TR 2004/17 - Income tax: indemnification of royalty withholding tax

This ruling contains references to repealed provisions, some of which may have been re-enacted or remade. The ruling has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten.
Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

Taxation Ruling

Income tax: indemnification of royalty withholding tax

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Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts of this document are a 'public ruling' for the purposes of **Part IVAAA of the Taxation Administration Act 1953** and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling considers the extent, if any, to which the recipient of a royalty payment, whose royalty withholding tax liability is indemnified by another person, is liable to pay royalty withholding tax on that indemnity.

2. That is, it considers the question of whether and to what extent a person who derives a royalty upon which they are liable under subsection 128B(5A) of the *Income Tax Assessment Act 1936* (ITAA 1936) to pay royalty withholding tax (RWT) and who is then indemnified for that liability by another person, is liable to pay RWT on the amount of the indemnity. The question turns on whether the indemnity amount is itself a 'royalty'.

3. In *Commissioner of Taxation v. Century Yuasa Batteries Pty Ltd* (1998) 82 FCR 288; 98 ATC 4380; (1998) 38 ATR 442 ('CYB') the Full Federal Court ruled on a matter concerning the indemnity of interest withholding tax. It decided that the lender in that case was not liable for interest withholding tax (IWT) on the amounts by which the borrower 'grossed up' the payments of interest it made to the lender to ensure that, after any deduction or withholding on account of tax, the lender received the full amount of interest it otherwise would have received under the loan agreement. This ruling considers whether the decision in that case applies equally to RWT indemnities.

4. In this Ruling 'royalty' means royalty as defined in section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) which in turn adopts the meaning in subsection 6(1) of the ITAA 1936. (See paragraph 78 for the definition of royalty.)

Background

5. In CYB the question of IWT liability turned on whether the amounts by which interest was grossed-up could properly be said to be 'interest' or 'in the nature of interest' within the meaning of the then IWT definition of 'interest' in subsection 128A(1) of the ITAA 1936.

6. The parties accepted that the term 'interest' bore its ordinary meaning which, the Court said, 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]

7. The Court ruled that the amounts by which the interest payments were grossed-up did not fit the description of interest (or the statutory extension as it then was) and that the amounts were 'neither interest nor in the nature of interest but were an indemnity against [the lender's] liability for income tax'.[2]

8. In the light of that case industry uncertainty may have arisen concerning the treatment of RWT indemnities, specifically whether the amounts by which royalty payments are grossed up to reflect the indemnity fit within the definition of 'royalty' for RWT purposes.

Example of a RWT indemnity clause

9. The example below relates to a lease of equipment and the indemnification of RWT. However, such a clause could also arise in other contracts so the Ruling should not be read as being limited to equipment leases. In the example the RWT indemnity clause is designed to ensure that the person obtaining the RWT indemnity receives amounts under the contract equivalent to the amounts contracted for, not reduced by RWT.

10. A contract for the use of equipment may contain a clause along the following lines:

> In consideration of the terms and covenants contained in this agreement the lessor agrees to lease to the lessee and the lessee agrees to hire from the lessor certain equipment.

11. The following is considered to be an example of a standard RWT indemnity clause:

> The lessee shall pay all Australian taxes including withholding taxes. Where the lessee is unable to make any payment to the lessor without a deduction or withholding the lessee shall immediately pay such additional amount so that the net amount received by the lessor will equal the full amount received had no such deduction or withholding been made.

[1] (1998) 82 FCR 288 at 291; 98 ATC 4380 at 4383; (1998) 38 ATR 442 at 444.
[2] (1998) 82 FCR 288 at 292; 98 ATC 4380 at 4384; (1998) 38 ATR 442 at 445.

Legislative Context

12. RWT is a liability imposed by the combined operation of subsection 128B(5A) and either subsection 128B(2B) or subsection 128B(2C) of the ITAA 1936. It is imposed on a person who derives royalty income to which subsection 128B(2B) or 128B(2C) applies. RWT is payable on the gross amount of the royalty at the rate declared by Parliament. That rate is currently 30% of the gross amount of royalty,[3] generally reduced to either 10% or 5% under Australia's tax treaties.[4]

13. By subsection 128B(2B) of the ITAA 1936 RWT applies to income that consists of a royalty derived by a non-resident and:

- Is paid to the non-resident by a resident of Australia. No RWT applies where the royalty paid by the resident is an outgoing incurred in carrying on business in a foreign country at or through a permanent establishment ('PE') of the resident in that country (paragraph 128B(2B)(a) and subparagraph (b)(i)).
- Is paid to the non-resident by another non-resident and the royalty paid is an outgoing incurred by the second non-resident in carrying on business in Australia at or through a PE in Australia (paragraph 128B(2B)(a) and subparagraph (b)(ii)).

