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Australian Dividend Withholding Tax

Abstract

Subsection 128B(4) of the Income Tax Assessment Act 1936 (Cth) imposes income tax on Australian dividends that are subject to section 128B. The application of section 128B to a particular corporate distribution will depend, in broad terms, on the nature of the distribution and its source, the manner or capacity in which the recipient derives it and the recipient's residence and tax status. The relevant legislative provisions are spread across the Income Tax Assessment Acts of 1936 and 1997, Australia's Double Tax Agreements, the Taxation Administration Act and the Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974. They include provisions that define, for Australian income tax purposes, concepts such as 'dividend', 'non – share dividend', 'franked dividend', 'demerger dividend', 'dividend attributable to a permanent establishment' and dividends that are 'conduit foreign income'. Certain entities are obliged, by provisions in Subdivision 12 – F in Schedule 1 to the Taxation Administration Act, to withhold income tax payable under subsection 128B(4) from the effected dividends they pay or receive. A taxpayer's Australian assessable or exempt income does not include Australian dividends upon which subsection 128B(4) withholding tax is payable and so the taxpayer is not obliged to lodge an Australian tax return on account of them.

Keywords

Dividend withholding tax; s 128B(4) ITAA 1936 (Cth)

AUSTRALIAN DIVIDEND WITHHOLDING TAX

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Subsection 128B(4) of the Income Tax Assessment Act 1936 (Cth) imposes income tax on Australian dividends that are subject to section 128B. The application of section 128B to a particular corporate distribution will depend, in broad terms, on the nature of the distribution and its source, the manner or capacity in which the recipient derives it and the recipient's residence and tax status. The relevant legislative provisions are spread across the Income Tax Assessment Acts of 1936 and 1997, Australia's Double Tax Agreements, the Taxation Administration Act and the Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974. They include provisions that define, for Australian income tax purposes, concepts such as 'dividend', 'non – share dividend', 'franked dividend', 'demerger dividend', 'dividend attributable to a permanent establishment' and dividends that are 'conduit foreign income'. Certain entities are obliged, by provisions in Subdivision 12 – F in Schedule 1 to the Taxation Administration Act, to withhold income tax payable under subsection 128B(4) from the effected dividends they pay or receive. A taxpayer's Australian assessable or exempt income does not include Australian dividends upon which subsection 128B(4) withholding tax is payable and so the taxpayer is not obliged to lodge an Australian tax return on account of them.

LEGISLATIVE FRAMEWORK

The Australian Commonwealth and State parliaments have concurrent constitutional powers to tax income. Under current fiscal arrangements, only the Commonwealth raises tax on income. It does so in terms of the *Income Tax Assessment Act 1997* ('ITAA 97'), the *Income Tax Assessment Act 1936* ('ITAA 36') and, where it has concluded a relevant double taxation agreement ('DTA'), the *International Tax Agreements Act 1953* ('ITAA 53').¹ The rates of income tax from time to time are enacted in Ratings Acts.

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¹ Collectively referred to as 'the Acts'. Australia's DTAs are enacted as Schedules to the ITAA 53. Where a DTA is involved, the ITAA 97 and the ITAA 36 are incorporated and read as one with the ITAA 53 and in the event of any inconsistency, the ITAA 53 has effect

An amount of taxable Australian income derived by a foreign resident is taxed by assessment or, in the case of some dividends, interest and royalties, by final withholding. In the latter case the liability to withhold is on the payer of the income amount or the Australian entity that receives it on behalf of the foreign resident.

The Australian assessable income of foreign residents² includes their ordinary and statutory income derived during the income year³ from all Australian sources or which is included in assessable income on some basis other than Australian source.⁴ The assessable income of a non-resident shareholder of a company includes dividends paid by the company out of profits sourced in Australia and non-share dividends⁵ derived from sources in Australia.⁶ If the non-resident shareholder is carrying on business in Australia at or through the shareholder's Australian permanent establishment, and the company is resident in Australia, the non-resident's dividends and non – share dividends are assessable regardless of source.⁷ These general rules governing the assessability of dividends and non-share dividends are subject to any specific provisions of the Acts dealing with the income tax treatment of dividends and non – share dividends.⁸ The income tax rates for non-residents, imposed by the *Income Tax Rates Act 1986*, are applied to their taxable income.⁹ Taxable income is any excess of gross assessable income over deductible expenditure.¹⁰ An amount is assessable income if the Acts so provide.

– ITAA 53; s 4. Australia has entered into many bilateral DTAs so, as a matter of practical necessity, discussion in this article has been limited to relevant provisions in the UK; USA; Chinese and Indian agreements.

² 'Foreign resident' means a person who is not a resident of Australia for the purposes of the ITAA 36; see ITAA 97 s 995 – 1(1) – 'foreign resident'; ITAA 36, s 6(1) – 'resident' or 'resident of Australia'.

³ 1 July – 30 June.

⁴ ITAA 97 ss 6 – 5(3); 6 – 10(5). An amount may be included in the Australian assessable income of a foreign resident on the basis of a DTA between Australia and the taxpayer's country of residence. See subdivision 842 – B of the ITAA 97 for some items of Australian source income of foreign residents that are exempt from Australian income tax.

⁵ Non-share dividends are discussed below.

⁶ ITAA 36 s 44(1)(b).

⁷ ITAA 36 s 44(1)(c).

⁸ ITAA 36 s 44(1).

⁹ For the purposes of the *Income Tax Rates Act 1986*, a non-resident taxpayer means a person who is a non-resident at all times during the year of income and who was not entitled during the year of income to assessable compensation or an assessable allowance, pension or benefit under the legislation stipulated in the definition of 'prescribed non-resident' in s 3(1). A person who does not qualify as a prescribed non-resident is treated as a resident

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The assessable income of a non-resident does not include an amount of income on which Australian withholding tax is payable. A dividend paid by an Australian company that is derived by a person, or persons,¹¹ that is non-resident at the time of derivation, upon which withholding tax is payable, or upon which withholding tax would, but for paragraph 128B(3)(ga)¹² or (jb),¹³ be payable, is not assessable income and is not exempt income of a person.¹⁴ The effect of s 128D in relation to dividends that are subject to s 128B, or that would be so subject but for the exceptions mentioned, is that they are not assessable or exempt for any purpose of the Acts.¹⁵ 'Withholding tax' in this context means final income tax payable, under s 128B in Division 11A in Part III of the ITAA 36, at flat rates on the gross amounts of certain dividends, including non – share dividends, interest and royalties.¹⁶ The liability of the payer, or Australian recipient, of the income, to withhold and remit the income tax payable, arises under the *Pay As You Go* ('PAYG') provisions in subdivision 12 – F of Schedule 1 to the *Taxation Administration Act 1953* ('TAA').

Income tax is imposed on gross income to which s 128B applies by s 6 of the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974* ('WTA') at 30% for

for rating purposes. The rates of income tax for individual prescribed non – residents are set out in Part II of Schedule 7 of the Act and the general rate for companies, resident and non – resident, is currently 30%; s 23(2).

¹⁰ ITAA 97 s 4 – 15(1).

¹¹ The liability to pay income tax under ss 128B(4) arises when the non-resident person derives the s 128B dividend regardless of whether it is derived beneficially or in some other capacity such as a trustee. So for example where a dividend is paid to a non-resident trustee in circumstances where a non-resident beneficiary is entitled to it, both the trustee and the beneficiary derive it for the purposes of subsections 128B(1) and (4).

