IT 2468 - Income tax : withholding tax : building societies investments : interest or dividends

There is an Addendum notice for this document.

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TAXATION RULING NO. IT 2468

INCOME TAX : WITHHOLDING TAX : BUILDING SOCIETIES INVESTMENTS : INTEREST OR DIVIDENDS

F.O.I. EMBARGO: May be released

REF N.O. REF: 86/491-9 DATE OF EFFECT: Immediate

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F.O.I. INDEX DETAIL

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PREAMBLE Sub-sections 128B(4) and (5) of the Income Tax Assessment Act impose liability to withholding tax on dividends and interest respectively derived by non-residents. This Ruling considers whether income derived by non-residents on certain investments with permanent building societies constitute interest or dividends for the purposes of determining the appropriate withholding tax rate.

2. Building societies are organisations whose principal aim is the provision of long term finance for housing. They are regulated by State legislation in the different States, viz. Permanent Building Societies Act 1967 (NSW), Building Societies Act 1958 (VIC), Building Societies Act 1985 (QLD), Building Societies Act 1975 (SA), Building Societies Act 1976 (WA) and Building Societies Act 1876 (TAS) ('State Acts'). These State Acts regulate the formation, registration and management of building societies, and provide for guarantees and indemnities. They specifically regulate the activities which the societies may conduct, such as receiving money on deposit, raising money on loan, investing those funds and making advances, generally to members of the societies.

3. The State Acts provide that the societies may raise funds as deposits, as loans or as share capital. Some investment accounts are open to non-members, others are open to persons who have become members through acquiring shares in the society. Investments can be made by depositing the funds with the society in a deposit redeemable on demand, upon notice or on expiry of a certain period. In many cases, however, an investment in a building society is represented by shares in the society. For example, a person who invests a principal amount of $10,000 may be allotted 10,000 $1 shares in the society, usually redeemable on demand, upon notice or on expiry of a certain period. People investing in share accounts are

offered a rate of return set in advance. For instance, the State Acts in Victoria (section 20), New South Wales (section 52), Western Australia (section 53) permit the payment of 'interest' on shares, and the relevant Queensland legislation (section 51) provides for the issue of shares with or without interest. Surplus profits made by the society are not usually distributed to investors with share accounts and the returns made to investors are in effect no different from interest paid by banks to their depositors.

RULING

4. In deciding whether returns on investments to investors who hold shares in a building society amount to dividends or interest for withholding tax purposes, the substance of the transaction must be considered. The words "interest" and "dividend" must be given their ordinary meaning regardless of the term chosen to describe the return in the State Acts or in the investment contract.

5. For the purposes of the withholding tax provisions in Division 11A, Part III of the Assessment Act, the term "interest" is defined in sub-section 128A(1) to include amounts "in the nature of interest". This inclusive definition ensures that the provisions apply to amounts such as discounts on bills which, while in the nature of interest, may not have fallen within the ordinary concept of interest. Under the general law, the term "interest" signifies "a sum payable in respect of the use of another sum of money called the principal". (Osborn's Concise Law Dictionary, 6th Ed.).

6. The ordinary meaning of "dividend", which is extended by the definition contained in sub-section 6(1) of the Assessment Act, is a "share of profits whether at a fixed rate or otherwise allocated to the holders of shares in a company". (Halsbury's Laws of England 4th Ed. Vol. 7 paragraph 596). This meaning of "dividend" as a distribution of profits is reflected in the prohibition contained in section 565 of the Companies Act 1981 against the payment of dividends other than out of profits. It is also reflected in paragraphs 44(1)(a) and (b) of the Act which, subject to section 128D, operates to include in the assessable income of resident and non-resident shareholders dividends paid by a company out of profits.

7. While interest is payable out of a company's assets generally, it is a characteristic of dividends that they represent a distribution of profits. This also means that a company does not have the power to bind itself unconditionally to the payment of dividends to shareholders, regardless of whether or not there are profits available for that purpose. Interest, on the other hand, is payable pursuant to a contractual obligation binding the company regardless of the availability of profits or of the origin of the funds used to meet that contractual liability.

8. A further difference between interest and dividends arises from the fact that interest becomes payable on a certain date, or throughout a period, pursuant to a contractual obligation and without requiring further action on the part of

either lender or borrower. On the other hand, dividends are payable generally only after a formal declaration by the company.

9. Almost always in the case of investments issued by building societies, even if issued as shares, the relationship of borrower and lender is created. The society binds itself to return the principal amount on expiry of a certain period or on notice and to pay a return at a fixed rate. This contractual obligation is unconditional - it does not depend on the availability of profits, nor does it depend on a declaration being made by the society. Accordingly, returns on deposits with building societies whether for a fixed or no-fixed term are interest and not dividends. Withholding tax at the rate of 10% applies to that interest when paid to non-residents.

10. This approach is also consistent with Taxation Ruling No. IT 2226 which, for purposes of the income tax position of the building societies, treats the amounts concerned as interest incurred rather than as a distribution of profits.

11. There may be some exceptional cases where on an application of the principles in paragraphs 4-9 it is concluded that amounts being paid by building societies on some shares are in substance "dividends". This Ruling is not intended to apply to such payments.

12. The practice outlined in the preceding paragraphs applies to the calculation of tax to be withheld from amounts paid or credited to non-residents by building societies after the date of effect of this Ruling.

COMMISSIONER OF TAXATION
3 March 1988