14. The liability for RWT is further extended under subsection 128B(2C) of the ITAA 1936 to two other situations where a PE is involved, namely:

- where a royalty is paid by an Australian resident to another Australian resident and the royalty income is derived by the second mentioned Australian resident in carrying on business at or through a PE in a country outside Australia. No RWT applies if the royalty paid by the first mentioned Australian resident is an outgoing wholly incurred by that resident in carrying on business at or through a PE in a country outside Australia (paragraph 128B(2C)(a) and sub-paragraph (b)(i));
- where a royalty is paid to an Australian resident by a non-resident and:
  - (i) the royalty income is income of the resident in carrying on business at or through a PE in a country outside Australia; and

[3] *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* paragraph 7(c).
[4] Australia's most recent tax treaties with the United States and the United Kingdom adopt a rate of 5%, whereas most of our other tax treaties have a 10% rate.

(ii) the royalty is an outgoing of the non-resident in carrying on business at or through a PE in Australia (paragraph 128B(2C)(a) and sub-paragraph (b)(ii)).

15. RWT is not payable on a royalty where a tax treaty applies and either subsection 17A(4) or 17A(5) of the *International Tax Agreements Act 1953* operates to exclude the royalty from the scope of the RWT provisions.[5] An example of a royalty excluded by the operation of subsection 17A(5) is an equipment royalty paid to a United States resident.

16. Australia's tax treaties contain their own definitions of 'royalty' which are similar but not identical to the definition in subsection 6(1) of the ITAA 1936. This ruling applies to a transaction that is a 'royalty' satisfying both subsection 6(1) and 128B(5A) provided subsection 17A(4) or 17A(5) does not exclude the transaction (as mentioned in paragraph 15) from the RWT provisions.

17. Where a royalty falls within both a tax treaty definition and subsections 6(1) and 128B(5A), and the treaty operates to limit the rate of Australian tax on the royalty without precluding the application of subsection 128B(5A) to the royalty, this ruling will still apply.

Class of person/arrangement

18. This Ruling contains the Commissioner's opinion on the way in which a tax law or tax laws apply to the class of person and class of arrangements described below.

19. The class of person to which this Ruling applies are persons who derive royalties upon which they are liable to pay RWT under the combined operation of subsection 128B(5A) and either subsection 128B(2B) or 128B(2C) of the ITAA 1936 (see paragraphs 12 to 17), and who are indemnified for that tax.

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[5] Subsection 17A(4) of the *International Tax Agreements Act 1953* provides:
'If:
(a) a provision ('basic royalty provision') of an agreement is covered by either of the following paragraphs:
(i) paragraph 1 or 2 of Article 12 of the Chinese agreement;
(ii) a corresponding provision of another agreement; and
(b) another provision of the agreement expressly excludes particular royalties ('excluded royalties') from the scope of the basic royalty provision;
section 128B of the Assessment Act (which deals with liability for withholding tax) does not apply to the excluded royalties.'
Subsection 17A(5) of the *International Tax Agreements Act 1953* provides:
'Section 128B of the Assessment Act (which deals with liability for withholding tax) does not apply to the payment of a royalty as defined in subsection 6(1) of that Act if:
(a) the royalty is paid to a person who is a resident of a Contracting State or territory (other than Australia) for the purposes of an agreement; and
(b) the agreement does not treat the amount paid as a royalty.'

20. The class of arrangements to which this Ruling applies are arrangements by which a person's liability for RWT is fully or partly indemnified by another person.

Date of effect

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

Ruling

22. A person whose RWT liability is indemnified by another person will be liable to pay RWT on the indemnity amount to the extent that the indemnity amount is paid or credited as consideration for any of the matters listed in paragraphs (a) to (f) of the royalty definition in subsection 6(1) of the ITAA 1936.

23. Where an indemnity amount can properly be said to be 'consideration' for any of the listed matters it will be a royalty within the subsection 6(1) definition. In each case this will depend upon the proper construction of the agreement under which the indemnity is given.

24. Where the agreement contains an indemnity clause of the kind set out in paragraph 11 and, pursuant to that clause, an amount is paid or credited that is properly attributable to the grant of a right that satisfies the definition of royalty in subsection 6(1) (such as the right in the example in paragraph 10), the amount so paid or credited will itself be a royalty.