¹² Section 128B does not apply to the franked part of a dividend, see the discussion of franked dividends below.

¹³ Section 128B does not apply to Australian dividends, derived by a non – resident superannuation fund for foreign residents, that are exempt from tax in the fund's country of residence, see discussion below.

¹⁴ ITAA 36 s 128D.

¹⁵ This may be significant in a case where the non – resident taxpayer is also required to file an Australian tax return in respect of other assessable Australian income. For example, net exempt income is taken into account in calculating tax losses; ITAA 97 division 36; and capital gains and losses on disposal of taxable Australian property, such as shares, are disregarded provided they were used exclusively to produce exempt income as opposed to non – assessable non – exempt income for the purposes of ITAA 36, s 128D; ITAA 97, Division 855 and s 118 – 12(1)(2)(2)(b)(vii).

¹⁶ ITAA 36 s 6(1) – 'withholding tax'; ITAA 97 s 995 – 1(1) – 'withholding tax'. See also ITAA 36 ss 128B(4)(5)(5A).

dividends; 10% for interest and 30% for royalties.¹⁷ This Act is incorporated and read as one with the ITAA 36¹⁸ and with any applicable DTA. A DTA concluded between Australia and the non – resident's country of residence may stipulate a rate of income tax different from that prescribed by s 6.¹⁹ The USA Convention is an example in point.

Article 10 of the US Convention confirms the jurisdiction of both Contracting States to tax a dividend derived by a resident of one Contracting State derived from a company resident in the other Contracting State.²⁰ Article 10(2) limits Australia's tax to 5% of the gross amount of the dividends, if they are beneficially derived by a company that holds directly at least 10% of the voting power in the company paying the dividends, and 15% of the gross amount of the dividends in all other cases.²¹

In accordance with various provisions of the ITAA 36, ITAA 97, TAA and *Superannuation Industry (Supervision) Act 1993*,²² the Commissioner of Taxation makes a Legislative Instrument regarding the lodgment of returns for each year of income.²³ Statements in this article about a non – resident taxpayer's obligation to lodge an Australian income tax return are based on the Legislative Instrument for the year ended 30 June 2008 ('LI 08').²⁴

Reference is made above to 'non – share dividends'. Division 974 of the ITAA 97 extends beyond shares the range of interests that are recognized as equity in a company. An interest that is an equity interest in a company but is not a share, is treated in the same way as a share for some income tax purposes particularly in

¹⁷ Section 7.

¹⁸ Section 5.

¹⁹ Above n 2.

²⁰ ITAA 53 Sch. 2, article 10(1) and (2). The position is the same for the UK agreement, Sch. 1 article 10(1) and (2); the Chinese agreement, Sch. 28 article 10(1) and (2) and the Indian agreement Sch 35 article 10(1) and (2).

²¹ The same limits were agreed by article 10(2) in the UK agreement and an overall limit of 15% of the gross amount of the dividends was agreed by article 10(2) in the Chinese and Indian agreements.

²² See in particular ITAA 36, ss 161(1) and (1A), 162 and 163; TAA, Schedule 1, s 388 – 55.

²³ Legislative Instruments are registered on the *Federal Register of Legislative Instruments* in accordance with the *Legislative Instruments Act 2003*.

²⁴ The full citation is 'Lodgment of returns in accordance with the *Income Assessment Act 1936*, the *Income Tax Assessment Act 1997*, the *Taxation Administration Act 1953* and the *Superannuation Industry (Supervision) Act 1993* for the year of income ended 30 June 2008'; number: F2008L02310, classification: Notices, registered: 06.27.2008.

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relation to the determination of the tax treatment of returns on the interest.²⁵ By the same token a share in a company may be classified as a debt interest, or non – equity share, for income tax purposes, in which event any dividend from it may be treated as interest. A distribution on a non – share equity interest is a non – share dividend.²⁶

The Australian imputation system in Part 3 – 6 of the ITAA 97 partially integrates the income tax liabilities of an Australian corporate tax entity and its members. It allows the entity to frank distributions of profits to its members for income tax it has paid on those profits. Members that are Australian residents at the time the franked distribution is made²⁷ are entitled to a tax offset for the franking credit in any assessment to Australian income tax that includes the franked dividend, grossed up for the franking credit, in assessable income. Australian members are allowed a refund if they are unable to fully utilize the tax offset in reducing their income tax.²⁸ Foreign corporate and individual residents satisfy the residency requirement if the franked dividend is attributable to their Australian branch at the time it is made.²⁹ Dividends, or deemed dividends,³⁰ and non – share dividends are frankable to the extent they are not unfrankable under s 202 – 45,³¹ The income tax treatment of non – resident dividends and non – share dividends depends on whether they are frankable or unfrankable, franked or unfranked or conduit foreign income.³²

Division 802 of the ITAA 97 relates to foreign residents' income with an underlying foreign source. An unfranked frankable distribution that an Australian corporate tax entity makes to a foreign resident is not subject to dividend withholding tax, and is not assessable income, to the extent that the entity declares it to be conduit foreign income.³³

²⁵ ITAA 97 s 974 – 1.

²⁶ The basic test for an equity interest is in s 974 – 75(1). If an interest satisfies both the debt test and the equity test, it is treated as a debt interest and not an equity interest; s 974 – 5(4).

²⁷ ITAA 97 ss 270 – 70, 207 – 75.

²⁸ ITAA 97 s 200 – 5.

²⁹ ITAA 97 s 207 – 75(2).

³⁰ ITAA 97 s 995 – 1(1) – 'distribution', s 960 – 120(1) item 1.

³¹ ITAA 97 s 202 – 40.

³² The relevant provisions are discussed below.

³³ ITAA 97 ss 802 – 5, 802 – 15(1).

DIVIDEND WITHHOLDING PROVISIONS

Subsection 128B(1) prescribes the dividend income to which s 128B applies, and subsection 128B(4) imposes a liability to income tax on the person who derives it, in the following terms:

128B(1) [Dividend] Subject to subsections (3), (3A), (3D) and (3E), this section applies to income that:

is derived, on or after 1 January 1968, by a non – resident; and

consists of a dividend paid by a company that is a resident.

128B(4) [Tax on dividends] A person who derives income to which this section applies that consists of a dividend is liable to pay income tax upon that income at the rate declared by the Parliament in respect of income to which this subsection applies.

DERIVATION AND RESIDENCE

Subsections 128B(1)(a) refers to income that is ‘derived ... by a non-resident’. The ordinary meaning of ‘derive’ is to ‘obtain (something) from (a source)’.³⁴ So a person derives income when it is received. For Australian income tax purposes, a person is taken to have received or derived income as soon as it is applied or dealt with in any way on the person’s behalf or as directed by the person.³⁵ For example, an amount of dividend income is derived by the shareholder when it is paid into the shareholder’s bank account, reinvested in the company pursuant to a dividend reinvestment plan or offset against the shareholder’s company debt.

A person may also be taken to have derived income for a specific purpose of the Act. For the purposes of s 128B, a beneficiary derives a dividend from a trust estate on becoming presently entitled to it.³⁶

As a general rule a trustee is not assessable, as trustee, to income tax upon the income from the trust estate.³⁷ Division 6 of the ITAA 36, which governs the assessment of income tax on the income from a trust estate, operates on a flow through basis and taxes the net income³⁸ from a trust estate in the hands of the beneficiaries that are presently entitled to it. The trustee is liable for the tax payable on any net income from the trust estate for a year of income to which no beneficiary, a beneficiary under

³⁴ Compact Oxford English Dictionary, 3rd edition.

