedierCo to design the bridging works for the highway for \$3 million. Employees of SpeedierCo come to Australia and inspect the site and return to Germany. The employees return at regular intervals for short periods to Australia to confirm testing of soils and other design parameters. However all the plans and drawings are produced in Germany and then transmitted to RevHead.

29. The bridging design work provided by SpeedierCo is a contract for related activities. Therefore the payment of \$3 million to the foreign resident SpeedierCo is subject to a withholding amount of 5% of \$3 million. SpeedierCo requests a variation to nil on the basis that there are no business profits or other activity which would give rise to taxation in Australia. RevHead offers to lodge a request for variation to a Nil withholding amount on SpeedierCo's behalf. On the basis of the particular circumstances of SpeedierCo, the Tax Office agrees and issues a notice varying the amount required to be withheld to Nil.

Example 9 – exploration activities

30. JumpOnCo (JOC) is an Australian gold explorer which holds exploration licences. JOC contracts with a foreign resident, Sensor to conduct flights to collect and analyse electronic data recorded over the exploration areas. There is no withholding obligation as Sensor's activities are not works or related activities.

31. JOC believes from the exploration analysis that a mine is viable. JOC contracts with a South African firm to supply and install a sampling mill and ablution buildings to the mine site. The site development work is works. Payments made under the contract to the South African firm are prescribed payments and subject to withholding.

Date of effect

32. This draft Ruling represents the preliminary, though considered, view of the Australian Taxation Office. This draft may not be relied upon by taxpayers or practitioners. When the final Ruling is released, it will explain the Commissioner's view of the law as it applies for contracts entered into after 30 June 2004.

Commissioner of Taxation

15 March 2006

Appendix 1 – Explanation

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

Legislative Background

33. Part 2-5 in Schedule 1 to the TAA sets out the Pay As You Go (PAYG) withholding provisions. The PAYG withholding provisions are a way for tax to be collected throughout the year as income is earned. The PAYG provisions impose an obligation to withhold, but do not impose or determine liability to income tax. Amounts withheld are remitted by the payer for credit against the payee's tax liability for the year of income. The credits are applied against the payee's tax liability and any excess is refunded in accordance with Division 3 Part IIB of the TAA.

34. A variation to the amount required to be withheld is provided for under section 15-15 of Schedule 1 to the TAA. The Commissioner of Taxation may vary the amount required to be withheld including to nil in a particular case or class of cases to meet the special circumstances of taxpayers. These special circumstances will include where there are no taxing rights over the payment.

35. The Review of Business Taxation (Ralph Review) concluded that there are high levels of non-compliance with Australian income tax obligations by foreign residents who do not have a permanent presence in Australia. The Ralph Review recommended the introduction of a withholding regime for foreign residents.

36. The regime is a compliance mechanism which broadly aims to ensure that the withheld monies approximate the tax liability of the payee. In the event that an entity fails to lodge a tax return the revenue is protected by the amount of the withholding. The payee's obligations to lodge a tax return for the year of income are not negated by the PAYG withholding measures.

Explanation

37. The PAYG withholding provisions are found in Part 2-5 of Schedule 1 to the TAA. The provisions set out a broad framework of obligations on payers to withhold in respect of particular payments or transactions. Various provisions create the obligation on an entity to withhold from payments made by the entity by reference to payments. The provisions also define the scope of the withholding arrangements including the remitting and reporting obligations of the payer.

38. The withholding obligation is separate from the liability to taxation and relies on an objective test of whether a payment meets the tests described in Part 2-5 of Schedule 1. A summary of all the withholding payments is found in section 10-5 of Schedule 1 to the TAA. The FRW provisions are listed in the table in subsection 10-5(1) at items 22B and 22C and are found in Subdivision 12-FB of Schedule 1 to the TAA.

39. In accordance with section 12-5 of Schedule 1 to the TAA, if more than one provision in the table in subsection 10-5(1) applies to a payment, only one amount is to be withheld from the payment. Generally the most specific provision to the circumstances of the payment will apply. However, pursuant to subsection 12-5(3), FRW does not apply if the payment or transaction is caught by another withholding provision specified in the table in subsection 10-5(1). In other words apply the FRW provisions if the payment is not caught by any other withholding specified in the table.