25. If, upon a proper construction of the agreement, the indemnity amount is found to be paid as consideration for a matter not falling within the subsection 6(1) definition, it will not be a royalty and will not be subject to RWT.

Explanation

The Commissioner's view

26. The Commissioner's view is that a person who is indemnified for a RWT liability where some or all of the indemnity is itself consideration paid or credited for any matter answering the description in paragraphs (a) to (f) of the royalty definition (subsection 6(1) of the ITAA 1936) will, to that extent, be liable for RWT on the indemnity amount. The indemnity amount in that situation will itself be a royalty.

27. Whether the indemnity amount is such 'consideration' will in each case be a question of construction of the agreement under which the indemnity was paid.

Royalty definition

28. Royalty is defined in subsection 6(1) of the ITAA 1936 beginning as follows:

> "**royalty**" or "**royalties**" includes any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for … [the matters listed in paragraphs (a) to (f) of the definition].[6]

29. The definition is inclusive. Payments or credits that are 'royalties' within the ordinary meaning of that term come within its scope. So too do the types of payments or credits listed in paragraphs (a) to (f) of the subsection.[7]

30. The definition makes it clear that an amount that is not a royalty within the ordinary meaning of 'royalty' may yet answer the description in subsection 6(1), no matter how the amount is described or computed and whether it is paid or credited periodically or not, where it is paid or credited 'as consideration for' a matter listed in the definition.

However described or computed

31. The form of a payment or credit and the way in which it is computed will not be conclusive in determining whether or not it is a royalty under the definition; nor will the description given to it in any agreement between the parties.[8]

32. If, having regard to the substance of the contract, a payment or credit falls within the scope of the definition, it will be a royalty whether it is paid in a lump sum or periodically. Unlike the ordinary meaning of royalty, it is not necessary for the payment or credit to be calculated by reference to the degree of use of the property, right or know-how. For example, in the case of a film, it will be a royalty whether it represents an amount calculated by reference to each showing, a lump sum to cover an agreed number of showings or is a share of the gross or net takings for exhibition of the film.[9]

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[6] See the section 'Definitions' at paragraph 78 for the full definition of royalty.
[7] See further Taxation Ruling No. IT 2660 *Income Tax: Definition of Royalties*.
[8] See for example *The Commissioner of Taxation of the Commonwealth of Australia v. Sherritt Gordon Mines Ltd* (1977) 137 CLR 612 at 627; 77 ATC 4365 at 4372; (1977) 7 ATR 726 at 734 where Mason J said: 'In other cases where payments have been calculated by reference to the quantity of articles or goods produced in accordance with technical information provided by the payee and the payments have been described as royalties the Courts have been careful to avoid adopting that description as a correct description of the character of the payments'.
[9] See further IT 2660 para 15.

33. It follows also that RWT indemnity amounts are not precluded from being a royalty merely because they are described as an 'indemnity of tax' or similar.

34. In addition, the definition makes it clear that it is not important how the amount is computed and so the fact that a RWT indemnity amount is calculated by reference to withholding tax does not preclude it from being a royalty.

Periodical

35. The subsection 6(1) definition of royalty makes it clear that the payment or credit need not be periodical. It can be a one-off payment or credit.

As consideration for

36. To the extent that an amount is paid or credited as consideration for any matter listed in paragraphs (a) to (f) of the subsection 6(1) definition, it will be a royalty. An RWT indemnity amount so paid or credited will thus be a royalty.

37. Whether a particular amount is so paid or credited is a question of fact[10] and will depend in each case on a proper construction of the agreement under which it was given, that is, whether it constitutes any part of the price of obtaining or securing one or other of the listed matters.

38. Consideration has been defined as the act or promise offered by the one party and accepted by the other as the price of that other's promise.[11]

39. Valuable consideration was defined in *Currie v. Misa* (1875) LR 10 Exch 153 at 162 as:

> … some right, interest, profit or benefit accruing to the one party, or some forbearance, detriment loss or responsibility, given, suffered, or undertaken by the other.

40. The indemnification of RWT is thus capable of being 'consideration' or 'consideration paid or credited'.

The use of, or the right to use

41. Some of the listed matters are described in terms of 'the use of, or the right to use' various items of property, such as copyright, patent, design, equipment, visual images or sounds, spectrum etc. The question thus arises whether an RWT indemnification can be

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[10] *Foreman v. Federal Commissioner of Taxation* 83 ATC 4073 at 4075; 13 ATR 928 at 932.