³⁵ ITAA 97 ss 995 – 1(1) – ‘this Act’; ‘derive’; 6 – 5(4); 6 – 10(3).

³⁶ ITAA 36 s 128A(3).

³⁷ ITAA 36 s 96.

³⁸ ITAA 36 s 95(1) – ‘net income’.

a legal disability or a beneficiary that is non – resident at the end of the year of income, is presently entitled³⁹ unless the income is subject to the withholding requirements of Subdivision 12 – H in Schedule 1 to the TAA.⁴⁰

Section 128A(3) provides, for the purposes of Division 11A, that a beneficiary who is presently entitled to a dividend included in the income of a trust estate is deemed to have derived the dividend when the present entitlement arose.⁴¹ Generally a beneficiary is presently entitled to a share of the income from a trust estate when the beneficiary has an indefeasible interest in possession in the amount of income and has an immediate and enforceable right to demand payment from the trustee.⁴² Subsection 95A(2) of the ITAA 36 provides, for the purposes of the Act, that where a beneficiary has a vested and indefeasible interest in any of the income of a trust estate but is not presently entitled to that income, the beneficiary shall be deemed to be presently entitled to it. So a beneficiary who lacks the legal capacity to make an enforceable demand of the trustee for payment of the income is nevertheless presently entitled to it, for income tax purposes, in circumstances where the requirements of s 95A(2) are satisfied. The combined effect of subsections 95A(2) and 128A(3) is that a non – resident beneficiary derives a trust dividend for the purposes of subsection 128B(1) on acquiring a vested and indefeasible interest in it without regard to the beneficiary’s legal capacity to make demand for payment.

A ‘non – resident’ means a person who is not a resident of Australia⁴³ and, for the purposes of the ITAA 36 including s 128B(4), a person includes a company.⁴⁴

The ordinary meaning of ‘person’⁴⁵ is a human being or individual and ‘company’ means a body corporate or any other unincorporated association or body of persons but does not include a partnership or a non – entity joint venture.⁴⁶

³⁹ See generally Division 6 of the ITAA 36.

⁴⁰ ITAA 36 s 99G. Subdivision 12 – H in Schedule 1 to the TAA, which relates to distributions of managed investment trust income to foreign residents, is beyond the scope of this article.

⁴¹ ITAA 36 s 128A(3).

⁴² *Taylor v F C of T* (1970) 119 CLR 444, 451 – 452. See also the more recent pronouncement in *Raftland Pty Ltd v Federal Commissioner of Taxation* [2008] HCA 21; 2008 ATC 8348 at 8375 para. 172 that ‘[A] person of full capacity who has a present entitlement to trust income can vindicate that entitlement by curial action.’

⁴³ ITAA 36 s 6(1) – ‘non – resident’.

⁴⁴ ITAA 36 s 6(1) – ‘person’.

⁴⁵ Compact Oxford English Dictionary, 3rd edition.

⁴⁶ ITAA 36 s 6(1) – ‘company’; ITAA 97 s 995 – 1(1) – company.

The general definition of non – entity joint venture⁴⁷ confirms that, for Australian income tax law, the parties to a joint venture contract to share the output of an economic activity do not constitute a company even in the broad sense in which that term is defined.

‘Company’ includes a corporate limited partnership,⁴⁸ a corporate unit trust⁴⁹ and a public trading trust.⁵⁰

If a company is a foreign hybrid company in relation to an income year,⁵¹ the foreign hybrid tax provisions (which include s 128B⁵²) apply as if the company were a partnership.⁵³ The partners in the partnership are the shareholders in the company.⁵⁴ In this context an issue arises as to whether a foreign company such as a US or UK limited liability company, that is a foreign hybrid company, is a person for the purposes of subsection 128B(4). It is arguable that because ‘person’ is defined to include a company and ‘company’ is defined to exclude a partnership, a foreign hybrid company is not a person for the purposes of subsections 128B(1) and (4) and so it incurs no liability to Australian income tax when it derives a s 128B dividend. The contrary position is that the definition of ‘person’ is inclusive only and that the purpose of the foreign hybrid tax provisions, which align the Australian tax treatment of foreign hybrid companies with that for foreign tax, was not to remove the legal personality of those companies to create an exemption from dividend withholding tax especially as some of the ‘partners’ may not be Australian attributable taxpayers.

Subject to certain exclusions, s 128B(1) provides that s 128B applies to income derived by a non – resident that consists of a dividend paid⁵⁵ by a company that is a resident.⁵⁶ A company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders

⁴⁷ ITAA 97 s 995 – 1(1) – ‘non – entity joint venture’.

⁴⁸ ITAA 36 ss 94B – ‘income tax law’; 94D – ‘corporate limited partnership’; 94J; 94K.

⁴⁹ ITAA 36 s 102L(6).

⁵⁰ ITAA 36 s 102T(7).

⁵¹ ITAA 97 Division 830.

⁵² ITAA 97 s 995 – 1(1) – ‘foreign hybrid tax provisions’.

⁵³ ITAA 97 s 830 – 20.

⁵⁴ ITAA 97 s 830 – 25.

⁵⁵ ‘Paid’ in relation to dividends or non – share dividends includes credited or distributed; ITAA 36; s 6(1) – ‘paid’.

⁵⁶ ITAA 36 s 128B(1)(a)(b).

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who are residents of Australia, is a resident of Australia.⁵⁷ The location of the company's share register is immaterial to the operation of s 128B(1). 'Non – resident' is not specially defined for the purposes of s 128B(1) so a company that does not satisfy these requirements is a non – resident for the purposes of subsection 128B(1)(a) and (b).

The concept of 'resident' or 'resident of Australia' in relation to a person other than a company, means an individual who resides in Australia. A finding that an individual resides, or does not reside, in Australia at a particular time, is always a conclusion or inference to be drawn from relevant facts such as the nature of the individual's presence, abode, family connections, economic activity, consumption of services and electoral registration, in Australia. 'Resident' includes an individual domiciled in Australia who is unable to prove, to the satisfaction of the Commissioner of Taxation, a permanent place of abode outside Australia; and an individual who has been in Australia, continuously or intermittently, during more than half of the year of income and who cannot satisfy the Commissioner of a usual place of abode outside Australia and no intention to reside in Australia.⁵⁸ Subdivision 768 – R of the ITAA 97 modifies certain general tax rules for individuals in Australia, be they residents of Australia or foreign residents, if they hold a temporary visa granted under the *Migration Act 1958* and satisfy the other requirements to be a 'temporary resident'.⁵⁹ Subdivision 768 – R has no effect on the operation of s 128B(1) which applies to a s 128B dividend paid to a non – resident regardless of whether the non – resident is also a temporary resident or not.

A taxpayer that is a resident of Australia may be taken to be a non – resident in terms of the overriding tie – breaker provision of an applicable DTA. As a general rule Australia's DTAs include the principle that a person is not a resident of a Contracting State for the purposes of the agreement if that person is liable to tax in that State in respect only of income from sources in that State.⁶⁰ The clearer formulation is that in the USA Convention which reads in part ' ... a person who:

(iii) is subject to Australian tax on income which is from sources in Australia; ... shall not be treated as a resident of Australia except to the extent that the income is subject to Australian tax as the income of a resident'.⁶¹ As indicated above, whether an individual taxpayer resides in Australia is a matter of fact and

⁵⁷ ITAA 36 s 6(1) – 'resident' or 'resident of Australia'.

