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Aspects of Interest Withholding Tax

Abstract

Interest withholding tax is often a misunderstood or forgotten tax. It has greater application than may first be thought. This paper addresses the nature and imposition of the tax amongst practical matters, particularly from the point of view of the lender.

Keywords

interest withholding tax

ASPECTS OF INTEREST WITHHOLDING TAX

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Interest withholding tax is often a misunderstood or forgotten tax. It has greater application than may first be thought. This paper addresses the nature and imposition of the tax amongst practical matters, particularly from the point of view of the lender.

There are two principal forms of withholding tax in the Australian tax system – interest withholding tax and dividend withholding tax. This paper deals with the first of these.¹

Outline of interest withholding tax

Interest withholding tax is not unique to Australia. Other countries which impose such a tax include Singapore, Indonesia, until recently Hong Kong and, further afield, England and the United States of America. Its structure is simple. The tax is a liability imposed upon the recipient of the interest income. However, the tax, is at least at first instance, collected by requiring the payer of the interest income (the “borrower”) to make a deduction from the gross income paid to the recipient (the “lender”).² The borrower is then obliged to remit an amount equal to the deduction to the Commissioner of Taxation.

1 In addition, there is the withholding tax imposed by s 126 Income Tax Assessment Act 1936 (“ITAA”). This withholding tax relates to bearer debentures where the name and address of the holder of the debenture has not been disclosed by the issuer company to the Commissioner of Taxation. In summary, if there is tax payable under s 126, there is no tax payable under s 128B; the tax is imposed upon the issuer of the debentures, not on the holder of the debentures (which is the reverse of the s 128B structure); if the tax is imposed, the issuer is entitled to deduct and retain for its own use an amount equal to the tax payable; it is possible for an exemption to be obtained under s 128F in relation to bearer debentures in which case the s 126 tax will not be payable.

All references to sections are to the ITAA, unless otherwise specified.

2 Whilst most cases will involve interest paid on loans, interest is payable in any number of situations which makes the use of the terms “borrower” and “lender” potentially misleading – for example interest paid on the purchase price under a long term contract. Notwithstanding this, in this paper the more usual terms “borrower” and “lender” will be used.

Withholding tax is, in many cases, a final tax, meaning that the lender is not obliged to disclose the income, on which withholding tax is payable, as assessable income.³ As a necessary corollary, the lender is not entitled, in those cases, to claim deductions associated with deriving the income. Interest income which is subject to withholding tax because of s 128B(2A) is disclosable as assessable income.

Withholding tax (both dividend and interest) represents some 1% of total tax revenue in the Australian tax system. Of this, interest withholding tax is the dominant source generating some 90% of withholding tax revenue. In absolute terms, it has been estimated that interest withholding tax represented some \$750m in 1989-1990.⁴

In the case of interest withholding tax, the deduction required is 10% of the gross amount of the interest paid.⁵

A few comments should be made as to the seemingly low 10% level of tax imposed on interest.

- The deduction is made as regards the gross income of the lender without any allowance for deductions for the costs of deriving the income.
- If the lender is not able to take advantage of foreign tax credits in its home jurisdiction, it is effectively being taxed twice on the same income (that is by the Australian tax system and by that of the home jurisdiction).
- It is the invariable practice in international loan transactions for a borrower to be required to gross up interest payments so that the lender receives the same net amount that would have been received had the deduction not been made. Grossing up entails the borrower paying more than 100% of the interest. In fact the amount paid by the borrower is not 110% but rather 111.11%.⁶

3 Section 128D.

4 Barbara Smith, "Non-residents and Interest Withholding Tax" (1990) CCH Journal of Australian Taxation 80 at 81.

5 Income Tax (Dividends and Interest Withholding Tax) Act 1974. By way of contrast, dividend withholding tax is levied at the rate of 30% (15% in the case of a recipient resident in Papua New Guinea) unless a double tax treaty applies in respect of the non-resident, in which case the rate is 15%.

The House of Representatives Standing Committee on Finance & Public Administration in its Report *Following The Yellow Brick Road* 1991 after detailed analysis as to whether the rate should be changed recommended that the issue be referred to the Industry Commission and that attention should be directed to the appropriateness of differential rates depending on the residence among other considerations. The Committee also recommended, pending that review, that the Commissioner of Taxation be provided with a discretionary power to impose the top marginal rate of tax on interest income earned by non residents where there was reason to believe the income derived was related to an avoidance arrangement undertaken by a resident. (pp 29-30 of the Report)

6 The formula for calculating the grossed up amount is:
$$\frac{100}{100 - T} \times 100 = GA$$

Where:

T = amount of withholding tax as a percentage;

GA = gross amount payable (as a percentage of the notional interest rate).

Why a withholding tax?

At one time, the Australian interest withholding tax regime was concerned only with payments of interest by residents to non-residents. Whilst the tax is now imposed in wider circumstances than that, that original position provides an insight into the perceived value of a withholding tax system.

Where the recipient of the income is a non-resident, a withholding tax system offers to a taxing authority a relatively effective means of collection. Such is required because courts of one jurisdiction are reluctant and usually decline to enforce the revenue laws of another.⁷ Even if foreign courts were willing to enforce Australian tax laws, the extra effort and expense of having to enforce judgments in a foreign jurisdiction would be a major disincentive to collection.

Another reason for the withholding tax system is that it makes determination of the liability to withholding tax relatively simple, particularly as questions as to the source of the income are eliminated.

Finally, it is said that a withholding tax system is more compatible with the terms of double tax treaties.⁸ Presumably, this is because quantification of the withholding tax liability is that much simpler than quantification under other systems. This leads to more certainty as to the amount which may be subject to double tax and thus in need of relief under the various double tax treaties.

