IT 2647 - Income tax: interest withholding tax - exemption from withholding tax - requirement that borrowed moneys be used in an australian business

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TAXATION RULING IT 2647

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Reference no.:	Subject refs:	Legislative refs:
I 1012782	**INTEREST WITHHOLDING TAX DEBENTURE ISSUE OUTSIDE AUSTRALIA USE OF MONEYS IN AN AUSTRALIAN BUSINESS**	**128F(4)(b) 128F(7)**

OTHER RULINGS ON THIS TOPIC: IT 2238; CITCM 867

TITLE: INCOME TAX: INTEREST WITHHOLDING TAX - EXEMPTION FROM WITHHOLDING TAX - REQUIREMENT THAT BORROWED MONEYS BE USED IN AN AUSTRALIAN BUSINESS

NOTE:. Income Tax Rulings do not have the force of law.

. Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

What the Ruling is about

The purposes of this Ruling are:

(a) to set out the Australian Taxation Office view of how paragraph 128F(4)(b) of the Income Tax Assessment Act 1936 (the Act) applies where moneys raised offshore by banks and other financial institutions are on-lent in the course of their normal business of moneylending;

(b) to give some guidance as to the circumstances when use of funds by a bank or other financial institution will be regarded as satisfying the requirements of subparagraph 128F(4)(b)(i); and

(c) to provide guidance on the information that has to be provided and the steps to be taken by an applicant for a section 128F certificate in order to satisfy the requirements of subparagraph 128F(4)(b)(ii).

SUMMARY

2. Financing the acquisition of buildings and equipment for use in the Australian operations of a bank or finance company, and the financing of leasing and trading activities of such entities will be regarded as uses of funds in an Australian business for the purposes of subparagraph 128F(4)(b)(i). The use of borrowed funds to maintain a pool of liquid assets to meet claims of depositors will also meet the requirements of subparagraph 128F(4)(b)(i). Accordingly, where the other requirements of section 128F are met, these uses of funds will enable the bank or other financial institution to obtain an exemption from withholding tax.

3. To obtain a withholding tax exemption in cases where Australian resident banks borrow overseas to on-lend to customers, the Commissioner has to be satisfied that those customers are Australian residents who will use the money to establish or conduct a business in Australia or acquire an interest in an Australian business. This Ruling provides that banks and other financial institutions will be regarded as satisfying the use in an Australian business requirement in respect of the on-lending of borrowed funds - and thereby get a withholding tax exemption - if they provide certain undertakings and otherwise comply with the requirements of section 128F.

CONTEXT

4. Interest payments to non-resident debenture holders by companies resident in Australia are free of Australian withholding tax if section 128F of the Act applies [subsection 128F(2)]. One of the pre-conditions for the section to apply is that the Commissioner has issued a subsection 128F(4) certificate [paragraph 128F(1)(e)]. Where the Commissioner is satisfied as to the foreign source of the funds raised, certain matters regarding the marketing and placement of the debentures, and is satisfied that the purpose of the borrowing falls within subparagraphs 128F(4)(b)(i) or (ii), a certificate must be issued [subsection 128F(4)].

5. Paragraph 128F(4)(b) requires that the borrowing operation be undertaken by the company for the purpose of raising money -

(i) to be used by that company in an Australian business; or

(ii) for expenditure by the company, by way of a loan or otherwise, for the purpose of making those moneys, or moneys derived directly or indirectly from those moneys, available to another person or persons for use by that other person or those other persons in an Australian business or Australian businesses.

6. Although they are clearly alternatives, both subparagraphs require the money to be used in an Australian business.

7. Subsection 128F(7) explains the concept of "use of moneys in an Australian business" in the following terms:

(a) use of those moneys in Australia by a person who is a resident of Australia, for the purpose of, or for the establishment or acquisition of, or of an interest in, a

business carried on, or to be carried on, by that person wholly or partly in Australia; or

(b) the use of those moneys outside Australia by a person who is a resident of Australia for purposes connected with the operations in Australia of a business carried on by that person wholly or partly in Australia.