⁵⁸ Same as above.

⁵⁹ ITAA 97 s 995 – 1(1) – 'temporary resident'.

⁶⁰ See generally the ITAA 53, Sch. 1 (the UK Agreement), Article 4; Sch. 2 (USA Convention), Article 4; Sch. 28 (Chinese Agreement), Article 4 and Sch. 35 (Indian Agreement), Article 4.

⁶¹ ITAA 53 Sch. 2, Article 4(1)(a)(iii).

degree that will not turn exclusively on whether all or some of the individual's income is sourced in Australia.

An individual that is not a resident of Australia under the ITAA 36 or any applicable DTA, is a non – resident for the purposes of subsection 128B(1)(a).

The liability for subsection 128B(4) income tax arises when a s 128B dividend is derived by a non – resident regardless of whether the non – resident is beneficially entitled to the dividend and regardless of whether it subsequently transpires that the non – resident becomes a resident for the income year in which the dividend is derived.

The meaning of 'dividend' in subsections 128B(1) and (4)

Subsections 128B(1) and (4) refer to 'income that ... consists of a dividend'. 'Income' in Division 11A and the WTA includes a dividend.⁶² 'Dividend' in turn is not specially defined for the purposes of Division 11A other than to include part of a dividend and to exclude a dividend paid in respect of a non – equity share.⁶³

In the absence of a special definition, 'income' would mean 'income in ordinary concepts'. The effect of the definition of 'income' in s 128A(1AA) is to preclude any argument that 'dividend' in subsections 128B(1) and (4) is restricted to dividends that are income in ordinary concepts and so does not extend to amounts that are not ordinary income but which are defined to be dividends for the purposes of the Acts.

The general meaning of 'dividend' for the purposes of the ITAA 36 is the definition of 'dividend' in s 995 – 1(1) of the ITAA 97⁶⁴ which reads as follows:

In this Act, except so far as the contrary intention appears: ... 'dividend' has the meaning given by subsections 6(1) and (4) and 6BA(5) and s 94L of the *Income Tax Assessment Act 1936* and section 375 – 872 of this Act.

The definition of 'dividend' in s 6(1) of the ITAA 36 includes any distribution made by a company to any of its shareholders, whether in money or other property; and any amount credited by a company to any of its shareholders as shareholders. It is clear from the plain meaning of this 'positive' limb of the definition that to be a 'dividend' to which s 128B applies, the money or other property must be distributed

⁶² ITAA 36 s 128A(1AA) – 'income'. 'Income' is not generally defined in the ITAA 36 and ITAA 97 which operate on 'ordinary income' and 'statutory income'; ITAA 97 ss 995 – 1(1), 6 – 5(1) and 6 – 10(2).

⁶³ Dividends from non – equity shares such as certain preference shares, to which s 128B applies, are subject to interest withholding tax; s 128A(1AB)(d) – 'interest'.

⁶⁴ This is because 'this Act' is defined to include the ITAA 36. It also includes Schedule 1 to the *Taxation Administration Act 1953*, see ITAA 97 s 995 – 1(1) – 'this Act'.

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to a person that is on the register of shareholders of the company making the distribution or it must be credited to such a shareholder in that capacity.

The general definition of 'dividend' specifically excludes payments, credits and distributions debited against an amount standing to the credit of the share capital account of the company; payments, credits and distributions debited to the company's share capital account for the redemption or cancellation of a redeemable preference share up to the amount specified as paid – up on the share in the redemption or cancellation notice given to the shareholder by the company⁶⁵ and a reversionary bonus on a life assurance policy.⁶⁶ By s 6(4), the general exclusion for debits to share capital account does not apply if the debit is made under an arrangement whereby a person pays or credits money or property to the company that it credits to its share capital account and the company then makes any payment, credit or distribution to another person which it debits to its share capital account.⁶⁷ Although Australian companies are required to pay dividends out of profits⁶⁸ which would not necessarily be the case under an arrangement contemplated by s 6(4), any corporate payment, credit or distribution under such an arrangement is a dividend for the purposes of s 128B(1).⁶⁹

A company's share capital account for these purposes is an account that the company keeps of its share capital or any other account that was created on or after 1 July 1998 to which the first amount credited was an amount of share capital. If a company's share capital account is tainted it is taken not to be a share capital account for the purposes of the definition of a dividend in s 6(1) of the ITAA 36.⁷⁰ So distributions debited to a tainted share capital account are dividends for the purposes of s 128B. Generally a company's share capital account becomes tainted if an amount is transferred to it from another of the company's accounts and the company was an

⁶⁵ It is a precondition for this exclusion that the company give the holder of the share such a notice when it redeems or cancels the share.

⁶⁶ ITAA 36 s 6(1) – 'dividend'.

⁶⁷ ITAA 36 s 6(4).

⁶⁸ *Corporations Act 2001* (Cth) s 254T.

⁶⁹ For a dividend to be assessable to income tax under s 44(1) of the ITAA 36 it must be paid out of profits. Although it is not relevant to the operation of s 128B(4), it is noteworthy that, for the purposes of assessment to income tax under s 44, a distribution, debited against an amount standing to the credit of a share capital account, that is a dividend because it was made under an arrangement contemplated in subsection 6(4), is deemed under subsection 44(1B) for the purposes of s 44 to have been paid out of profits derived by the company.

⁷⁰ ITAA 97 s 975 – 300(3).

Australian resident immediately before the time of transfer.⁷¹ If a company has more than one share capital account, the accounts are taken to be a single or combined share capital account and tainting of any of the accounts has the effect of tainting the combined account.⁷²

Bonus shares and bonus non – share equity interests

The taxation treatment of bonus shares and bonus non – share equity interests is governed by s 6BA of the ITAA 36.

Where a company issues bonus shares to its shareholders and credits its capital account with profits in connection with the issue, the bonus shares are not a dividend in the hands of the shareholders.⁷³ The position is the same where the company credits its capital account with the amount of any dividend to a shareholder and the shareholder does not have a choice whether to be paid the dividend or to be issued with the shares. The company's capital account, however, is tainted by the credit of profits or dividends.⁷⁴

If, on the other hand, a shareholder has a choice whether to be paid a dividend or to be issued shares and the shareholder chooses to be issued with shares, the dividend is deemed to be credited to the shareholder. The capital account is not tainted if it is credited with the amount of the dividend. There is an exception for shareholders in a listed public company within the meaning of the ITAA 97. If the listed public company does not credit its share capital account in connection with the issue of the bonus shares, the dividend is not deemed to have been credited to the shareholder.⁷⁵

The rules in s 6BA apply to a non – share equity interest in the same way as they apply to a share.⁷⁶

A dividend, or non – share dividend, that is taken to be credited to a non-resident shareholder, or non – share equity holder, in an Australian resident company,

⁷¹ ITAA 97 ss 995 – 1(1) – 'share capital account', 'tainted'; 975 – 300(1)(3); 197 – 50(1)(2); 197 – 5.

⁷² ITAA 97 s 975 – 300(2).

⁷³ Subject to the anti – avoidance provisions in ITAA 36; ss 45, 45A and 45B.

⁷⁴ ITAA 36 s 6BA(4).

⁷⁵ ITAA 36 ss 6BA(5)(6). This is not the position in relation to listed public company non – share dividends which are taken to be credited to the shareholder; see s 6BA(7).