Imposition of interest withholding tax

It is commonly believed that interest withholding tax is less imposed only when interest is payable by an Australian tax resident to a non-resident. This is not so. Indeed, interest withholding tax may be imposed in transactions involving only Australian residents and again in transactions involving only non-residents.⁹ The four cases where interest withholding tax is imposed are:

See EDR 69

In jurisdictions where the withholding tax is greater than 10%, the grossed up amount can increase quite quickly. For example in Singapore, where the withholding tax is levied at 20%, borrowing costs are increased by an effective 25%; in Indonesia, where the withholding tax is imposed at 30%, the effective borrowing costs are increased by nearly 43%.

For a discussion of other issues relating to grossing up see below "Grossing Up and s 261".

7 See Sykes and Pryles, *Australian Private International Law* (Law Book Co 1979) 151-152.

8 Butterworths, *Australian Income Tax & Practice*, Vol 6, paragraph 128A/01.

9 The ITAA does not refer to residency per se. Rather the relevant sections refer to "a person to whom this section applies" which is defined as meaning:

- the Commonwealth;
- a State;
- an authority of the Commonwealth or of a State;
- a person who is a resident.

The first three of these are self explanatory. The balance of this paper will concentrate on the provisions as it relates to residents. Section 128B(1A).

A Non-Resident Lender – Resident Borrower

Interest withholding tax is imposed where:

- income is derived by a non-resident on or after 1 January 1968;
- that income consists of interest paid¹⁰ to that non-resident by a resident;
- that interest is not wholly incurred by that resident as an outgoing in carrying on business at or through a permanent establishment outside Australia; and
- that income is not derived by the non-resident in carrying on business at or through a permanent establishment in Australia.¹¹

B Non-Resident Lender – Non-Resident Borrower

Interest withholding tax is imposed where:

- income is derived by a non-resident on or after 1 January 1968;
- that income consists of interest that is paid to that non-resident by a person (or persons) each of whom is also a non-resident;
- that interest is an outgoing incurred by that person or those persons in carrying on business at or through a permanent establishment in Australia; and
- that income is not derived by the non-resident lender in carrying on business at or through a permanent establishment in Australia.¹²

C Resident Lender – Resident Borrower

Interest withholding tax is imposed where:

- income is derived on or after 2 July 1973 by a resident;
- that income is derived by that resident in carrying on business at or through a permanent establishment outside Australia;
- that income consists of interest paid by another resident; and
- that interest is not wholly incurred by the resident borrower in carrying on business at or through a permanent establishment outside Australia.¹³

D Resident Lender – Non-Resident Borrower

Interest withholding tax is imposed where:

- income is derived on or after 2 July 1973 by a resident;

10 Withholding tax cannot be avoided by having the borrower deal with the interest payable to the lender. Section 123A(2) deems interest to have been paid to another "although it is not actually paid over to the other person but is reinvested, accumulated, capitalised, carried to any reserve, sinking fund or insurance fund however designated, or otherwise dealt with on behalf of the other person or as the other person directs."

11 Section 128B(2)(b)(i) and (3)(h)(ii).

12 Section 128B(2)(b)(ii) and (3)(h)(ii).

13 Section 128B(2A)(i).

- that income is derived by that resident in carrying on business at or through a permanent establishment outside Australia;
- that income consists of interest paid by a person who is (or persons, each of whom is) a non-resident;
- that interest is an outgoing incurred by the non resident borrower in carrying on business at or through a permanent establishment in Australia.¹⁴

There are three critical concepts involved in each of these situations:

- A Residency;
- B Interest; and
- C "Carrying on business at or through a permanent establishment".

A *Residency*

Little will be said here about the concept of residency, as the usual rules for determining residency apply. This is not to say that questions of residency do not, in practice, give rise to difficult questions.

In a banking context, it is, for example, very difficult to determine in relation to a particular borrower whether or not a withholding tax liability will be incurred. Indeed, it is not sufficient to make a determination at the time the loan is taken out or the first interest payment is made as the borrower's residency may change any number of times during the currency of the loan. A recent ruling gives an example of the almost impossible position that a financier can find itself in.¹⁵ Migrants would normally be regarded as residing in Australia from the date of arrival in Australia, even though their personal business interests take them away from Australia for substantial periods. Notwithstanding this, it is a question of degree and it is possible for such persons notwithstanding the presence of the balance of their family in Australia, to be regarded as non-residents, if most of their time is spent outside Australia.

Further complication flows from the 183 day test.¹⁶ As the ruling indicate "there may be situations ... where a person does not reside in Australia during a particular year but is present for more than six months (perhaps intermittently and intending to take up residence in Australia in the future)".¹⁷ Such a person would be deemed to be a resident in Australia if more than 183 days in any tax year are spent in Australia, even though after spending that time in Australia it is some years before he and his family finally make it to Australia on a permanent basis and could be said to be resident in Australia on ordinary concepts.

Such considerations places both lender and borrower in an invidious position of having to monitor almost continually the residency status of the borrower. The borrower needs to do so to determine whether it is obliged to

¹⁴ Section 128B(2A)(b)(ii).

¹⁵ IT 2607.

¹⁶ Section 6(a)(ii) definition of "resident".

¹⁷ IT 2607 para 17.

make the deductions (on pain of penalty tax); the lender so as to ensure that its tax is paid by deductions or declared in its annual return as appropriate (again, on pain of penalties).

B Interest

Interest is not defined in the Act other than to say that it includes “an amount in the nature of interest, not being an amount referred to in subsection 26C(1)”.¹⁸ Consequently, one has to go to the common law where interest means “the return or compensation for the use or retention by one person of a sum of money belonging to or owed to by another”.¹⁹ As noted earlier, interest is not found only in respect of loans and similar financial transactions, but also where there is no loan. For example, interest may be payable on the deferred purchase price of property; interest may be payable on judgments given by courts. As there is no reason given in the ITAA to read down the types of interest which may be liable to withholding tax, one has to remain vigilant and not discount the possibility of the tax being imposed simply because there is no loan (in the strict sense) involved.

Notwithstanding the apparently wide meaning of the concept “interest”, the ITAA was amended in 1986 to deal with three particular cases:

- discounted and deferred interest instruments;
- bill acceptance and discount transactions;
- hire purchase and similar transactions.