[11] *Cheshire & Fifoot's Law of Contract*, 8th Australian edn, LexisNexis Butterworths, Australia, 2002, para. 4.10.

properly regarded as consideration 'for the use of or the right to use' property.

42. In *Commissioner of Stamp Duties (N.S.W.) v. J.V. (Crows Nest) Pty Ltd* (1986) 7 NSWLR 529; 86 ATC 4740; (1986) 17 ATR 1086 the question was whether a franchisee's covenant to pay the franchisor a service fee was consideration 'for the use of property' (goodwill being the property in that case) and thus 'rent' within the extended definition of that term in the *Stamp Duties Act 1920* (NSW). McHugh JA (with whom Samuels JA agreed) said in relation to the modern meaning of 'rent':[12]

> That definition is concerned with whether the payment – whatever its purpose – is part of the consideration for the right to use premises. It is immaterial that the payment may reimburse the lessor in respect of one of his obligations if the payment is part of the consideration for the use of the property. In most, if not all cases, a payment made by a lessee of rates and taxes owing by the lessor is made as part of the consideration for the use of the premises and for no other purpose.

43. His Honour's comments support the proposition that where the user under an agreement for the use of property has an obligation to indemnify or reimburse the owner for a liability that would otherwise fall on the owner, the obligation is not, by reason alone of the indemnity or reimbursement, precluded from being 'consideration for the use of the property'. The same reasoning, in the Commissioner's view, applies to an obligation to indemnify a RWT liability.[13]

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[12] (1986) 7 NSWLR 529 at 539; 86 ATC 4740 at 4747; (1986) 17 ATR 1086 at 1095.

[13] A contrasting case is *Yanchep Sun City Pty Ltd v. Commissioner of State Taxation (WA)* 84 ATC 4761; (1984) 15 ATR 1165, heard before Olney J of the Supreme Court of Western Australia. The case concerned a lessee's covenant under a lease to pay all rates and taxes charged in respect of the leased premises and the issue was whether such payments were 'rent'. His Honour (at ATC 4766; ATR 1170-71) decided that the payments were not made 'in consideration for the use of the land'. Similarly, His Honour said payments by a lessee to keep premises in repair, payments to meet a lessor's costs of and incidental to the preparation of the lease and 'numerous other examples … particularly covenants whereby the lessee agrees to indemnify the lessor against all manner of liabilities that may accrue during the term of the lease' were instances where the payment was not made in consideration for the use of the land. It was not enough, His Honour said, 'to look merely for a contractual liability on the part of the lessee to pay money to or on behalf of the lessor. To be rent the payment must be one which is essentially a payment for the right to use the demised premises'.
In *Crows Nest*, however, McHugh JA did not accept Olney J's view. Referring at NSWLR 539; ATC 4747; ATR 1095 to the *Yanchep* case, McHugh JA said he understood Olney J to mean that 'if a payment by the lessee was directed to indemnifying a liability of the lessor, it was not a right to use property' and then said: 'The distinction which His Honour appears to make does not seem satisfactory. For it seems to call for a different result depending on whether the lessor calculates a single lump sum payment to compensate him for the cost of letting and maintaining his property or whether he segregates his various overheads from the net return which the letting of property gives'. The Commissioner, with respect, considers McHugh JA's to be the better view.

44. *In David Securities Pty Ltd and Others v. Commonwealth Bank of Australia* (1992) 175 CLR 353; (1992); 92 ATC 4658; (1992) 24 ATR 125 the High Court considered the claim by borrowers for restitution of certain moneys that they had paid to a bank under the 'grossing up' clause of a loan agreement.

45. The clause required the borrowers' interest payments to include an additional amount which ensured that the net amount received by the bank would not be reduced by the interest withholding tax the borrowers might be required to deduct. The borrowers alleged that they paid over the additional amounts in the mistaken belief that the statutory liability for withholding tax was theirs and not the bank's.

46. Mason CJ, Dean, Toohey, Gaudron and McHugh JJ of the majority commented in a joint judgement that the loan agreement was such that it was severable into its relevant parts and the consideration could be 'broken up' or apportioned; various obligations of the one party could be related to the consideration given by the other.[14]

47. The Court found on the facts that the borrowers had no indebtedness in respect of withholding tax, the discharge of which could form consideration for the moneys they paid. The payments were therefore not made for good consideration.[15]

48. Notwithstanding the particular factual finding, the case is authority for the principle that the severability or otherwise of an agreement into its relevant parts will be relevant in identifying or apportioning the consideration given for particular contractual obligations.[16] In the case of an agreement to indemnify RWT that principle will be relevant in deciding whether the indemnity obligation is consideration for any of the matters answering the description in section 6(1), that is, whether the indemnity fits the description of 'royalty'.