⁷⁶ ITAA 36 s 6BA(7)(a); ITAA 97; Division 974. The debt/equity rules in Division 974 are referred to above.

pursuant to s 6BA, is a dividend for the purposes of subsections 128B(1) and (4)⁷⁷ that is, as a general rule, a frankable distribution.⁷⁸

Non – share and non – equity share dividends

Section 128B applies to a non – share dividend in the same way as it applies to a dividend.⁷⁹ This is also the agreed position in cases governed by a DTA.⁸⁰ As a general rule a non – share dividend is frankable.⁸¹

A non – equity share distribution is not a dividend for the purposes of subsections 128B(1) and (4). It is treated as an amount of interest for the purposes of Division 11A.⁸² A reference in a DTA to income from shares, or to income from other rights participating in profits, does not include a reference to a return on a debt interest as defined in Division 974 – B of the ITAA 97.⁸³

Distributions from corporate limited partnerships

By s 94L of the ITAA 36, the reference to a dividend in subsections 128B(1) and (4) includes a distribution, whether in money or other property, to a partner in a corporate limited partnership that is attributable to profits or gains arising during a year of income in which the partnership is a corporate limited partnership. A corporate limited partnership is a limited partnership that is treated like a company for Australian income tax purposes in relation to the year of income pursuant to the provisions of Division 5A of the ITAA 36.⁸⁴

As a general rule a corporate limited partnership distribution is frankable,⁸⁵

⁷⁷ ITAA 36 ss 6BA(7)(c), 128AAA(1)(c).

⁷⁸ ITAA 97 ss 960 – 120(1); 202 – 40; 202 – 45 – reference is made to the Australian imputation system in Part 3 – 6 of the ITAA 97 above.

⁷⁹ ITAA 36 ss 128AAA(1)(c).

⁸⁰ See generally the ITAA 53, Sch. 1 (the UK Agreement), Article 10(4); Sch. 2 (USA Convention), Article 10(6) Sch. 28 (Chinese Agreement), Article 10(3) and Sch. 35 (Indian Agreement), Article 10(3).

⁸¹ ITAA 97 s 202 – 40(2) but see ss 202 – 45(f) and 215 – 15 and the discussion below of the exclusion of non – share dividends that are unfrankable under s 215 – 10 from the operation of s 128B.

⁸² ITAA 36 s 128A(1AB)(d).

⁸³ ITAA 53 s 3(2A).

⁸⁴ ITAA 97 s 995 – 1(1) – ‘corporate limited partnership; ITAA 36 ss 94A and 94D.

⁸⁵ ITAA 97 ss 960 – 120(1); 202 – 40; 202 – 45. See the discussion of franked dividends, and unfranked frankable dividends that have been declared to be conduit foreign income, below.

Film licensed investment companies

Section 375 – 872 of the ITAA 97 relates to certain distributions of capital to shareholders in a film licensed investment company ('FLIC') on a liquidation or share buy back or other return of capital. Such payments are taken to be dividends sourced in Australia provided the shares were issued on or before 30 June 2007 during the period that the FLIC's concessional capital licence was in force.⁸⁶

Section 375 – 872 distributions of FLIC concessional capital that are taken to be dividends are, as a general rule, frankable.⁸⁷

Specific provisions

The general definition of dividend as set out above applies in relation to the Acts, including s 128B, 'except so far as the contrary intention appears'. This aspect of the definition of a dividend for the purposes of subsections 128B(1) and (4) is addressed in relation to distributions to entities connected with a private company;⁸⁸ excessive payments to shareholders, directors and associates,⁸⁹ liquidation distributions⁹⁰ and the dividends specifically excluded from the operation of s 128B by subsections 128B(3)(3A)(3D)(3E).

Distributions to entities connected with a private company

Division 7A in Part III of the ITAA 36 treats certain private company payments, loans and debt forgiveness as dividends. By s 109Z a Division 7A dividend is taken to have been paid out of profits and to have been paid to the recipient as a shareholder in the private company.

Division 7A dividends paid by a resident private company are disregarded for the purposes of Division 11A and subdivision 12 – F in Schedule 1 to the TAA 53.⁹¹ As withholding tax is not payable in respect of Division 7A dividends, they are not non – assessable non – exempt income of the non – resident pursuant to s 128D. They are assessable pursuant to subparagraph (b)(i) of subsection 44(1) of the ITAA 36 to the extent to which they are paid out of profits derived by the company from sources in

⁸⁶ See generally ITAA 97; subdivision 375 – H.

⁸⁷ ITAA 97 ss 960 – 120(1), 202 – 40, 202 – 45, 375 – 872(4). See the discussion of franked dividends, and unfranked frankable dividends that have been declared to be conduit foreign income, below.

⁸⁸ ITAA 36 Part III; Division 7A.

⁸⁹ ITAA 36 s 109.

⁹⁰ ITAA 36 s 47.

⁹¹ ITAA 36 s 109ZA.

Australia. The deeming provision in s 109Z extends only to profits leaving their source to be determined according to the facts in a particular case. If the non – resident is carrying on a business in Australia at or through a permanent establishment and the dividends are attributable to the permanent establishment, they are assessable regardless of whether they are paid out of profits derived from sources in or out of Australia.⁹²

A non – resident person that derives Division 7A dividends that are assessable pursuant to s 44(1) must lodge an Australian tax return for the income year in which they are paid.⁹³

Division 7A dividends are generally unfrankable.⁹⁴ Unfranked frankable⁹⁵ Division 7A dividends that are declared to be conduit foreign income, are non – assessable non – exempt income of the non – resident taxpayer.⁹⁶

Excessive payments to non – resident shareholders, directors and associates

Payments that are otherwise deemed to be dividends for the purposes of the ITAA 36 under s 109 are not dividends for the purposes of Division 11A of Part III.⁹⁷ As they are deemed to be dividends paid by the company out of profits to the recipient as a shareholder in the company,⁹⁸ a non – resident payee of such dividends must lodge an Australian tax return for the year in which they are paid to the extent that the dividends are assessable under s 44(1).⁹⁹ Section 109 dividends are unfrankable¹⁰⁰ and so cannot be declared conduit foreign income.¹⁰¹

⁹² ITAA 36 s 44(1)(b)(i) and (c)(i). The meaning of ‘attributable’ and ‘permanent establishment’ are discussed below in relation to subsection 128B(3E).

⁹³ ITAA 36 s 161; LI 08, Table A (3); Table D, subject to Table M; Table F(2).

⁹⁴ ITAA 97 s 202 – 45(g)(i).

⁹⁵ ITAA 36 ss 109RB and 109RC.

⁹⁶ See the discussion of conduit foreign income below.

⁹⁷ ITAA 36 s 109(1)(d).

⁹⁸ ITAA 36 s 109(1)(d)(i)(ii)(iii).

⁹⁹ See the provisions of the ITAA 36 and LI 08 cited in above n 65, and 66.

¹⁰⁰ ITAA 97 s 202 – 45(g)(iii).

¹⁰¹ See discussion of conduit foreign income below.