Brief comment will also be made as regards:

- swaps; and
- payments under guarantees.

(i) Discounted and deferred interest instruments

It is a common occurrence for funds to be raised by the issue of instruments which promise the repayment of a specified amount at a date certain in the future. Funds are raised by selling that instrument in a market at a discount, the amount “borrowed” being the discounted amount paid in the marketplace. Alternatively, the instrument may bear deferred interest.

Section 128AA of the ITAA deals with one variety of such discounted instruments, viz a qualifying security.²⁰ It provides that where a person

18 Section 128A(1), s 26C(1) involves gains on the sale or redemption of Treasury Notes (which do not bear interest) and Commonwealth Bonds (which do bear interest). Neither are subjected to withholding tax as regards the interest component because of s 128A(1) and as regards the gain made on any disposal because the Commissioner regards the disposal price simply as “a purchase price” and as not including any interest component. The Commissioner supports this seemingly curious conclusion by saying that it would be difficult to quantify the gain which would be subject to tax – see IT 2055.

19 See *Halsbury's Laws of England* (4th ed) Vol 32, para 106.

20 A qualifying security is a security:

- (a) Issued after 16 December 1984;
- (b) Not being a prescribed security within the meaning of s 26C;

transfers a qualifying security and the transfer price exceeds the issue price, so much of the transfer price as equals the excess is deemed to be income that consists of interest.²¹

The section is designed to overcome the situation whereby a non-resident holder sells a qualifying security to a resident holder shortly before maturity, or shortly before interest is payable. In the absence of s 128AA:

- in some cases the issuer would not be subject to withholding tax;
- if so, the new (resident) holder would not need to make any deduction; and
- most importantly, no part of any gain made on the sale of the security by the non-resident holder would be subject to a withholding tax deduction, notwithstanding it may have held the security for a considerable period of time during which its value has appreciated.

By s 128AA, it is assumed that the gain made on the sale is interest and a resident purchaser will be obliged to make a deduction before payment of the purchase price to the non-resident holder.²² This formulation used by the ITAA is but an approximation of the "true" interest component, because there are other factors which may affect the amount paid on transfer. For example, where the instrument bears a fixed interest rate, market rates may have moved favourably or not since its issue. Alternatively, the creditworthiness of the issuer may have changed since issue of the security or a new tax imposed on receipts. These, among any number of other factors, may influence the amount a person may be willing to pay for the security and, on general principles, are more akin to capital items than interest.

Because the deemed interest is calculated by reference to the difference between transfer price and the original issue price, it could be that, as a result of a number of sales of the same security, successive transferors could be required to make more than one deduction as regards the same gain. Section 128AB ameliorates this to some degree.

Where the Commissioner is satisfied that the transferor of the security is an Australian tax resident, or the transfer price is derived from a source in

(c) Which has an eligible return; and

(d) Where the eligible return can be ascertained at the time of the issue of the security, the eligible return for the security is greater than 1.5% pa.

See ss 128A(1B) and 159GP(1).

An "eligible return" exists where, in relation to a security (which is issued at a discount, bears deferred interest or is capital indexed or by any other mechanism), it is reasonably likely that the aggregate of all payments under the security, other than periodic (that is not less often than annual) interest payments, will exceed the issue price of the security. The eligible return is the excess – s 159GP(3) and (b).

A "security" is widely defined as including stocks, bonds, bills of exchange, promissory notes, etc – s 159GP(1).

21 "Transfer price" and "issue price" bear the meaning given in s 159GP – s 128A(1A). Note that s 159GP(2) which allows The Commissioner to adjust the transfer price and issue price in the case of related party transfers, does not apply to s 128AA – s 128AA(2). The effect however is reimposed by s 128NA.

22 Section 221YP(3A).

Australia (and therefore assessable under general concepts, whether or not the transferor is resident), a certificate will be issued on application by the transferee. That certificate will specify the transfer price which is to apply in respect of a transfer by the transferee. The amount will be the purchase price paid by the transferee. If the transferee later decides to sell the security, the amount specified in the certificate will be regarded as the issue price of the security and thus the transferee will only have a "gain" if the sale price is greater than the purchase price that it paid for the security.

That the protection is limited can be seen from considering a sale by a non-resident holder who holds a certificate (the "original purchaser") to another non-resident (the "end purchaser"). The certificate is of no benefit to the end purchaser (the certificate already held by the original seller is available only to calculate the "interest" component received by the original purchaser from the sale to the end purchaser). Further, it is conceivable that the end purchaser cannot obtain its own certificate because it cannot satisfy s 128AB(1)(b) in that the transfer price is not derived from a source in Australia. Thus, any subsequent sale by the end purchaser will be subjected to an interest component equalling 100% of the excess over the original issue price.²³

(ii) Bill acceptance and discounting transactions; promissory notes

Funds can also be raised by bill facilities or promissory note facilities. In such facilities, the "borrower" draws bills of exchange which are accepted by a financier (effectively guaranteeing that the holder of the bill of exchange will be paid on maturity; the drawer is required to indemnify the acceptor against such liability). The bills are then sold into a market at a discount to the face value. If a resident drawer pays the face value of the bill on maturity to a non-resident holder, it seems clear if one accepts that interest is "the return or compensation for the use or retention by one person of a sum of money belonging to or owed to by another";²⁴ that the discounted amount would represent interest and withholding tax potentially payable.

Before the enactment of s 128AD, it was argued, however, that amounts paid by the drawer to a non-resident acceptor either to put it in funds to enable the acceptor to honour the bills on maturity or to indemnify the acceptor (it having already paid out on the bills) did not contain any amount that comprised interest. These sums were said to be sums paid under contractual arrangements (ie the indemnity) distinct from the bills and, in any event, were directed to the acceptor not the holder of the bills whose money the drawer has had the benefit.