49. In *Commissioner of State Revenue (Vic) v. Royal and Sun Alliance Insurance Australia Ltd* [17] the Supreme Court of Victoria, Court of Appeal, considered whether the amount representing the goods and services tax (GST) payable by an insurer on the insurance policies it issued, and which amount it on-charged to the insured, should be treated as part of 'premiums' and 'gross premiums' for the purposes of the relevant part of the *Stamps Act 1958* (Vic).

50. The word 'premium' as it appeared in the context of that Act bore in the Court's view its ordinary meaning which was 'the consideration, usually in the form of a monetary obligation, paid or payable by the insured for the grant or renewal of insurance cover or

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[14] (1992) 175 CLR 353 at 383; 92 ATC 4658 at 4672; (1992) 24 ATR 125 at 145.
[15] (1992) 175 CLR 353 at 381; 92 ATC 4658 at 4671; (1992) 24 ATR 125 at 144.
[16] See also the comments of Gleeson CJ, Gaudron and Hayne JJ on severability of consideration in the High Court case of *Roxborough and Others v. Rothmans of Pall Mall Australia Limited* (at paragraph 17) (2001) 208 CLR 516; (2001) 48 ATR 442; [2001] HCA 68.
[17] 2003 ATC 4998; (2003) 54 ATR 339; [2003] VSCA 177, heard before Ormiston, Batt and Chernov, JJ.A.

of other rights under a policy of insurance'. 'Gross premiums' referred to the total of all such sums received.

51. The Court held that notwithstanding that the insurer had charged a separate amount for GST, and separately designated it in the actual policies, the amount did form part of the 'premium' or 'gross premiums' for the purposes of the *Stamps Act 1958*. That is, the GST 'reimbursement' was consideration of the kind described in the definition.

52. In reaching its conclusion the Court per Ormiston JA observed that:

> [T]he artifice of designating some of the consideration as fire services levy, stamp duty or GST, though acceptable in practice (and indeed in law), could not detract from the fact that the cover would *not* be granted unless the whole of the stipulated sums had been paid, whether called premiums, GST or whatever … The total amount to be paid was (and still is) in fact the premium, unless by law it can be otherwise characterised or understood.[18]

53. A contrasting case is *Aktiebolaget Volvo v. Federal Commissioner of Taxation*[19] concerning payments made by an Australian resident company, Volvo Australia Pty Ltd ('Volvo Australia'), to its non-resident parent under an agreement made in 1972. The payments were made in consideration for the parent forbearing from supplying certain products to any person or corporation in Australia other than Volvo Australia itself.

54. The Commissioner included these payments as 'royalties' in the parent company's assessable income for the years ended 30 June 1974 to 1976 inclusive. One of the Commissioner's contentions was that the payments fell within the ordinary meaning of that term. The Commissioner argued that the payments were made in consideration of the grant of a right to the goodwill that the parent company had in Australia, particularly in the word 'Volvo' and associated symbols, and the rights which interdiction of competition in the exploitation of a licence to sell Volvo products in Australia would confer.

55. The Supreme Court of Victoria rejected the argument, pointing out that there was nothing in the agreement itself which conferred rights in goodwill – notwithstanding that the agreement may have rendered more valuable whatever of the goodwill the Australian subsidiary had or might acquire – and the payments were not made in consideration of the grant of any such right.

56. The cases illustrate that each agreement for the indemnity of RWT must be considered on its own facts and it is a matter of construction of the contract in each instance whether an indemnity amount can be related to a matter that answers the description in the subsection 6(1) definition.

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[18] 2003 ATC 4998 at 5008; (2003) 54 ATR 339 at 352.
[19] 78 ATC 4316; (1978) 8 ATR 747.

57. Similarly, an indemnity amount may be paid or credited under an agreement other than the one under which the royalty that was paid or credited gave rise to the initial RWT liability. For example, X may have a RWT liability arising out of a copyright licence agreement with Y which, under a separate agreement, Y agrees to indemnify as partial consideration for X giving Y the use of a trade-mark. Again, the indemnity is given as consideration for the use of property.