Liquidation distributions

By s 47(1) of the ITAA 36, liquidation distributions to shareholders from income derived by the company¹⁰² (whether before or during liquidation), other than income which has been properly applied to replace a loss of paid – up share capital,¹⁰³ are deemed, for the purposes of the Act, to be dividends paid to the shareholders by the company out of profits derived by it. The effect of s 47(1) is to bring liquidation distributions to which it applies within the meaning of ‘dividend’ for the purposes of s 128B. In relation to the obligation to withhold, the liquidator or person making the distribution is taken to be the company.¹⁰⁴

A liquidation distribution to a non – resident person that is deemed to be a dividend under s 47(1) is frankable.¹⁰⁵ Section 128B does not apply to the franked part of a liquidation dividend¹⁰⁶ and a franked liquidation dividend is non – assessable non – exempt income of the non – resident under s 128D. If the non – resident carries on business in Australia at or through a permanent establishment and the liquidation dividend is attributable to it, s 128B does not apply to the dividend regardless of whether it is franked or unfranked, and it is not non – assessable non – exempt income under s 128D. So it is subject to Australian income tax by assessment in the non – resident’s return for the year in which it is derived¹⁰⁷ unless it is an unfranked frankable liquidation dividend that has been declared to be conduit foreign income in which case it is non – assessable and non – exempt income.¹⁰⁸

Subsection 128B(3)

Subsection 128B(3) excludes the following dividends from the operation of s 128B:

1. Non – share dividends that are unfrankable under s 215 – 10 of the ITAA 97

Section 128B does not apply to income that consists of a non – share dividend that is unfrankable under s 215 – 10 of the ITAA 97.¹⁰⁹ As a general rule non – share

¹⁰² ‘Income derived by a company’ is defined in s 47(1A) to include all nominal capital gains without adjustment for any capital losses.

¹⁰³ This is a reference to company profits that were capitalized while the company was a going concern; *Glenville Pastoral Co Pty Ltd (in liq.) v F C of T* (1963) 109 CLR 199.

¹⁰⁴ TAA 53 Sch.1 s 12 – 225.

¹⁰⁵ ITAA 97 ss 960 – 120(1), 202 – 40; 202 – 45.

¹⁰⁶ ITAA 36 s 128B(3)(ga)(i) and the discussion of the exclusion of franked dividends below.

¹⁰⁷ See the discussion of subsection 128B(3E) below.

¹⁰⁸ See discussion of conduit foreign income below.

¹⁰⁹ ITAA 36 s 128B(3)(aaa).

dividends are frankable for corporate tax paid.¹¹⁰ A non – share dividend is unfrankable under s 215 – 10 if it is paid by an Australian bank in respect of a non – share equity interest that forms part of its Tier 1 capital and that was issued through its permanent establishment in a listed country¹¹¹ to raise funds for a purpose of its business, carried on through the permanent establishment, that is permitted by s 215 – 10(2). A s 215 – 10 dividend is not non – assessable non – exempt income of the non – resident for the purposes of s 128D and it is subject to Australian income tax to the extent that it is assessable under s 44(1) of the ITAA 36 in the non – resident’s return for the year in which it is derived. Unfrankable non – share dividends paid from non – Australian profits cannot be declared conduit foreign income.¹¹²

2. The dividends or non – share dividends of non – residents that are exempt from income tax because of ITAA 97 s 50 – 5 other than item 1.5A, 1.5B or 1.6 in the table; s 50 – 10; item 6.1 or 6.2 of the table in s 50 – 30; s 50 – 40 or item 9.1 or 9.2 of the table in s 50 – 45 and that are exempt from income tax in the country in which the non – resident resides.

Section 128 B does not apply to the above dividends or non – share dividends. The sections and table items mentioned refer to charitable, religious, scientific, health and public educational institutions; societies, associations or clubs established for the encouragement of science, community service, the development of primary and secondary resources, tourism, sports, culture, film and recreation, and funds established for charitable purposes by will before 1 July 1997. The total ordinary and statutory income of these entities is exempt from income tax provided the special conditions listed for each in the relevant table are satisfied.¹¹³ Although contrary to the effect of s 50 – 52, the *Australian Taxation Office* has adopted the position that a charitable institution does not need endorsement as exempt from income tax under subdivision 50 – B if it is listed by name in the *Income Tax Assessment Regulations 1997*, located outside Australia and exempt from income tax in its country of residence as prescribed by s 50 – 50(c).¹¹⁴

¹¹⁰ ITAA 97 s 215 – 5.

¹¹¹ Canada, France, Germany, Japan, New Zealand, the United Kingdom or the United States – ITAA 97 s 995 – 1(1) – ‘listed country’; ITAA 36; s 320; *Income Tax Regulation* 152C Part 1.

¹¹² See discussion of conduit foreign income below.

¹¹³ ITAA 97; ss 50 – 50; 50 – 52; 50 – 55; 50 – 57; 50 – 70.

¹¹⁴ See *Taxation Ruling* TR 2000/11.

Any non – profit association, organization, institution, society or club, the income of which is exempt from liability to income tax under the provisions of Division 50 of the ITAA 97, is not required to lodge a tax return.¹¹⁵

3. Income of an overseas charitable institution that is exempt in terms of s 121ELA(1) of the ITAA 36.

Section 128B does not apply to the income, including the dividend or non – share dividend income, of an overseas charitable institution that is exempt in terms of s 121ELA(1) in Division 9A of the ITAA 36. This section relates to income from a portfolio investment trust estate held by an Australian off shore banking unit as trustee for the sole benefit of an overseas charitable institution. For these purposes an ‘overseas charitable institution’ means a non – resident institution the income of which: (a) would be exempt under item 1.1 of s 50 – 5 of the ITAA 97 (and not under any other item) if the institution had a physical presence in Australia and incurred its expenditure and pursued its objectives principally in Australia; and (b) is exempt in the country in which it is resident.¹¹⁶ Paragraph (a) of the definition refers to the requirement in s 50 – 50(a). A charitable institution is exempt under item 1.1 of the table in s 50 – 5 if the special conditions in s 50 – 50 and s 50 – 52 are satisfied. The practical effect of the definition is that a non-resident charitable institution that is exempt from income tax in its country of residence is an overseas charitable institution for the purposes of Division 9A in the ITAA 36 if it is endorsed as exempt from Australian income tax by the Commissioner of Taxation under the rules in subdivision 50 – B of the ITAA 97.

An institution that is an overseas charitable institution for these purposes is not required to lodge an Australian tax return.¹¹⁷

4. Commonwealth Games Federation

Dividend or non – share dividend income derived on or after 1 January 2000 and before 1 July 2007 by the Commonwealth Games Federation is exempt by item 9.4 of the table in s 50 – 45 of the ITAA 97 and s 128B does not apply to it. The Federation is not required to lodge an Australian tax return.¹¹⁸

¹¹⁵ LI 08; Tables N and L.

¹¹⁶ ITAA 36 s 121C – ‘overseas charitable institution’.

¹¹⁷ LI 08; Tables N and L.

¹¹⁸ LI 08; Tables N and L.

5. Franked dividends or franked non – share dividends

Section 128B does not apply to the franked part of a dividend.¹¹⁹ Franked dividends are dividends paid from corporate profits that have been taxed at the corporate tax rate.¹²⁰ As a matter of policy non – resident franked dividends are not subject to further income tax under s 128B unless the Commissioner has determined under s 204 – 30(3)(c) in subdivision 204 - D of the ITAA 97 or s 177EA(5)(b) of the ITAA 36, that no imputation benefit is to arise in respect of the dividend. Section 128B applies to franked dividends that may reasonably be regarded as equivalent to the payment of interest on a loan under subsections 128B(3A), (3B) and (3C). If the non – resident carries on business in Australia at or through a permanent establishment and the franked dividend is attributable to the permanent establishment, the franked dividend is not subject to s 128B but is included in the non – resident's Australian assessable income.