Section 128AD was introduced to remove any suggestion that these arguments were correct.²⁵

23 The sale to the end purchaser will not give rise to an ongoing withholding tax imposition for the end purchaser unless it is carrying on business at or through a permanent establishment in Australia – s 128B(2)(b)(ii).

24 Above n 17.

25 See Treasurer's Comments in the Explanatory Memorandum to the Amending Legislation quoted in CCH Aust Federal Tax Reporter ¶68-740.

Section 128AD applies where:

- the drawer of a bill of exchange pays an amount (the “indemnification amount”) to the acceptor of the bill to compensate the acceptor in respect of any amount which the acceptor is liable to pay to the payee of the bill on presentment of the bill (the “eligible presentment amount”);
- no part of the indemnification amount will be included in the assessable income of the acceptor in any year of income; and
- some part (the “eligible presentment interest”) of the eligible presentment amount consists of interest.

In such circumstances, so much of the indemnification amount as compensates the acceptor in respect of the eligible presentment interest is “deemed to be income that consists of interest”.²⁶ A similar provision exists as regards promissory notes.²⁷

The legislation assumes that some part of the amount payable by the acceptor on maturity consists of interest. It is not clear that is in fact the case. If one returns to the common law definition given above,²⁸ it is not immediately clear that the acceptor has had the use of or has retained money belonging to or owing to the holder of the bill. If not, no part of the payment by the acceptor to the holder comprises interest meaning that the third prerequisite is not met, in turn meaning that the deeming provision does not apply. The argument that such payments contain an interest component is strongest when the drawer puts the acceptor in funds before maturity. In economic (but not necessarily, legal) terms, it is the borrower's money that is being used to pay out the bills on maturity and a strong case can be made that the drawer has had the use of the holder's money. Even then, however the argument is not tight because it assumes that the acceptor is in reality merely an agent of the drawer in effecting payment rather than liable on its own account. Again, the drawer does not necessarily have the benefit of the money of the holder who presents the bills on maturity as the original holder may have resold the bill into the market and so on.

The argument that the acceptor is simply a payment agent may have greater credence if the drawer was to put the acceptor in funds before maturity to enable it to pay. That the acceptor is not simply a payment agent for the drawer however is quite clear from the usual documentation. In any event, for the acceptor to be but a payment agent would be quite unattractive to market participants who look to the acceptor as having an independent liability for the amount of the bill. Indeed it is to the essence of the marketability of the bill that the acceptor “lends its name”. In such circumstances no money of the acceptor is being used; its name (as acceptor) is being lent to the transaction but nothing else.

26 Section 128AD(1).

27 Section 128AD(2).

28 Above n 17.

Consequently, the advent of s 128AD has done little to resolve the threshold question of what constitutes “interest”.²⁹

(iii) Hire purchase and similar agreements

It can be thought that hire purchase agreements and certain lease agreements are in economic terms equivalent to a loan taken out to purchase property. This is particularly so when all costs and responsibilities of ownership are cast upon the hirer/lessee. If one accepts that proposition, it is not too difficult to conclude that some of the payments made under a hire purchase or similar agreement represent interest. If so (the argument would run), withholding tax should be imposed on such payments to the extent they represent interest. Section 128AC is designed to do just this.

Affected are:

- hire purchase agreements; and
- lease agreements (or other agreements under which a person is entitled to use property owned by another) pursuant to which title is to be transferred to the user at the end of the agreement or where the term of the agreement is for the effective life of the property,

in either case entered into after 16 December 1984 (but only as regards “interest” payments made after 24 June 1986).³⁰

As regards such agreements, a formula is used to calculate the interest component of all payments. That formula focuses on the interest component as being the amount by which the total payments liable to be made under the relevant agreement exceeds the market value of the property in question (as valued at the commencement of the agreement).

Withholding tax is then imposed on payments made as regards such an agreement to the extent that such payments do not exceed the notional interest (where the notional interest is the interest calculated as per the Rule of 78 together with any interest carried forward from the immediately preceding payment).³¹

(iv) Guarantees

One of the perennial problems in relation to withholding tax is whether a guarantor in respect of obligations of a borrower is obliged to make a deduction on account of withholding tax as regards payments which may be thought to include interest.

The question is of some practical importance. If a lender has to resort to recovery from a guarantor, it invariably means that there is some doubt as to whether the principal debtor (the borrower) is in a position to pay all sums owing. In those circumstances any funds “saved” by not having to pay

29 For what is arguably a further deficiency in the section see “Interest Withholding Tax” by LM Magid in *Taxation Institute of Australia 1987 Convention and Seminar Papers* p 23 at 28.

30 Section 128AC.

31 Section 128AC(1), (5) and (7).

withholding tax (or for which the guarantor is obliged to gross up) are of great interest to the lender.

There are two relevant issues:

- whether any part of the amount paid under the guarantee can be regarded as interest; and
- if it is interest, whether it is interest as to which withholding tax is imposed. As to the first, there is no clear authority³² and the arguments on both sides have their attractions.³³ From the point of view of the guarantor, any moneys paid under the guarantee constitute a debt. That the debt is quantified (and has its genesis in the interest obligation of the principal debtor) is not to the point (or so it is argued). From the point of view of the holder of the guarantee, the moneys received are intended to be exactly equal to the interest that should have been paid by the principal debtor and are treated in every regard as interest (or so it is argued).

It has been suggested that an answer may lie in identifying the exact nature of the guarantee – is it a guarantee of payment or a guarantee of performance?³⁴ The argument is that if it were a guarantee of performance, the payment by the guarantor would not include any sum of interest, whereas a guarantee of payment (whereby the guarantor accepts a principal obligation to pay the interest) would necessarily involve a payment of interest.

Further obscurity can be introduced by replacing the guarantee with a letter of credit. The essence of letters of credit are that they are “separate transactions from the ... contract(s) on which they are based”³⁵ and may not even contain any reference to the underlying transactions in question.