58. On the other hand if Y indemnifies X's RWT liability as consideration for X giving Y the right to renew a royalty agreement with X there will be no RWT on the indemnification amount.[20] This is because such right is not a right of the kind listed in the royalty definition and does not otherwise answer the description of any of the matters listed.[21]

59. As a further example, a contract for the lease of certain equipment might contain the clauses in paragraphs 10 and 11. Upon a proper construction of the contract an amount paid by the lessee pursuant to the clause in paragraph 11 is found to be in substance part of the consideration for, and solely for, the lessor granting the lease. The payment in that case is a royalty notwithstanding the amount is described in the clause as the payment of withholding tax.

To the extent

60. The subsection 6(1) definition allows apportionment of amounts in the sense that it makes an amount a royalty to the extent to which it is paid or credited as consideration for the matters listed in paragraphs (a) to (f) of the definition. In some instances, an agreement under which a RWT indemnification is paid or credited may be a 'divisible contract', which is separable into parts so that different parts of the consideration may be assigned to severable parts of the performance, for example, an agreement for payment pro rata.[22] Whether an obligation to pay or credit a RWT indemnification amount is divisible from other obligations under the agreement is a

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[20] Where, however, the indemnity arrangement is non-commercial, the indemnity payment is unreasonably attributed to the right of renewal or there has been an unreasonable alteration of an existing arrangement for no sound commercial reason, the Commissioner may give consideration to applying Part IVA of the ITAA 1936. Under subsection 177F(2A) of the ITAA 1936 the Commissioner may determine that a taxpayer is subject to withholding tax on a particular amount if a scheme has been entered into or carried out whereby the taxpayer would otherwise not be liable to pay withholding tax on that amount and the taxpayer would have, or could reasonably be expected to have, been liable to pay withholding tax on it, but for the scheme.

[21] See for example the High Court case of *David Securities Pty Ltd and Others v. Commonwealth Bank of Australia* (1992) CLR 353 at 388; 92 ATC 4658 at 4675; (1992) 24 ATR 125 at 149 where Brennan J in a separate but concurring judgment concluded in relation to a loan agreement and the borrowers' obligation under a particular clause to pay the lender any amount deducted as withholding tax from the interest payments it made to the lender: 'The benefit for which the respective borrowers bargained by promising to pay the tax equivalent was the right to renew advances during the availability period and they have had the benefit of that right to the full'.

[22] *Chitty on Contracts*, 28th edn, vol. 1, Sweet & Maxwell, London, 1999, para 22-027.

question of construction (the process by which a Court determines the meaning and legal effect of a contract).[23]

The CYB case distinguished

61. In CYB the question on appeal before the Court was the 'proper characterisation', for IWT purposes, of the amounts by which the borrower was required to 'gross-up' on account of withholding tax the interest payments it made to the lender.[24]

62. To be subject to IWT those amounts had to be characterised as 'interest' within the meaning of subsection 128A(1). That subsection defined interest as, 'interest includes an amount in the nature of interest, not being an amount referred to in subsection 26C(1)'.[25] 'Interest', the Court said, bore its ordinary meaning, which was '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'.[26]

63. The Court, quoting the primary judge, agreed that the amounts in question 'do not have the character of a return or profit to the lender for the use of money advanced to the borrower, howsoever calculated or ascertained', and that the indemnification amounts were neither 'interest' nor 'in the nature of interest'.

64. In the words of the primary judge, Cooper J:[27]

> [The indemnification amounts] are not calculated by reference to the principal sum advanced and are not in the nature of an additional return or profit to [the lender] on the money advanced over and above the interest calculated and payable under clauses 5 and 17 … That the additional payments were a cost to the applicant of obtaining the use of the funds does not convert the payments to 'interest' in the hands of the lender where they are referable to costs and liabilities incurred by the lender as a consequence of the loan transaction itself coming into existence and being given effect to by the parties to it.

65. It is the Commissioner's view that the CYB decision is distinguishable from and not applicable to the RWT indemnification question in that for the indemnification amount to have been 'interest' it had to be more than simply consideration for the use of the loan monies; it also had to have the character of interest and be referable to the principal sum borrowed. In the case of an RWT amount no such additional qualification is necessary; the amount merely needs to be consideration for one or other of the matters listed in subsection 6(1).

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[23] *Chitty on Contracts*, 28th edn, vol. 1, Sweet & Maxwell, London, 1999, paragraphs 22-029 and 22-037.
[24] CYB (1998) 82 FCR 288 at 289; 98 ATC 4380 at 4381; (1998) 38 ATR 442 at 443.
[25] The reference to subsection 26C(1) of the ITAA 1936 is presently not relevant.
[26] CYB (1998) 82 FCR 288 at 289; 98 ATC 4380 at 4383; (1998) 38 ATR 442 at 444.
[27] *Century Yuasa Batteries Pty Ltd v. Commissioner of Taxation* (1997) 73 FCR 528 at 549; 97 ATC 4299 at 4315-6; (1997) 35 ATR 394 at 411.