8. In 1971, when section 128F was enacted, banks and other financial institutions were not as a general rule undertaking overseas borrowings by means of widely issued bearer debentures. This method of fund raising was, however, quite common amongst large Australian industrial companies who used the funds in their own Australian business or on-lent them, generally to associates and subsidiaries. That position has now changed and Australian banks also routinely use widely distributed commercial paper to raise funds offshore.

9. The issue that arises is whether Australian resident banks borrowing in this way to on-lend to their customers in their normal business of moneylending automatically satisfy the "use in an Australian business" test; or whether the Commissioner has to be satisfied that the banks' customers are Australian residents who will use the moneys to establish or conduct a business in Australia or acquire an interest in an Australian business.

10. In the course of settling this Ruling extensive consultation has taken place with the Australian Bankers' Association, the Australian Merchant Bankers' Association, the Australian Finance Conference, the Corporate Tax Association and the Taxation Institute of Australia.

RULING

Commissioner's view of the law

11. The critical question is whether the word "used" in subparagraph 128F(4)(b)(i) has its ordinary meaning or whether it refers to a use otherwise than by making the funds available for use by another person.

12. In Cooper Brookes (Wollongong) Pty Ltd v. F.C. of T. 81 ATC 4292 at p.4295-6; (1981) 11 ATR 949 at p.955 Gibbs CJ said:

> "It is an elementary and fundamental principle that the object of the court, in interpreting a statute, 'is to see what is the intention expressed by the words used': River Wear Commrs. v. Adamson (1877) 2 App. Cas. 743 at p.763. It is only by considering the meaning of the words used by the legislature that the court can ascertain its intention. And it is not unduly pedantic to begin with the assumption that words mean what they say: Cody v. J H Nelson Pty Ltd (1947) 74 CLR 629, at p.648. Of course, no part of a statute can be considered in isolation from its context - the whole must be considered."

13. Mason and Wilson JJ in their joint judgment in that case said:

> "The fundamental object of statutory construction in every case is to ascertain the legislative intention by reference to the language of the instrument viewed as a whole. But in performing that task the courts look to the operation of the statute according to its terms and to legitimate aids to construction." 81 ATC at p4305; (1981) 11 ATR at p.966.

14. The High Court decided in Cooper Brookes Case not to apply a literal interpretation. Mason and Wilson JJ said:

> "This construction is justified on the footing that it is a necessary implication to be deduced from the legislative scheme considered as a whole." (81 ATC at p.4307; (1981) 11 ATR at p.967)

The legislative scheme to which they were referring was the carry-forward loss provisions in sections 80, 80A, 80B and 80C of the Act.

15. Clyne & Anor. v. D.F.C. of T. 81 ATC 4429; (1981) 12 ATR 173 is another example of a tax case where the High Court decided that the literal interpretation should yield to a purposive one based on the statutory context of the paragraph being interpreted.

16. It is the view of this Office that the meaning of the word "used" in subparagraph 128F(4)(b)(i) is properly determined by the context in which it is found. While it is clear from the disjunctive drafting that subparagraphs 128F(4)(b)(i) and (ii) are alternatives, they form a legislative framework with subsection 128F(7) in relation to the "use in an Australian business" test. Accordingly, subparagraphs 128F(4)(b)(i) and (ii) must be read together. This leads to the conclusion that the word "used" in subparagraph 128F(4)(b)(i) means "used otherwise than by making the funds available for use by another person".

17. The nature of the exemption conferred by section 128F is that of a special purpose exemption requiring an appropriate connection between the borrowing and the use of the borrowed funds. When section 128F was enacted in 1971 the then Treasurer spelled out the purpose in his Second Reading Speech when he said that the Government regarded flows of capital from abroad "for the development of our resources and the economy generally" as an important issue. [emphasis added]

18. There were concerns at the time that the exemption could be abused. In respect of administrative procedures the Treasurer said:

> "If the particular borrowing meets the precise tests set out in the Bill and the Commissioner of Taxation is satisfied that the case falls within the terms and spirit of the other provisions of the Bill including the extensive guidelines contained in it, he will give to the borrower a certificate that he is so satisfied."

And later,

> "A certificate of exemption will be given by the Commissioner upon the borrower demonstrating how the money borrowed will, in the end, be used." [emphasis added]

19. There is nothing in the wording of subparagraph 128F(4)(b)(ii) that limits its operation to companies in industries other than banking. Indeed, many large corporate groups outside the banking industry have their own in-house finance companies these days. It is the view of this Office that the differences between the large industrial companies and banks are not material in the present context.