Assuming that the payment made by a guarantor constitutes interest, the second issue needs to be considered viz whether it is interest as to which withholding tax is imposed. One would have thought that a guarantor who makes payments consisting of interest would be obliged to make deductions in those cases (and only in those cases) where the principal debtor is obliged to make a deduction if it had made the payment. That is (arguably) not so.

Take a resident principal debtor who incurs the interest obligation in an Australian business. If the interest is payable to a non-resident, withholding tax is payable. If a guarantee was granted by a corporation (say, the principal debtor's parent company), it would be fairly easy to ensure that the interest obligations of the corporate guarantor were not outgoings incurred whilst carrying on business in Australia. If so structured, payments of interest by

32 See *Re Holder* [1932] AC 624; *Westminster Bank v National Bank of Greece* [1969] 3 All ER 504; *Re Hawkings* [1972] 3 All ER 386.

33 For an extended review of the alternative arguments, see: JA Dunstan “Eurocurrency Lending and Note Issues” in *The Law of Public Company Finance*, Law Book Co 1986 324, 330-331.

34 The distinction between the two forms of obligation is recognised (in a different context) in *Sunbird Plaza Pty Ltd v Maloney* (1988) 62 ALJR 195 at 197.

35 Uniform Customs and Practice for Documentary Credits (1983 Revision), International Chamber of Commerce Publication No 400 Article 3.

the non-resident corporate guarantor would not be subject to deduction on account of withholding tax. Such does not seem logical.

(v) *Swaps*

In an interest swap (that is, an agreement whereby two parties (the "counterparties") agree to satisfy the interest obligations of the other to third parties, there being usually a netting off of the two interest streams with a single sum being payable by one party to the other), there is at first glance a seemingly somewhat paradoxical situation whereby there are no interest withholding tax implications as to the net amounts payable between the counterparties. This is because the interest withholding tax obligation as regards the loans will have arisen as to the underlying interest streams themselves and all that has happened is that each counterparty has agreed that it will satisfy the other's interest stream obligation from two sources:

- its own funds to the extent that what is required is not greater than the interest obligation under its original interest stream obligation; and
- the net amount payable by the other party (if any).

The Commissioner accepts this view.³⁶ The Commissioner puts it this way:

[An interest swap] does not involve any additional loans between the parties or any disturbance of existing loans and obligations to pay interest as it falls due.³⁷

The same could not be said for swaps involving both principal and interest obligations. In such cases, it is at least arguable (and not discussed in IT 2050) that some portion of the net amount payable in respect of principal obligations will be referable to interest. The argument would be that the economic effect of a swap of both principal and interest is to have "borrowed" the principal in fact borrowed by the counterparty. Thus the first borrower's payments should include an amount of interest equal to that payable on the counterparty's loan.

C *Carrying on business; permanent establishment*

The third important concept in determining whether a liability for withholding tax is imposed is that of carrying on business at or through a permanent establishment. The difficulties involved can be illustrated by considering the position of a foreign financier wishing to finance the acquisition of Australian rental properties.

Whether someone is carrying on business is a question of fact. The Commissioner regards it as being easier to show that a corporation is carrying on business than it is to show a natural person is so carrying on business.³⁸ This stems from the notion that corporations (generally) have no reason for being other than to carry on business. For example, the courts

36 IT 2050.

37 IT 2050 para 5.

38 IT 2423 para 3.

have thought it difficult for a corporation that rents out its property to displace the conclusion that it is in the business of letting.³⁹

For a natural person, it is a question of degree. Owning and renting out but one property would not usually be said to be carrying on business. Owning and letting out 100 properties undoubtedly would.

How a financier wanting to lend moneys to such an individual is supposed to determine whether a business is being carried on if there are two, three or 10 properties is a mystery, particularly in these days of self assessment when it can be years (if ever) before the individual's affairs are scrutinised by the Commissioner. And yet, determination of the question "Is a business being carried on?" is critical in determining whether interest withholding tax is payable.

There is a second factor – the notion of a "permanent establishment". This is defined as excluding (in the context of rental properties) "a place where the person is engaged in business dealings through a bona fide commission agent or broker who ... acts in the ordinary course of his business as a commission agent or broker ...".⁴⁰ Thus, a non-resident landlord who engages a commission agent to attend to the management of the rental properties can ensure that the Australian connection is broken and thereby ensure the liability to withholding tax does not arise. The Commissioner accepts this view.⁴¹

Exemptions

There are a number of exemptions from the imposition of interest withholding tax:

- interest paid on certain government and government authority loans;⁴²
- interest of the types listed in s 128B(3);⁴³
- interest paid on offshore borrowings of offshore banking units;⁴⁴
- interest paid on certain widely distributed debentures.⁴⁵

The latter two exceptions bear further comment.⁴⁶

Offshore banking units

The favourable treatment given to offshore banking units ("OBUs") is designed to assist Australian banks to compete in offshore wholesale money

39 *American Leaf Blending Co Sdn Bhd v Director General of Inland Revenue (Malaysia)* [1978] 3 All ER 1185 at 1189; *Lilydale Pastoral Co Pty Ltd v FCT* 87 ATC 4235.

40 Section 6(1) – definition of "permanent establishment".

41 IT 2423.

42 Section 128GA.

43 The rationale for the exclusion of most if not all of the types of interest specified in this section is that the interest will have already been made subject to Australian tax.

44 Section 128GB.

45 Section 128F.

46 There have been in the past other exemptions. For comments on their operation and repeal see above n 29 at 28.

markets. Without the exemption, it is conceivable that an Australian bank (undoubtedly an Australian tax resident) which borrowed offshore could be obliged to deduct withholding tax from interest to those from whom it borrowed. Such borrowings are not able to be structured to be eligible for the widely distributed debenture exemption. Without such an exemption, the cost of borrowing would be increased for Australian banks.⁴⁷

Anti-avoidance provisions are included to discourage an OBU interposing itself between the "real" lender and the "real" borrower, obtaining the exemption and passing the benefit of that exemption onto the "real" borrower by charging the same or a similar rate of interest on the loan to the "real" borrower as it is obliged to pay to the "real" lender. In such circumstances the exemption is not available.⁴⁸

Wide distribution exemption

Section 128F(2) and (3) are the key to the "widely distributed debenture" exemption. They operate such as to provide that withholding tax is deemed not to be payable in respect of interest paid by a company in respect of debentures where:

- the company is, at the time the debentures were issued and at the time the interest is paid, a resident of Australia;⁴⁹
- the debentures are issued by the company outside Australia for the purposes of raising a loan outside Australia;
- the interest is paid outside Australia;⁵⁰ and
- the Commissioner has issued a certificate under s 128F(4) in respect of the loan.