66. In the example at paragraph 59 the indemnification of RWT is found to be part of the consideration (the price) for the lessee obtaining the lease of the equipment. That quality is sufficient in our view for the indemnification amount to be a 'royalty'.

Conclusion

67. For the reasons given, it is the Commissioner's view that an indemnification of RWT will be a royalty in terms of the definition of royalty contained in subsection 6(1) if and to the extent to which, on a proper construction of the agreement under which it is paid or credited, it is paid or credited as consideration for any of the matters listed in paragraphs (a) to (f) of the definition of royalty in subsection 6(1).

Gross up

68. Based on the Commissioner's approach, where:

- a person derives a royalty ('the initial royalty amount') for which they are liable for RWT;
- that liability is fully indemnified by another person; and
- the indemnification answers the description of 'royalty' in subsection 128B(5A), then

the total RWT on both the initial royalty and indemnification amount is calculated as:

- RWT = RWT rate × (1/(1-RWT rate)) × [initial royalty amount]; and

the RWT on the indemnification amount alone is calculated as:

- RWT rate × (RWT rate/(1-RWT rate)) × [initial royalty amount].

Deductibility

69. RWT indemnification amount is deductible to the person paying or crediting it to the extent that the requirements of deductibility under section 8-1 of the ITAA 1997 or 51(1) of the ITAA 1936 are satisfied and section 26-25 of the ITAA 1997 or section 221YRA of the ITAA 1936 does not apply.

Alternative views

70. The alternative view is that RWT indemnification payments are not royalties. This view relies on three arguments. The first argument is that the Commissioner's view, expressed herein, is inconsistent with the decision in CYB. However, as indicated earlier,

CYB is distinguishable because the subsection 6(1) definition of royalty is not confined in the way interest was held to be in the CYB case. The definition of royalty is wide enough to include consideration paid or credited by way of the indemnification of tax for the matters listed in paragraphs (a) to (f) of subsection 6(1).

71. The second argument is that the RWT indemnification amount is not calculated by reference to the rights bargained for under the contract and so cannot be paid as consideration for those rights; rather it is calculated by reference to the royalty withholding tax. The manner of computation of the indemnity, this argument goes, was a factor for the Court in CYB in finding against the Commissioner. Against this, the Commissioner would distinguish CYB, again on the grounds that unlike 'interest' an amount may be a royalty under subsection 6(1) no matter how it is computed.

72. Finally, it is said that if the parties describe the amount as an RWT indemnification, then the amount is an indemnification of tax and not an amount paid as consideration for the rights under the agreement. However, as explained earlier, the description given to an amount is not conclusive of its characterisation as a royalty under subsection 6(1) and therefore that description does not preclude it from being a royalty.

Examples

Example 1

73. Ausco, a company resident in Australia, has a contract with Japanco, a company resident in Japan, under which it pays royalties to Japanco for the use of copyright. The royalty payment is $10 million per year. The contract includes an indemnification of royalty withholding tax clause under which Ausco agrees to indemnify Japanco for any royalty withholding tax so that Japanco is to receive the $10m net of Australian RWT.

74. Under article 9(1) of the Japanese Agreement, Australia can tax the royalty[28] but the tax so charged is not to exceed 10% of the gross amount of the royalty. Australia exercises its taxing right.[29] Thus Japanco has a liability to pay[30] and Ausco a requirement to withhold[31] the following RWT amount:

RWT = 10% × (1/(1-1/10)) × $10m

RWT = $1.111m

75. Of this amount, the RWT on the indemnification amount itself is:

10% × (0.1/0.9) × $10m

= $0.111m

Example 2

76. The situation is the same as in example 1 except that Japanco is a resident of Hong Kong. The RWT rate is 30%.[32] Japanco has a liability to pay and Ausco a requirement to withhold the following RWT amount:

RWT = 30% × (1/(1-3/10)) × $10m

RWT = $4.286m

77. Of this amount, the RWT on the indemnification amount itself is:

30% × (0.3/0.7) × $10m = $1.286m

[28] Article 9(3) of the Japanese tax treaty (*Schedule 6 to the International Tax Agreements Act 1953*) says, among other things, that the term 'royalties' in the Article means 'payments of any kind to the extent to which they are received as consideration for – (a) the use of or the right to use any – copyright, patent, design…'.