Obligation to withhold

40. The obligation to withhold an amount from a payment is imposed by sections 12-315 and 12-317 of Schedule 1 to the TAA. In accordance with subsections 12-315(1) and (2):

- (1) An entity (the **payer**) that *carries on an *enterprise must withhold an amount from a payment it makes to another entity, or to other entities jointly, in the course or furtherance of the enterprise if:
 - (a) the entity receiving the payment, or any of the entities receiving the payment, is an entity covered by subsection (2); and
 - (b) the payment is of a kind set out in the regulations; and
 - (c) the payment is not:
 - (i) a *dividend of a company; or
 - (ii) interest (within the meaning of Division 11A of Part III of the *Income Tax Assessment Act 1936*); or
 - (iii) a *royalty; or
 - (iv) a departing Australia superannuation payment (within the meaning of Subdivision AA of Division 2 of Part III of the *Income Tax Assessment Act 1936*); or
 - (v) a payment worked out wholly or partly by reference to the value or quantity of *natural resources produced or recovered in Australia; or
 - (vi) a *mining payment; and
 - (d) the entity receiving the payment is not covered by an exemption in force under subsection 12-319(1), or at least one of the entities receiving the payment is not covered by an exemption in force under that subsection.

- (2) An entity is covered by this subsection if any of the following conditions is satisfied:
- (a) the entity is a foreign resident;
 - (b) the payer believes, or has reasonable grounds to believe, that the entity is a foreign resident;
 - (c) the payer has no reasonable grounds to believe that the entity is an Australian resident, and either:
 - (i) the entity has an address outside Australia (according to any record that is in the payer's possession, or is kept or maintained on the payer's behalf, about the transaction to which the payment relates); or
 - (ii) the payer is authorised to make the payment at a place outside Australia (whether to the entity or to anyone else);
 - (d) the entity has a connection outside Australia of a kind set out in the regulations.

41. Broadly then, an entity carrying on an enterprise must withhold on a payment when it is made to a foreign resident and the payment is of a kind set out in the regulations. Withholding is not required under the foreign resident withholding provisions on payments which are dividends, interest, royalties, departing superannuation payments, payments calculated on the value or quantity of natural resources, mining payments. These types of payments are subject to withholding under other provisions. An entity receiving the payment may also be covered by an exemption from withholding given by the Commissioner.

42. It should also be noted that the PAYG withholding provisions provide the administrative framework for the FRW provisions. For example, a payer is required to issue a payment summary to payees and report amounts withheld on the activity statement, pursuant to sections 16-155 and 16-150 respectively of Schedule 1 to the TAA. Further a withholding entity must apply to register with the Commissioner when the entity is first required to withhold an amount from a payment pursuant to section 16-140 of Schedule 1 to the TAA.

Foreign resident

43. Foreign resident is defined in section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). This definition applies to Schedule 1 of the TAA by virtue of section 3AA of the TAA.

foreign resident means a person who is not a resident of Australia for the purposes of the *Income Tax Assessment Act 1936*.

44. The question of who is a resident is dealt with extensively in other tax rulings such as TR 98 /17, IT 2615, IT 2650, and IT 2681. Where the entity receiving the payment is known by the payer to be a foreign resident the payer must withhold an amount from certain payments. The payer must also withhold on certain payments if:

- the payer believes or has reasonable grounds to believe that the entity is a foreign resident;
- the payer has no reasonable grounds to believe that the entity is an Australian resident and the entity has an address outside Australia according to any record in the payer's possession or the transaction or the payment is authorised to be made to a place outside Australia; or
- the entity has a prescribed connection outside Australia.

45. The question of what factors would give rise to a belief that an entity was a foreign resident are objective. If the payer believes that the payee is a foreign resident, then an obligation to withhold arises. Associated with this test is a purposive and positive test of whether the payer has facts which would reasonably give rise to a belief that the payer was a foreign resident. This second limb of the test negates the argument that a lack of complete certainty about the residency status of a payee relieves the payer from a withholding obligation.

46. Guidance on evidence which would go to establishing that a payer has reasonable grounds to form an opinion that a person is a foreign resident will depend on the facts of the case. Relevant factors could be place of formation, representations and warranties given by the payee, the origin of correspondence, location of contract signing, industry knowledge, reports, public commentary, accounts, professional advice and other matters peculiar to the arrangement.

Contract for works or related activities – a characterisation test

47. The use of the language '*contract for works or related activities*' (emphasis added) in subregulation 44C(1) of the TAR 1976 indicates that the test so created is a characterisation test. It indicates that a payment will not be covered by regulation 44C merely because it is made under a contract that includes the provision of some works or related activities – the regulation does not talk about a contract 'wholly or partly' for works or related activities.

