

Tax Brief

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Debt and Interest for Domestic and Tax Treaty Purposes

The Federal Court has just released a second judgment on the interpretation of an Australian tax treaty, this time on the Australia – US treaty. The judgment addresses the difficult intersection between Australia's debt-equity classification rules and the characterisation of income flows for the purposes of tax treaties. The Court held that the taxpayer, a non-resident financial institution, was liable to Australian withholding tax on amounts paid to it.

1. Background

The taxpayer, Deutsche Asia Pacific Finance Inc, was a US corporation and a member of the Deutsche Bank group. It invested \$998m with a limited partnership established in NSW. The limited partnership was a 'corporate limited partnership' ('CLP') for Australian tax purposes and so the CLP was taxed as if a company, and the taxpayer was treated as if it were a shareholder in that fictitious company. Nevertheless, it was agreed by the parties that Deutsche's investment in the CLP also constituted a debt interest under Australia's domestic debt-equity tests. Hence, the taxpayer's fictional share was a 'non-equity share' in the CLP, and any distributions on that share were assimilated to interest for various tax purposes.

The corporate limited partnership made various payments to the taxpayer in respect of its interest in the CLP. It was agreed that these payments were prima facie liable to Australian interest withholding tax but the taxpayer claimed it was exempt from withholding tax for two reasons:

- first, it argued the terms of the Australia – US treaty prevented Australia from imposing interest withholding tax on all (or most) of the amount it received; and
- as an alternative, the taxpayer claimed the Australian Tax Office ('ATO') could not insist on the withholding tax because the ATO's ruling on what the treaty means had ruled, in effect, that the payments were immune from withholding tax, and the taxpayer was entitled to rely on that Ruling.

2. Decision

2.1 Operation of the Treaty

The first part of the judgment dealt with the interpretation of the Australia – US treaty.

The taxpayer argued that article 11 (interest) of the treaty applied to the payments it received. In particular, the taxpayer sought to invoke article 11(3)(b) which would deny Australia the ability to impose withholding tax on

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“interest ... derived by a financial institution which is unrelated to and dealing wholly independently with the payer.” There was no dispute that the taxpayer was a financial institution for these purposes, nor was it disputed that the amount was “interest” for the purposes of the treaty under the extended definition of “interest” in article 11(5).

But the ATO argued that this exemption from Australian interest withholding tax was subject to a qualification in article 11(9)(a) – namely, that “interest .. paid by [an Australian resident] that is determined with reference to the profits of the issuer or of one of its associated enterprises ... may be taxed in [Australia] at a rate not exceeding 15 %.”

This provision has no counterpart in any other Australian treaty and, it seems to have been accepted, appears in this treaty because of US concerns to protect its interest withholding tax. The judge noted that US domestic law generally exempts “portfolio interest” derived by a non-resident lender from US withholding tax. However, that exemption can be lost if the interest is calculated by reference to receipts, sales, cash flow or profits. Where the exemption from US withholding tax has been lost, the apparent intention of article 11(9) is to ensure that it is not re-instated by the treaty.

The dispute thus revolved around the tension between the exemption from withholding tax in article 11(3) and the qualification to that exemption in article 11(9). The taxpayer argued that article 11(9) was a particular rule, addressed to a precise concern, and that was a US withholding tax concern. The US was worried about amounts which were labelled “interest” but were in substance dividends. The provision should not be read as applying to payments which, the taxpayer argued, were in substance interest.

The judge, however, was not prepared to treat the provision as having an operation which was determined principally by the US tax policy issue. He said, while domestic policy might explain the existence of a provision in a treaty, “that policy cannot control the construction and application of the provision as such ...” Moreover, he said:

- the US had reserved the right to tax interest paid by a resident of the United States in the circumstances described in article 11(9)(a) and this was not in exactly the same terms as the US rule which removed the interest withholding tax exemption, even if the treaty provision sprang from this rule; and
- the United States had conceded a similar taxing right to Australia.

He concluded, “the construction and application of that taxing right cannot be controlled by US domestic policy if the text in context – the ‘four corners of the actual text’ – points to a different construction.”

The judge concluded that the exception in article 11(9) was triggered – the CLP was the issuer, the amount in question was assimilated to interest under the treaty and it was calculated by reference to the profits of the issuer. (Indeed, it was actually a share of the profits of the issuer.) Hence, Australia’s claim to interest withholding tax at 10% could be sustained.

The taxpayer proposed a second argument – that, having regard to the terms of the transaction documents, the amount which was “determined with reference to the profits” of the CLP was actually a much smaller amount than the total payment which the taxpayer received. It argued that it

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was entitled to a basic amount plus or minus an adjustment and it was only this adjustment which was calculated by reference to the profits of the CLP.

This line of argument turned on fine points of interpretation of the transaction documents which were highly complex and precisely drafted; the judge simply disagreed with the taxpayer's interpretation of how they worked. He concluded the documents gave the taxpayer an entitlement to a single figure and that amount was entirely determined by reference to a profit calculation – that is, the net income of the CLP.

2.2 Impact of the Ruling

The second argument in the case concerned the effect of the ATO Ruling TR 2005/5 which deals with “the right to tax United States (US) and United Kingdom (UK) resident financial institutions ... in respect of interest income arising in Australia.”

The taxpayer pointed to a particular paragraph of the Ruling which described the circumstances in which the exemption from interest withholding tax would be invoked. That paragraph contained no cross-reference to the limitation on the exemption in article 11(9) of the Australia – US treaty. The taxpayer pointed to that paragraph in the Ruling, noted that it met the conditions in that paragraph, noted that no further conditions were expressed, and so concluded that it was entitled to rely on that paragraph in lieu of whatever the law might say.

The judge was not moved by this argument. He agreed with the Commissioner's view that, “having regard to the complex nature of article 11, the mere absence of discussion of some of those provisions cannot be construed as a positive statement that those other provisions do not apply.”

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