[29] Subsections 128B(2B) and (5A) of the ITAA 1936 and paragraph (7)(c) of the *Income Tax (Dividends, Interest, and Royalties Withholding Tax) Act 1974*, in conjunction with Article 9(3) of the Japanese tax treaty.

[30] Subsections 128B(2B) and (5A) of the ITAA 1936 and paragraph (7)(c) of the *Income Tax (Dividends, Interest, and Royalties Withholding Tax) Act 1974*, in conjunction with Article 9(3) of the Japanese tax treaty.

[31] Section 12-280 of Schedule 1 to the *Taxation Administration Act 1953* in conjunction with regulation 42 of the *Taxation Administration Regulations 1976*.

[32] See paragraph (7)(c) of the *Income Tax (Dividends, Interest, and Royalties Withholding Tax) Act 1974* and subsection 128B(5A) of ITAA 1936.

Definitions

78. In subsection 6(1) of the ITAA 1936 'royalty' or 'royalties' is defined as follows:

> 'royalty' or 'royalties' includes any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:
>
> (a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade-mark, or other like property or right;
>
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;
>
> (c) the supply of scientific, technical, industrial or commercial knowledge or information;
>
> (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);
>
> (da) the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by:
>
> (i) satellite; or
>
> (ii) cable, optic fibre or similar technology;
>
> (db) the use in connection with television broadcasting or radio broadcasting, or the right to use in connection with television broadcasting or radio broadcasting, visual images or sounds, or both, transmitted by:
>
> (i) satellite; or
>
> (ii) cable, optic fibre or similar technology;
>
> (dc) the use of, or the right to use, some or all of the part of the spectrum (within the meaning of the *Radiocommunications Act 1992*) specified in a spectrum licence issued under that Act;
>
> (e) the use of, or the right to use:
>
> (i) motion picture films;
>
> (ii) films or video tapes for use in connexion with television; or
>
> (iii) tapes for use in connexion with radio broadcasting; or

(f) a total or partial forbearance in respect of:

(i) the use of, or the granting of the right to use, any such property or right as is mentioned in paragraph (a) or any such equipment as is mentioned in paragraph (b);

(ii) the supply of any such knowledge or information as is mentioned in paragraph (c) or of any such assistance as is mentioned in paragraph (d);

(iia) the reception of, or the granting of the right to receive, any such visual images or sounds as are mentioned in paragraph (da);

(iib) the use of, or the granting of the right to use, any such visual images or sounds as are mentioned in paragraph (db);

(iic) the use of, or the granting of the right to use, some or all of such part of the spectrum specified in a spectrum licence as is mentioned in paragraph (dc); or

(iii) the use of, or the granting of the right to use, any such property as is mentioned in paragraph (e).

Detailed contents list

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

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Commissioner of Taxation
15 December 2004

Previous draft:
TR 2004/D8

Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 97/16; IT 2660

Legislative references:
- ITAA 1997 8-1
- ITAA 1997 26-25
- ITAA 1997 995-1
- ITAA 1936 6(1)
- ITAA 1936 6(1)(a)
- ITAA 1936 6(1)(b)
- ITAA 1936 6(1)(c)
- ITAA 1936 6(1)(d)
- ITAA 1936 6(1)(e)
- ITAA 1936 6(1)(f)
- ITAA 1936 26C(1)
- ITAA 1936 51(1)
- ITAA 1936 128A(1)
- ITAA 1936 128B(2B)
- ITAA 1936 128B(2B)(a)
- ITAA 1936 128B(2B)(b)(i)
- ITAA 1936 128B(2B)(b)(ii)
- ITAA 1936 128B(2C)
- ITAA 1936 128B(2C)(a)
- ITAA 1936 128B(2C)(b)(i)
- ITAA 1936 128B(2C)(b)(ii)
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- Taxation Administration Regulations 1976 42

Case references:
- Aktiebolaget Volvo v. FCT 78 ATC 4316; (1978) 8 ATR 747
- Century Yuasa Batteries Pty Ltd v. Commissioner of Taxation (1997) 73 FCR 528; 97 ATC 4299; (1997) 35 ATR 394
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- David Securities Pty Ltd and Others v. Commonwealth Bank of Australia (1992) 175 CLR 353; 92 ATC 4658; (1992) 24 ATR 125
- FCT v. Sherritt Gordon Mines Ltd (1977) 137 CLR 612; 77 ATC 4365; (1977) 7 ATR 726
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- Yanchep Sun City Pty Ltd v. Commissioner of State Taxation (WA) 84 ATC 4761; (1984) 15 ATR 1165

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