Section 128F(4) compels the Commissioner to issue the certificate if:

- having regard to certain matters, the Commissioner is satisfied that it is reasonable "to regard the debentures as having been issued with a view to public subscription or purchase or other wide distribution among investors"; and

47 The special status of OBUs is further highlighted by the announcement by the Prime Minister in his "One Nation" Package that "taxable income derived from pure offshore banking transactions by an authorised offshore banking unit in Australia will be taxed at the reduced rate of 10 per cent from 1 July, 1992. This ... recognises the unique character of offshore banking as a highly specialised activity distinct from the core business of the banking sector." PJ Keating, *One Nation*, AGPS 26 February 1992, p 77.

48 Section 128GB(3).

49 Section 128F(6) relaxes this to some degree by enabling a wholly owned and controlled non-resident subsidiary to be substituted as the issuer provided the only business of the subsidiary is the borrowing of money for the purpose of onlending to the parent company and the subsidiary lends the moneys to the parent on a non-profit basis. For the similar situation of the issue being effected by a non-resident agent of an undisclosed resident principal see IT 2652.

Note also that the exemption will be lost if a company other than the issuer assumes liability for the interest obligations – IT 2205.

50 As to what constitutes payment outside Australia when the payments are in Australian dollars (and consequently can only be effected in Australia) see IT 2515.

- the borrowing was undertaken by the company for the purpose of raising money to be used by the company in an Australian business; or for expenditure by that company for the purpose of making those moneys available to other persons for use by those other persons in an Australian business.

The size of the issues involved are large – \$100 million being the usual minimum. The cost (in time and effort and money) of putting together such an issue is not inconsiderable. Thus it would be a brave issuer who was prepared to enter the market without a good idea as to whether an exemption would be available. Failure to obtain an exemption would effectively increase borrowing costs by a 11.1% of the anticipated interest cost.

It is not however possible to obtain an exemption certificate until after the proceeds of the issue have been made available. Consequently, the practice is to apply for an advance informal (non-binding) ruling in relation to a particular issue of debentures. The advance ruling and certificate are issued by (and thus the applications for each are submitted to) the office of the ATO at which the issuer lodges its tax return. As may be expected various offices of the ATO can, at times, have differing views as to what will satisfy the statutory requirements.

Matters of particular concern in the past have included:

- the size of the issue (an issue of \$1 billion being thought to be more likely to achieve wide distribution than one of \$10 million);
- the face value of the debentures (it being thought that issuing debentures with a face value of A\$1m (as compared to A\$100,000) would hamper efforts made in achieving wide distribution); and
- the number of tender panel members (these institutions take on the role of finding investors/buyers for the debentures) and the number of investors/clients on their books.

The debentures may be represented by definitive instruments (they being separate instruments representing the separate interests of each investor) or by a global instrument (that is a single instrument representing the separate interests of all investors).⁵¹

At one time the Commissioner expressed some concern as to how wide distribution could be achieved as regards a global instrument. He now seems to accept that current practice and the legal basis of such global instrument is compatible with wide distribution where (amongst other matters) the global instrument is held by either or both of the two major international securities clearance houses for internationally traded securities, Euroclear and CEDEL.⁵²

It is instructive to note that there is no obligation placed upon anyone to achieve wide distribution. The Commissioner only has to be satisfied that it

51 For a description of the legal nature and use of global instruments see A Boxall, "Global Bonds and Notes" in *Directions in Finance Law*, Butterworths 1990, pp 117-135.

52 EDR 68.

is "reasonable to regard the debentures as having been issued *with a view ... to wide distribution*" (emphasis added). The Commissioner has accepted that this is so in relation to a proposed issue of debentures in the US and UK bill market, notwithstanding it was conceded by the issuer that the Bank of England would, as regards the UK market, be expected to take up some 65% of the issue. Somewhat cosmetic changes to the proposed documents were sufficient to convince the Commissioner that enough was being done to issue with a view to wide distribution.⁵³

The Commissioner is not disturbed too greatly by US securities laws which, in some circumstances, require debentures to be held (ie not onsold) for finite periods of time (30-60 days) as he views such periods as being only part of the life of the debentures which are expected to be onsold after that holding period.⁵⁴

The Commissioner has recently elucidated his understanding of s 128F(4)(b).⁵⁵ As noted above that section states that the borrowing must have been undertaken for the purpose of raising money to be used by the company in an Australian business or in making those moneys available to other persons for use by those persons in an Australian business. Notwithstanding the disjunctive "or", the Commissioner takes the view that the first limb should not be read literally but rather should be read to mean "used otherwise than by making the funds available for use by another person".⁵⁶ The consequence for financial institutions is that they cannot obtain an exemption for borrowings to finance, amongst other matters, consumer credit and housing loans for its customers, notwithstanding such is part of (in the words of s 128F(4)(b)(i)) that issuing institution's "Australian business".⁵⁷

Commercial loans are acceptable as they would constitute loans to other persons for use in an Australian business and thus falling within the second limb of s 128F(4)(b).⁵⁸

The Commissioner recognising that it is "often not possible to trace a flow of funds from their source, ... to their application in the course of the business of the bank or finance company" has indicated that he will accept in the case of financial institutions that the requirements of s 128F(4)(b) are satisfied if certain undertakings are provided as part of the application process.⁵⁹

53 IT 2288.

54 IT 2196.

55 IT 2648.

56 Ibid para 16.

57 Ibid para 22.

58 Section 128F(4)(b)(ii).

59 IT 2648 para 28.

The undertakings are to the effect that the borrowing is not undertaken for the purposes 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 (ie for private or domestic use).