20. Subparagraph 128F(4)(b)(ii) expresses a clear policy intent that where moneys are borrowed offshore to be on-lent, the person to whom the moneys are on-lent has to use the funds in an Australian business in order for the company raising the funds offshore to get an exemption from Australian withholding tax on interest payments. It is considered this fact lends support to the view that subparagraphs 128F(4)(b)(i) and (ii) need to be read together.

21. If subparagraph 128F(4)(b)(i) was interpreted and applied in isolation from subparagraph 128F(4)(b)(ii), offshore borrowings that would otherwise fail the test in subparagraph 128F(4)(b)(ii) because the end use was not in an Australian business would be able to be arranged free of Australian withholding tax simply by having the offshore borrowing done through any bank resident in Australia, including Australian subsidiaries of foreign banks. This would clearly defeat the policy underlying the specific purpose exemption.

22. Another consequence would be that offshore borrowings by banks to finance consumer credit, housing loan portfolios and loans to non-residents would be able to be raised free of Australian withholding tax, even though such a result seems clearly inconsistent with the intention of Parliament expressed in subparagraph 128F(4)(b)(ii).

23. The other difficulty presented by a literal interpretation is that it is inconsistent with the introduction in 1988 of specific withholding tax exemption provisions for interest payments by offshore banking units of Australian banks. Accordingly, it is the view of this Office that the word "used" in subparagraph 128F(4)(b)(i) does not bear its ordinary meaning but is properly to be interpreted in the light of subparagraph 128F(4)(b)(ii) as meaning "used by the borrowing company and not made available by loan or otherwise to any other person".

24. It follows that where the funds are on-lent the requirements of subparagraph 128F(4)(b)(ii) have to be satisfied. This view is consistent with Taxation Ruling No IT 2238. The basic reasons for rejecting the submission by the company referred to in that Ruling apply with equal force in relation to any other case where the borrowed funds are to be on-lent.

Accepted paragraph 128F(4)(b)(i) activities

25. It is accepted by this Office that banks and financial institutions may undertake borrowing operations for purposes other than on-lending that will satisfy subparagraph 128F(4)(b)(i). An exhaustive list of such purposes cannot be made. However, borrowing to finance the acquisition of buildings and equipment for use in the Australian operations of a bank or other financial institution, and the financing of leasing and trading activities of a bank or finance company would satisfy the

requirements of subparagraph 128F(4)(b)(i). Similarly, the use of borrowed funds to maintain a pool of liquid assets to meet withdrawals by depositors will also satisfy the requirements of subparagraph 128F(4)(b)(i).

Undertaking by banks and financial institutions on subparagraph 128F(4)(b)(ii)

26. Banks and other financial institutions can also obtain exemption from Australian withholding tax if they fulfil the requirements of subparagraph 128F(4)(b)(ii).

27. It is accepted that it is often not possible to trace a flow of funds from their source, through the Treasury function of a bank or finance company where the funds are generally pooled, to their application in the course of the business of the bank or finance company.

28. Accordingly, in cases where funds are being raised overseas for on-lending, or where the uses may include on-lending, the requirements of paragraph 128F(4)(b) will be considered to be satisfied if a bank or financial institution provides an undertaking in the following form:

> "**Undertaking on use of funds in an Australian business: paragraph 128F(4)(b) of the Income Tax Assessment Act 1936**
>
> The following undertakings are given on behalf of [company name](the borrower).
>
> The borrowing operation was not undertaken for the purpose of lending the proceeds to:
>
> (a) non-residents;
>
> (b) Australian residents for use in a non-Australian business; or
>
> (c) Australian residents for non-business purposes (i.e. for private or domestic use)."

29. The form of this undertaking was settled in close consultation with the umbrella bodies representing the banking and finance industry. It will enable banks and other financial institutions to continue to obtain exemptions from withholding tax.

30. These procedures will apply to all cases where indicative letters have not yet issued. Where favourable indicative letters or Advance Opinions have already been issued to banks and other financial institutions, section 128F certificates will be issued as soon as practicable.

COMMISSIONER OF TAXATION

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