48. Equally, the provision of any things under a contract that are not works or related activities does not mean the contract is not one for works or related activities – the regulation does not talk about a contract 'exclusively' for works or related activities.

49. To characterise a contract as one for works, it will be necessary to examine the range of obligations created by the contract to determine its essential character. As a practical matter, a contract will not be one for works or related activities if the works and/or related activities are merely incidental to the provision of something else under the contract. The examples in the 'Examples' section of this Ruling illustrate this test.

Payment of a kind set out in the Regulations

50. For the purposes of paragraph 12-315(1)(b) of Schedule 1 to the TAA an obligation to withhold arises on a payment set out in regulation 44C of the TAR 1976. Regulation 44C prescribes payments that are made under contracts, entered into after 30 June 2004, for works or related activities.

51. The term payment means the total or gross (GST inclusive) amount paid under a contract irrespective of whether it is paid by conventional means for example, cash, cheque, transfer, setting off an account of the payee, or paid as the provision of a non cash benefit (section 14-5 of Schedule 1 to the TAA). The payment is made pursuant to section 11-5 of Schedule 1 to the TAA when the amount is first applied or dealt with in any way on the payee's behalf.

Works

52. 'Works' are defined in subregulation 44C(3) of the TAR 1976. 'Works' are defined to include the construction, installation, and upgrading of buildings, plant and fixtures. The word 'including' indicates that this is not an exhaustive list of activities which constitute works for the purposes of regulation 44C and as outlined in the Explanatory Statement to the Taxation Administration Amendment Regulations 2004 (No. 1) we must also look to the ordinary meaning of the word as understood in the construction, infrastructure and resource sectors. In accordance with the Explanatory Statement this is:

broadly the activity of creating or altering a physical asset such as a building or structure, changing the form of the earth such as earthworks, or a combination of these activities.

The Butterworth's Australian Legal Dictionary defines 'works' as:

the construction, alterations, repair, refurbishment, or fitting out of buildings, other structures, and equipment designed to be used in the provision of services.

53. Implicit in the definitions is the notion that a contract for 'works' involves, in whole or in part, the performance or exercise of skill and labour. It is more than merely a contract for the sale of goods as it involves the performance of works. A contract purely for the supply of a good, however large where no associated works are being undertaken, would not constitute a contract for works and hence payments made pursuant to that contract would not be prescribed in accordance with regulation 44C of the TAR 1976.

54. The inclusion of the words 'installation and upgrading' in the definition point to activities in addition to the construction of primary structures. Clearly work on existing structures is also included. Although buildings, plant and fixtures incorporate a wide range of structures, the definition is further extended by the examples. The examples of what is included in the definition of works are:

Dam, electricity links, mine site development, natural gas field development, natural resource infrastructure, oilfield development, pipeline, power generation infrastructure, railway or road, residential building, resort development, retail or commercial development, upgrading airport, upgrading telecommunications equipment, water treatment plant.

55. The examples provided under the definition of 'works' further exemplify the breadth of activity. Whilst focussed on larger infrastructure and natural resource projects all construction projects whether an office building, a resort construction, amusement park, shopping centre or a residential house would answer the description of works potentially subject to FRW. In a practical sense the lower the level of work and the less the contracted price the less likely there are to be foreign residents undertaking the work.

Related activities

56. A payment is also a prescribed payment in accordance with regulation 44C of the TAR 1976 if it is a payment under a contract for works or 'related activities'. Related activities are similarly defined in subregulation 44C(3) as:

includes activities associated with the construction, installation and upgrading of buildings, plant and fixtures.

Examples

Administration, assembly, de-commissioning plant, design, commissioning and operation of facilities, costing, engineering, erection, fabrication, hook-up, installation, project management, site management, supervision and provision of personnel, supply of plant and equipment, warranty repairs.

57. From the definition and the examples provided, related activities will include all activities associated with works, in effect which enable the works to be undertaken. In practice, if works are being undertaken by an entity, any activities undertaken by the entity that are in any way related to those works will be included within the meaning of related activities.

58. It should also be noted that payments under a contract for activities to be undertaken by one entity that relate to works undertaken for the payer by another entity would be prescribed. So, for example, if Entity A has a contract with the payer to construct a building and Entity B (a foreign resident) provides under a different contract design services relating to that construction, the payments to Entity B would be prescribed.

When is the supply of plant and equipment a related activity?