The Commissioner has the power under the anti - streaming provisions of subdivision 204 - D to determine that no imputation benefit is to arise from a franked dividend that has been streamed to one member of a corporate tax entity in preference to another. He has a similar power to cancel the benefit of an arrangement that is a franking credit scheme under s 177EA. The cancellation of an imputation benefit subjects the underlying dividend to s 128B and so makes it non – assessable non – exempt income of the non – resident pursuant to s 128D.

Income from a trust estate or from partnership assets retains its tax character in the hands of a beneficiary or partner. Section 128B applies to franked dividends derived by a non – resident beneficiary or partner in circumstances where the distribution to the beneficiary or partner, or the application of the franked dividends on behalf of the beneficiary or partner, may reasonably be regarded as equivalent to the payment of interest on a loan under the provisions in subsections 128B(3A)(3B) and (3C). The provisions cover financial arrangements in which the beneficiary or partner derives the dividends as lender or on behalf of a lender.¹²¹ To determine the extent to which an amount may reasonably be regarded as equivalent to the payment of interest, regard is to be had to the way in which the amount was calculated, the conditions applying to the payment or application of the amount and any other relevant matters.¹²² The effect of subsection 128B(3A) is that s 128B applies to the relevant

¹¹⁹ ITAA 36 s 128B(3)(ga)(i). A reference to a 'franked dividend' in this section includes a 'franked non – share dividend'.

¹²⁰ The imputation provisions in Part 3 – 6 of the ITAA 97 have been referred to above.

¹²¹ ITAA 36 s 128B(3A).

¹²² ITAA 36 s 128B(3C).

franked dividends as dividends and not as interest¹²³ and, pursuant to s 128D, they are non – assessable non – exempt income of the non-resident.

The income tax treatment of dividends that are attributable to a non – resident's Australian permanent establishment is discussed below in relation to subsection 128B(3E). Franked dividends that are not so attributable are non – assessable non – exempt income of the non – resident in the year in which they are derived¹²⁴ and the amount of the franking credit on the distribution is not included in the non – resident's assessable income and the non – resident is not entitled to a tax offset for the franking credit.¹²⁵ The non – resident is not required to lodge an Australian return on account of such dividends.¹²⁶

6. Dividends paid by Pooled Development Funds ('PDFs')

PDF means a company that is a PDF within the meaning of the *Pooled Development Funds Act 1992*.¹²⁷ The income tax treatment of distributions to shareholders in a PDF is governed by the provisions of Division 10E of the ITAA 36.¹²⁸ By s 124ZM non-resident franked and unfranked dividends from a PDF are exempt from income tax and, by subsection 128B(3)(ba), s 128B does not apply to them. Non – residents are not required to lodge a return on account of income that is not taxable in Australia.¹²⁹

7. Dividends derived from assets included in the insurance funds of a non-resident life assurance company carrying on business through an Australian permanent establishment.

The above dividends are excluded from the operation of s 128B by subparagraph (gb) in subsection 128B(3). They are not non – assessable non – exempt income for the purposes of s 128D and so are taxable to a non-resident by assessment¹³⁰ to the extent that they are paid from profits sourced in Australia.¹³¹ If the non – resident is carrying

¹²³ Subsection 128B(3A) applies to distributions that are dividends for income tax purposes including the debt/equity provisions in Division 974 of the ITAA 97.

¹²⁴ ITAA 36 s 128D.

¹²⁵ ITAA 97 s 207 – 90.

¹²⁶ LI 08; Tables D and F(2).

¹²⁷ ITAA 97 s 995 – 1(1) – 'PDF'.

¹²⁸ For the purposes of the ITAA 36, PDF does not include a PDF in the capacity of a trustee; ITAA 36; s 6(1) – 'PDF'.

¹²⁹ LI 08; Tables D and F(2).

¹³⁰ LI 08; Tables D and F(2).

¹³¹ ITAA 36 s 44(1)(b)(i)(ii).

on business in Australia at or through a permanent establishment and the dividends are attributable to the permanent establishment, they are taxable in Australia regardless of source.¹³² 'Insurance funds', in relation to a company, means all the Australian statutory funds of the company and all other funds maintained by the company in respect of the life assurance business of the company.¹³³

8. Assessable income diverted under certain tax avoidance schemes.

Division 9C in the ITAA 36 deals with tax avoidance agreements involving certain exempting provisions. Exempt dividends that are made assessable under the provisions of Division 9C are not subject to s 128B,¹³⁴ they are not non – assessable non – exempt income under s 128D and so they are taxable to a non – resident recipient by assessment¹³⁵ to the extent that they are sourced in Australia.¹³⁶ The source of the dividends is irrelevant if they are attributable to the non – resident's Australian branch.¹³⁷

9. Dividends or non share dividends paid by Australian resident companies to a non – resident superannuation fund that is exempt from income tax in the country in which it resides and that is a fund for foreign residents.

The above dividends are excluded from the operation of s 128B by subparagraph (jb) in subsection 128B(3) and they are non – assessable non – exempt income under s 128D even if the non – resident fund is carrying on a business in Australia at or through a permanent establishment.¹³⁸ The fund is not required to lodge an Australian tax return on account of its Australian dividends.¹³⁹

10. Dividends subject to family trust distribution tax

A dividend or non – share dividend paid to a non – resident that is not assessable under s 271 – 105 in Division 271 of Schedule 2F of the ITAA 36 is not subject to s 128B.¹⁴⁰ A dividend is not assessable under Division 271 if it was distributed by a

¹³² ITAA 36 s 44(1)(c)(i)(ii).

¹³³ ITAA 36 s 6(1) – 'insurance funds'.

¹³⁴ ITAA 36 s 128B(3)(j).

¹³⁵ LI 08; Tables D and F(2).

¹³⁶ ITAA 36 s 44(1)(b)(i)(ii).

¹³⁷ ITAA 36 s 44(1)(c)(i)(ii).

¹³⁸ ITAA 36 s 128B(3E)(c).

¹³⁹ LI 08; Table F(2).

¹⁴⁰ ITAA 36 s 128B(3)(k).

company, that has elected to be included in a family group in relation to a family trust, to someone other than the specified individual or a member of the family group, and family trust distribution tax was paid or reduced in respect of the dividend under the provisions of Division 271. As the dividend is not assessable the non – resident is not required to lodge a tax return on account of it.¹⁴¹

11. *Demerger dividends*

A ‘demerger dividend’ means that part of a demerger allocation that is assessable as a dividend under s 44(1) of the ITAA 36 or that would be so assessable apart from subsections 44(3) and (4).¹⁴² Subsections (3) and (4) apply to a demerger dividend¹⁴³ unless the head entity has made an election within the provisions of subsection 44(2). Subsection 44(3) provides that s 44 applies to the relevant demerger dividend as if it had not been paid out of profits and subsection 44(4) provides that it is not assessable income or exempt income.

By subsection 128B(3D), s 128B does not apply to a demerger dividend provided s 45B of the ITAA 36 does not apply to it. Section 45B may apply to a demerger dividend that is provided to a non – resident under a scheme entered into for a purpose, other than an incidental purpose, of enabling the non – resident to obtain the tax benefit of s 128B(3D) or any other tax benefit.¹⁴⁴ If s 45B does not apply to the dividend and the head entity has not made an election under subsection 44(2) the dividend is not taxable by withholding or assessment.¹⁴⁵ If a subsection 44(2) written election has been made or if subsection 44(5) applies, so that the dividend is assessable, the non – resident recipient is required to include it in an Australian tax return.¹⁴⁶

If the Commissioner makes a determination under subsection 45B(3), the amount of the demerger benefit, or the part of the benefit, is taken not to be a demerger dividend for the purposes of the ITAA 36.¹⁴⁷ This in turn will exclude the operation of subsection 128B(3D) and the dividend is taxed by withholding and, pursuant to s 128D, is non – assessable non – exempt income of the non-resident recipient who is

¹⁴¹ LI 08; Tables D and F(2).