Collection

Withholding tax is due “by the person liable to pay the tax” 21 days after the month in which the income to which the tax relates was derived.⁶⁰ It is to be remembered that the person liable to pay the tax is the recipient of the interest (the lender), not the borrower. The primary collection mechanism however is found in s 221YL and it reveals that it is the borrower which, at first instance, is expected to pay the tax.⁶¹

Section 221YL(2A) deals with payments made outside Australia and provides that where interest is payable by a person (the borrower) to another (the lender) and the lender has an address outside Australia or the borrower is authorised to pay the interest outside Australia, the borrower is obliged “before or at the time when the interest is paid ... [to] make a deduction from the interest of an amount [equal to the withholding tax]”.⁶²

Section 221YL(2B) is concerned with payments made inside Australia. Where the interest is paid to a person in Australia (“A”) and another non-resident person (“B”) is entitled to receive the interest from A, A is obliged to make a deduction from the interest of an amount equal to the withholding tax upon receipt.

Sections 221YL(2C)(2D) and (2E) deal with the situation where the recipient of the interest is an Australian resident but has derived the interest whilst carrying on business at or through a permanent establishment outside Australia (in which case it is possible that withholding tax is payable). In that case, the recipient is obliged to give notice to the Commissioner and the borrower. Thereafter, the borrower is obliged to make the relevant deductions.

There is a general protective provision to the effect that a person is not obliged by anything in s 221YL to make a deduction unless in fact withholding tax is payable. Whilst its presence is welcome, it is little comfort to those who have difficulty in determining whether the tax is payable or not.⁶³

Having made the deduction, those making the deduction are obliged to:

- within 21 days after the month in which the deduction has been made, pay to the Commissioner an amount equal to that deduction; and
- within four months of the end of financial year in which the deduction is made provide to the Commissioner a signed statement in respect of the deduction.⁶⁴

Failure to make the deduction renders the person obliged to make the deduction:

⁶⁰ Section 128c(1).

⁶¹ Having made payment of the withholding tax, the borrower is entitled to recover from the “person liable to pay the ... tax” (ie the lender) an amount equal to the withholding tax paid – s 221YQ(2).

⁶² Section 221YL(2A).

⁶³ Section 221YL(3).

⁶⁴ Section 221YN(1).

- guilty of an offence and liable to a fine;⁶⁵
- liable to be made to pay to the Commissioner an amount equal to the deduction;⁶⁶ and
- liable to a penalty equal to the deduction plus additional tax at the rate of 20% pa.⁶⁷

If the deduction is made but not accounted for to the Commissioner, the person so obliged is:

- guilty of an offence and liable to a fine and imprisonment;⁶⁸ and
- liable to additional tax equal to 20% pa.⁶⁹

What of the lender whose tax has not been paid because the deduction is not made or accounted for by the borrower? If the lender does not monitor the borrower, ensuring that the borrower does make and account for the deduction, it can find itself liable to a 20% pa tax penalty.⁷⁰

Grossing up and section 261

Lenders invariably require borrowers to make payments free of set off and all deductions. This, of course, is a matter of contract between the parties to the loan contract and cannot affect an overriding obligation to make a deduction if imposed by statute. Consequently, loan agreements invariably⁷¹ seek to ensure that notwithstanding any such deduction, the lender receives the original amount contemplated. There are two types of provisions used.⁷²

Imposing a grossing up obligation in an unsecured loan is relatively free of difficulty. The grossing up provision will appear in the loan agreement and the lender will monitor the borrower to ensure that it is making the deductions, accounting to the Commissioner and grossing up payments of interest. The only safe way for a lender to monitor is to insist that it be provided with copies of the receipts issued by the Commissioner on payment of the deductions. It is not sufficient for the lender to assume that simply

65 Section 221YL(4A).

66 Section 221YL(4B).

67 Section 221YQ(1).

68 Section 221YN(2).

69 Section 221YN(4).

70 Section 128c(3). There is scope to apply for remission of the penalty – s 128c(4).

71 Occasionally, one sees a "withholding tax absorbed loan". Such is a loan on which withholding tax is paid but for which the lender agrees to take the net amount of interest (ie the post deduction amount). In recent years, Japanese banks have been the most common of such lenders. They can lend on this basis because they are allowed under the Japanese tax system a credit (against their general tax liability) equal to the amount of the deduction. Such loans are, of course, cheaper than loans that must be grossed up but the lenders will generally charge a fee for provision of such loans.

72 For a discussion of the two types and their different consequences, see P Wood, *The Law and Practice of International Finance*, Sweet & Maxwell (1980) 287-291 and GA Penn, AM Shea and A Arora, *The Law and Practice of International Banking*, Sweet & Maxwell (1987) 88-90.

because it is receiving 100% of the due interest, that the borrower is also making the deduction.

Failure by the lender to monitor in this way can result in the Commissioner seeking to recover the tax from the lender. Since this may occur some time after the loan has been paid out, it would not be surprising if the lender were to find it difficult to recover the tax (and penalties) from the borrower.

Matters are more difficult as regards secured loans. The major hurdle to a grossing up provisions is s 261 which provides that: "... a covenant or stipulation in a mortgage, which has or purports to have the purpose or effect of imposing on the mortgagor the obligation of paying [withholding tax] on the interest to be paid under the mortgage ... shall be absolutely void."

