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Deloitte Touche Tohmatsu

10 October 2003

The Secretary
Senate Economics Legislation Committee
Parliament House
Canberra ACT 2600

Dear Sir

INTERNATIONAL TAX AGREEMENTS AMENDMENT BILL 2003 ("THE BILL")

We are writing in relation to the treatment of interest derived by financial institutions under the new United Kingdom tax treaty (**"the Treaty"**), which is to be given the force of law by the Bill.

Background

Broadly, article 11(3)(b) of the Treaty provides that interest arising in one Contracting State that is derived by a "financial institution" resident in the other Contracting State may not be taxed in the first-mentioned State, subject to certain safeguards.[1]

In practice, this means that interest paid by an Australian resident borrower to a UK resident "financial institution" will be exempt from Australian interest withholding tax (**"IWT"**) once the Treaty takes effect. This will benefit Australian businesses by reducing the cost of obtaining finance from UK financial institutions[2] and is to be welcomed. It will also align the treatment of borrowings from UK financial institutions with those from US financial institutions, following recent changes to the US-Australia tax treaty.

Submission

Our submission relates to the definition of "financial institution" in article 11(3)(b), which reads as follows:

> For the purposes of this Article, the term "financial institution" means a bank or other enterprise substantially deriving its profits by raising debt finance in the financial markets or by taking deposits at interest and using those funds in carrying on a business of providing finance.

We submit that the definition should be extended to include a wholly-owned subsidiary of a "financial institution", as defined. This is to ensure that the IWT exemption applies where a financial institution

[1] Namely, the requirement that the financial institution be unrelated to and deal wholly independently with the payer of the interest (article 11(3)(b)), the exclusion of "back-to-back" loans (article 11(4)), the limitation of benefits rule (article 11(9)) and the exclusion of group treasury and group financing companies (Exchange of Notes, item 6(b)).

[2] As noted in the Treasurer's Press Release of 21 August 2003, in which the new Treaty was announced.

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conducts some of its business via a subsidiary, which is a regular occurrence.[3] If the definition is not extended in this way, the exemption from IWT may be denied in cases such as the following:

(a) An Australian resident obtains an interest bearing loan from a UK resident wholly-owned subsidiary of UK financial institution, where the subsidiary has been funded with equity from the parent. The subsidiary itself would not meet the requirement of "raising debt finance in the financial markets or taking deposits at interest".

(b) An Australian resident obtains an interest bearing loan from a UK resident wholly-owned subsidiary of UK financial institution, where the subsidiary has been funded with interest bearing debt from the parent. The subsidiary itself may not meet the requirement of raising debt finance "in the financial markets" or by taking "deposits" at interest.

In cases such as these, the IWT exemption may be denied merely because the UK financial institution provides finance to the Australian borrower via a wholly-owned subsidiary, rather than directly. Economically, funds obtained "by raising debt finance in the financial markets or by taking deposits at interest" are used in "carrying on a business of providing finance", however the technical requirements of article 11(3)(b) may not be met.

In our view, this would inappropriately deny access to the IWT exemption and would prevent the intended benefits for Australian businesses from being fully realised. It could also create compliance difficulties for Australians borrowing from the UK. When deciding whether or not to deduct IWT, they would have to determine whether the particular legal entity they are dealing with qualifies as a "financial institution", even if its parent undoubtedly qualifies.

Suggested amendment

We recognise that it is not practical to amend the Treaty and therefore suggest that the Bill be amended to include an appropriate amendment to the *International Tax Agreements Act 1953* ("**Agreements Act**"). We would suggest a provision along the following lines, which could be inserted into section 3 of the Agreements Act:

> A reference in an agreement to a financial institution shall be taken to include a reference to an entity that is a wholly-owned subsidiary of a financial institution (as defined in section 995-1 of the *Income Tax Assessment Act 1997*).

This should allow the IWT exemption for financial institutions to apply appropriately under both the UK and US treaties (and any future treaties that include similar a exemption), without compromising any of the safeguards relating to the exemption.[4]

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[3] For example, the Australian Prudential Regulation Authority recognises that banks regularly conduct some of their activities using subsidiaries and special purposes vehicles, and applies its prudential standards accordingly (*APRA Guidance Note 222.1*).

[4] See footnote 1.

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If you wish to discuss any aspect of this submission, please do not hesitate to contact us on the numbers below.

Yours sincerely
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