59. The examples in regulation 44C of the TAR 1976 of related activities include 'supply of plant and equipment' related to works. This example would include contracts for the use of plant and equipment in undertaking the works (Example 2 in the 'Examples' section of this Ruling illustrates this). However, because the example in the regulation is about 'activities' related to works, prescribed payments would not include payments under a contract purely for the acquisition by the payer of plant or equipment (that is a contract for goods) where there were no associated works or where any associated works were merely incidental to the acquisition.

60. Conversely, a payment under a contract exclusively for the acquisition of plant or equipment by the payer would be prescribed if the acquisition was merely incidental to works being undertaken by the payee. That is because the supply of the plant or equipment by the payee, who was also carrying out the works, would be properly characterised as an activity related to the works. This is consistent with the policy as stated in the Explanatory Statement to the Taxation Administration Amendment Regulations 2004 (No. 1):

The payments covered are those under a contract for work performed and for services and equipment provided. Withholding is required from all payments under the contract and related contracts regardless of the total value of the payments under the contract.

61. Therefore separating a contract for works into separate contracts, so that there are separate contract(s) for the supply of goods and separate contract(s) for the provision of services will not of itself negate the requirement to withhold on the payments made under the contract for goods for which a foreign resident is paid. The supply of the goods is related to the works being undertaken and would constitute a contract for related activities. Any payments made under this contract for the supply of the goods would be prescribed in accordance with regulation 44C of the TAR 1976. In a similar way payments to sub contractors are also included.

Intermediaries and agents

62. Broadly a person who receives a prescribed payment on behalf of a foreign resident as outlined in subsection 12-315(2) of Schedule 1 to the TAA, or where such a foreign resident is or becomes entitled to receive or have the payment dealt with on their behalf, the Australian agent or intermediary must withhold from that payment on receipt of the monies or at the point entitlement to the monies arises in accordance with section 12-317 of Schedule 1 to the TAA. This provision ensures an obligation to withhold arises in agency arrangements or where there is an Australian intermediary for one or more foreign residents.

63. Where the original payer or a previous intermediary has already withheld an amount the subsequent withholding obligation is reduced by the amounts already withheld by others from the payment pursuant to regulation 44D of the TAR 1976.

Withholding rate

64. Pursuant to subsection 15-10(2) of Schedule 1 to the TAA the rate of withholding is determined in accordance with subregulation 44C(2) of the TAR 1976. The rate of withholding is set at 5% of each prescribed payment made. However, provision exists for the Commissioner to either vary the rate of withholding, including to nil, in accordance with subsection 15-15 of Schedule 1 to the TAA; or to provide an exemption from the FRW obligations pursuant to section 12-319 of Schedule 1 to the TAA.

Variations

65. The Commissioner can vary the amount required to be withheld including to a nil amount to meet the special circumstances of a particular case or class of cases. A variation must be a written notice given by the Commissioner to the entity or published in the Gazette if it applies for a class of entities in accordance with subsection 15-15(3) of Schedule 1 to the TAA.

66. Where a variation is sought the Commissioner, in accordance with the policy objective of the measure, seeks to ensure that the total withholding amount for the income year approximates the payee entity's likely final income tax liability for the year of income. Consequently, this will ensure that any additional amounts which must be collected from the non resident to meet their Australian income tax obligations is kept to a minimum. It should be noted a request for a variation can seek an increase or a decrease in the withholding rate.

67. Whilst the payer may lodge an application for a variation, the Commissioner will be unlikely to be able to decide on the request as the information necessary to decide the application will be known only to the foreign resident. Consequently it will usually be the case that the foreign resident applies for the variation. Nevertheless, to the extent that the foreign resident allows the payer to act on their behalf or as a conduit for obtaining a variation, the Commissioner will endeavour to determine the application based on the information provided.

68. A common reason for obtaining a variation will be that because of the operation of a tax treaty that Australia has with another country there are no, or altered, taxing rights over the particular transaction or payment. The Commissioner must form a view on the proper interpretation of the treaty in the circumstances of the entity's case.

69. Variations can also be sought in circumstances where the amount of tax payable on the income arising from the gross payment to the foreign resident is less [or more] than the withholding amount given by the statutory rate of 5%. The Commissioner's practice is generally to accept the arithmetical calculations provided in variation applications subject to further enquiry where necessary, or review where compliance risks have been identified by the application or the works or related activities being undertaken.