Mortgage is defined as including "... any charge lien or encumbrance to secure the repayment of money and collateral or supplementary agreement".⁷³ At times, it has been argued that s 261 would not apply to a grossing up provision in a loan agreement, not being a document under which the lender acquires a proprietary interest in any asset, (such being thought necessary if the document is to be – under general concepts – mortgages, charges, lien or encumbrance). Notwithstanding that the point was not argued, the Federal Court of Australia has accepted that a loan agreement was "collateral" if not "supplementary" to the securities taken by the lender and thus came within the statutory definition of mortgage.⁷⁴

What is the practical effect of s 261 as regards a secured loan? It renders void (not illegal)⁷⁵ the grossing up obligation and thus the lender cannot sue for recovery of the amount not grossed up, nor rely on non-payment as an event of default entitling it to enforce any securities it may have.

Whilst it would, in view of the court's comments, be inappropriate to rely upon a grossing up provision in a loan agreement which was secured by a mortgage, it can be noted that there remain structures available to lenders and borrowers which arguably do not fall foul of s 261.⁷⁶

The two most common methods are:

- to structure the loan such that the security is not given to the lender. For example, A may lend money to B, C may give a guarantee to A and B gives an indemnity (and security) to C. In such a case, A has no mortgage (either in the narrow or the wider statutory sense). C could be a resident Australian company associated with the lender A and would be obliged to make a fully grossed up payment under the unsecured guarantee.⁷⁷

⁷³ ITAA s 261(5).

⁷⁴ *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271 at 302.

⁷⁵ *Ibid* at 302.

⁷⁶ Any such arrangements should not be impeachable by virtue of Part IVA as those provisions do not apply to withholding tax – s 128A(4).

⁷⁷ There is another reason why foreign lenders may not want to take direct security – s 25(2) ITAA deems interest upon money secured by mortgages on property in Australia to be derived from a source in Australia (and thus assessable). Such will not occur if the only "security" is the guarantee which could hardly be said to be a mortgage "on property".

- to provide that the loan is immediately repayable should the borrower not gross up. At first, this looks like imposing an obligation upon the borrower to gross up and making it an event of default (entitling the lender to accelerate the loan) if that obligation is not satisfied. The key to the distinction is that no "obligation" is imposed upon the borrower to gross up – the loan agreement simply puts the borrower on notice that if it elects to not gross up, the loan will be immediately due.

Such a distinction was recognised and upheld in *Brett v Barr Smith* where Higgins J stated (in relation to an earlier version of s 261):

"Obligation" is a technical term of law, with a clear definite meaning, ... There is no ground here for treating "obligation" as meaning moral obligation, or social obligation, or business obligation (in the sense of commercial pressure or expedience) or anything but legal obligation. The test is, is there any legal sanction – would an action be [available] ... against the mortgagors for failure to pay the income tax? "Obligation" involves binding; and there is nothing here to bind the mortgagor to pay the amount of the tax ...⁷⁸

The Commissioner supports the distinction between being under an obligation to make payment and voluntarily making payment. "Even though a borrower, ... may not be legally compelled to comply with a grossing up clause, an additional amount to satisfy the lender's withholding tax liability may still be paid voluntarily. This arrangement between borrower and lender is not prohibited by income tax law ..."⁷⁹

Can borrowers who have made deductions on account of withholding tax and who have grossed up payments notwithstanding they can be (because of s 261) under no obligation to gross up, recover such payments from the lender? The tax is, after all, meant to be a tax on the lender not the borrower. Lenders would, however, say that the tax is a cost of the lending, and its payment by the borrower is reflected in the rates quoted by the lender. Thus, the argument would run, to allow the borrower to recover the tax payments would erode the return that the lender expected to receive (and the borrower was expected to pay).

In *David Securities*, the court found that:

- s 261 made grossing up provisions in mortgages void but not illegal;⁸⁰ and
- the borrower, in grossing up when under no legal obligation, made a mistake of law not of fact.⁸¹

This conclusion meant that payments by the borrower could not be recovered from the lender. The distinction between a mistake by the borrower as to law (on the one hand) and as to fact (on the other) was, the court admitted,

⁷⁸ (1919) 25 CLR 87 at 97.

⁷⁹ EDR 69 at para 14.

⁸⁰ (1990) 93 ALR 271 at 302.

⁸¹ Ibid at 303-304.

“... particularly difficult to draw where what is involved is performance of what appear to be contractual obligations”.⁸²

The court also noted considerable criticism in Canada, Australia, New Zealand and England of the longstanding distinction between payments made under mistake of law which are not recoverable in an action for money had and received, and payments made under mistake of fact which are recoverable). The court felt compelled to maintain the distinction.⁸³ This was particularly so in light of recent pronouncements of the High Court in the general area of restitutionary claims.⁸⁴

The court accepted that the following passage represented the current state of the law:

The true proposition is that money paid under a mistake of law, by itself and without more, cannot be recovered back. ... If there is something more in addition to a mistake of law – if there is something in the defendant's conduct which shows that, of the two of them, he is the one primarily responsible for the mistake – then it may be recovered back.⁸⁵

Having decided on the facts that there was nothing in the lender's conduct which showed it was primarily responsible for the borrower's mistake in making the payments it thought it was obliged to make, the borrower failed in recovering the grossed up amounts paid.

Even the inclusion of a (void) grossing up provision was insufficient to render the lender culpable in any way, even though the court recognised that it was probable that, had the clause not been included, the payments would not have been made. Query whether a lender could, subsequent to the decision, still plead “innocence” if it now included a void grossing up provision. The answer would presumably still be the same (that the voluntary, though on one analysis misguided, grossing up is not recoverable. The position may be different if the borrower was able to show that the lender had mislead it (in breach of s 52 Trade Practices Act) to understand that the grossing up obligation was legally binding.⁸⁶

⁸² Ibid at 302.

⁸³ Ibid at 304-305.

⁸⁴ *Pavey & Matthews Pty Ltd v Paul* (1987) 162 CLR 221; *Australia and New Zealand Banking Group Limited v Westpac Banking Corporation* (1988) 164 CLR 662; *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107; and *Foran v Wright* (1989) 88 ALR 413.

⁸⁵ Ibid at 305.

⁸⁶ The decision is not one without its critics. An appeal was heard by the High Court of Australia on 30 October 1991. Judgment was reserved.