Exemptions

70. The Commissioner may grant a foreign resident an exemption from FRW pursuant to section 12-319 of Schedule 1 to the TAA, which relieves the payer of the obligation to withhold in accordance with paragraphs 12-315(1)(d) and 12-317(1)(d) of Schedule 1 to the TAA. The exemption is only granted if the Commissioner is satisfied that the entity:

- (a) has an established history of compliance with its obligations under taxation laws. 'Taxation laws' mean all the acts and regulations which the Commissioner administers, see section 995-1 of the ITAA 1997; and
- (b) is likely to continue to comply with those obligations in the future.

71. The exemption is limited to the time period specified in accordance with subsection 12-319(2) of Schedule 1 to the TAA.

72. The Commissioner may have regard to any matters when deciding whether to grant an exemption but is specifically authorised in subsection 12-319(3) of Schedule 1 to the TAA to have regard to:

- (a) whether the entity was subject to the PAYG instalment system in the year for which exemption is sought and the previous 2 income years;
- (b) the amount of any outstanding tax related liabilities currently due and payable; and

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- (c) the extent to which the entity and its associates have complied with their tax obligations in the year of income in which the exemption is proposed and the previous 2 income years.

73. In a practical sense the exemption is designed for those foreign entities which have a permanent presence in Australia and are compliant with their tax obligations. The Commissioner will only be able to form a view on the compliance of a new foreign resident if the foreign resident is in Australia long enough to satisfy all of their other tax obligations. The Commissioner would expect to see all tax obligations satisfactorily discharged as a minimum to concluding that there was an established history of compliance.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

74. There is a view that an obligation to withhold only arises on that part of the payment that relates to the assessable income of the foreign resident in accordance with regulation 44C of the TAR 1976. This view is typically that payments under contracts for works or related activities can be apportioned so that a withholding obligation only applies to the service component of the contract. This is based on the view that to do otherwise could include within the prescribed payment a portion that relates to profit or income that is not subject to Australian income tax.

75. The Commissioner does not hold this view. Income derived by foreign residents may be subject to Australian taxation depending on the terms of relevant tax treaties and the source where the income is derived or other specific provisions which tax the income in Australia.

76. Withholding is a mechanism which relies on payment activities or transactions. Australia, as do many other countries, is able to impose within its jurisdiction a withholding on whatever payments or transactions as are specified in legislation. There is no requirement to determine a taxing right to validly enforce an obligation to withhold. At the point of establishing liability consideration must be given to taxing rights on the income under any relevant tax treaty and the correct amount of tax otherwise payable. Whether tax is properly payable may only be known in some cases after the event. The withholding occurs on events within jurisdiction and whilst preliminary to the establishment of liability to taxation it is reasonable to assume that income generated from activities by a foreign resident in Australia will be assessable income.

77. The withholding rate of 5% was arrived at as a proxy to reflect the tax that would be assessed on the net rate of return calculated on the gross payments. Other approaches could mean the payer would be placed in the unenviable position of having to determine the tax obligations of the foreign entity. The payer would not possess this information and it would lead to increased compliance costs.

78. Further it is the Commissioner's view that there is no authority for dissecting a contract to discern what part of the payment is for goods and what part of the payment is for services if in truth it is a contract that can be characterised as one for 'works or related activities'.

79. The Commissioner does not accept that only payments for services by non-residents undertaken in Australia were intended to be within the meaning of 'works and related activities'.

Appendix 3 – Your comments

80. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 28 April 2006

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Appendix 4 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 98/17; IT 2615; IT 2650;
IT 2681

Subject references:

- apportionment
- foreign resident withholding
- PAYG
- withholding
- works or related activities
- variations

Legislative references:

- ITAA 1997 995-1
- TAA 1953 3AA
- TAA 1953 Pt IIB
- TAA 1953 Sch 1 Pt 2-5
- TAA 1953 Sch 1 10-5
- TAA 1953 Sch 1 10-5(1)
- TAA 1953 Sch 1 11-5
- TAA 1953 Sch 1 12-5
- TAA 1953 Sch 1 12-5(3)
- TAA 1953 Sch 1 12-FB
- TAA 1953 Sch 1 12-315
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- TAA 1953 Sch 1 12-317
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- TAR 1976 44C(3)
- TAR 1976 44D
- ITAA 1936 Pt III Div 2 Subdiv AA
- ITAA 1936 Pt III Div 11A

Other references:

- Butterworth's Australian Legal Dictionary
- Explanatory Statement to the Taxation Administration Amendment Regulations 2004 (No. 1)
- The Review of Business Taxation (Ralph Review)

ATO references

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