¹⁴² ITAA 36 s 6(1) – ‘demerger dividend’; ‘demerger allocation’.

¹⁴³ Subject to the provisions of subsections 44(5) and (6).

¹⁴⁴ ITAA 36 s 45B(2).

¹⁴⁵ ITAA 36 ss 128B(3D) and 44(4).

¹⁴⁶ LI 08; Tables D and F(2).

¹⁴⁷ ITAA 36 s 45BA(1).

not required to lodge an Australian return on account of it.¹⁴⁸ Demerger dividends are unfrankable¹⁴⁹ so a situation cannot arise where it could be argued that s 128B does not apply because the dividend is franked¹⁵⁰ or because it has been declared to be conduit foreign income.¹⁵¹

Pursuant to subsection 128B(3E), a demerger dividend that is attributable to the non – resident’s Australian branch is not subject to s 128B and it is not non – assessable non – exempt income under s 128D. It may or may not be taxable in Australia depending on whether a subsection 44(2) election has been made, whether subsection 44(5) applies and whether the Commissioner has made a determination under subsection 45B(3).¹⁵² If it is assessable it must be included in the non – resident’s return for the year in which it was derived.¹⁵³

12. Conduit foreign income

So much of the unfranked part of a frankable distribution made by an Australian corporate tax entity that the entity declares, in its distribution statement, to be conduit foreign income, is, in the hands of a foreign resident, non – assessable non – exempt income that is not subject to s 128B.¹⁵⁴ Conduit foreign income is foreign sourced income derived directly or indirectly and the amount of a company’s conduit foreign income at a particular time is calculated by applying ss 802 – 30 to 802 – 55.¹⁵⁵ Australian corporate tax entities are encouraged by the deeming provision of s 802 – 60(2) to declare, for a franking period, the same proportion of foreign conduit income for all membership and non – share equity interests. However, even if the declaration of foreign conduit income is disproportionate, an entity that receives a frankable distribution that has an unfranked part is entitled to rely on the distribution statement made by the entity that made the distribution.¹⁵⁶

¹⁴⁸ LI 08; Tables D and F(2).

¹⁴⁹ ITAA 97 s 202 – 45(i).

¹⁵⁰ See franked dividends discussed above.

¹⁵¹ See the discussion of conduit foreign income below.

¹⁵² See the discussion of subsection 128B(3E) below.

¹⁵³ LI 08 Table A(3).

¹⁵⁴ ITAA 97 ss 802 – 5; 802 – 15(1).

¹⁵⁵ ITAA 97 ss 995 – 1(1) – ‘conduit foreign income’; 802 – 25.

¹⁵⁶ ITAA 97 s 802 – 60(4).

13. Dividends or non – share dividends paid on or after 26 June 2005 that are attributable to the non – resident’s Australian permanent establishment

Section 128B does not apply to Australian dividends¹⁵⁷ paid to a non – resident company or individual, other than in the capacity of a trustee, which are attributable to the non – resident’s Australian permanent establishment.¹⁵⁸ To the extent that such dividends are not exempt, or non – assessable non – exempt, income of the non – resident they may be subject to Australian income tax by assessment under s 44(1) of the ITAA 36.¹⁵⁹ The provisions of Division 6 in the ITAA 36 relate to the way in which the net income from a trust estate is assessed to income tax, the interaction between Division 6 and ss 128B(1) and (4) in relation to non – resident trust dividends is discussed below.

Only dividends that are attributable to the non – resident’s Australian permanent establishment are excluded from the operation of s 128B.¹⁶⁰ ‘Attributable’ is not specially defined for these purposes. In s 128B(3E) ‘permanent establishment’ of a person has the same meaning as in a DTA that relates to a foreign country and affects the person or, in the absence of a relevant DTA, it has the meaning given by s 6(1) of the ITAA 36.¹⁶¹ A ‘permanent establishment’ as defined in s 6(1) and Australia’s DTAs, is first and foremost a place at or through which the taxpayer carries on a business.¹⁶² So s 128B(3E), in the absence of any overriding provision of a relevant DTA, will apply to a dividend that is attributable or ascribed to a place in Australia that is the non – resident’s permanent establishment regardless of whether it is also attributable to a business that the non – resident conducts from the permanent establishment. The practical effect of this construction is that subsection 128B(3E) is satisfied in circumstances where the dividend was caused by, or is characteristic of, or was made or originated in, the place that is the non – resident’s permanent establishment in Australia.¹⁶³ Whilst a dividend may be attributable to the stockbroking or investment activities a non – resident conducts through a permanent

¹⁵⁷ ‘Dividend’ includes ‘non – share dividend’ for the purpose of the discussion in this segment.

¹⁵⁸ ITAA 36 s 128B(3E) effective 26 June 2005.

¹⁵⁹ ITAA 36 s 128D and the note to subsection 128B(3E). This aspect is discussed further below.

¹⁶⁰ ITAA 36 s 128B(3E)(b).

¹⁶¹ ITAA 36 s 128B(3F).

¹⁶² ITAA 36 s 6(1) – ‘permanent establishment’; ITAA 53 Sch 1 (UK agreement) Art. 5(1); 2003 UK notes LGB 03/170, note 2; 41/03 note 2; Sch 2 (US agreement) Art. 5(1); Sch 28 (Chinese agreement) Art. 5(1); Sch 35 (Indian agreement) Art.5(1).

¹⁶³ See for example the meaning of ‘attribute’ and ‘attributable’.

establishment in Australia, it is difficult to envisage circumstances in which a dividend is attributable, within the ordinary meaning of 'attribute', to a place that is a permanent establishment. The position is semantically different, but no less problematic, under Australia's DTAs.

It is agreed in article 10(5) of the US agreement¹⁶⁴ that the limits to Australia's right to tax dividends paid to a resident of the US do not apply if the taxpayer in question 'carries on business in the other Contracting State ... through a permanent establishment situated in that State, or performs in that other State independent personal services from a fixed base situated in that other State, and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment or fixed base. In that case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply'.¹⁶⁵ So in this instance it is required that the share or non – share equity interest be effectively connected with the place that is the non – resident's permanent establishment. A share, or a non – share equity interest, is a bundle of rights and, as in the case of any dividend it may produce, it is difficult to know the circumstances in which it will be effectively connected with the place that is the non – resident's permanent establishment as opposed to the business activities that are conducted there. The fact that the business profits' or independent personal services' article applies once the necessary connection is found, arguably indicates an intention or purpose of the lawmaker that the relevant connection is established by a finding that the share or interest is an asset in the business or enterprise that the taxpayer conducts from its permanent establishment. Likewise it is arguable in cases where subsection 128B(3E)(b) is in dispute, that dividends that are derived from investment activities that are an integral part of a business or enterprise that the taxpayer conducts from its permanent establishment are attributable to that permanent establishment.

Once it is established that s 128B does not apply to an amount of dividend income paid to a non – resident because it is attributable to the taxpayer's permanent establishment in Australia¹⁶⁶ or, in the case of a relevant DTA, because the share or non – share equity interest is effectively connected to that permanent

¹⁶⁴ ITAA 53 Sch. 2.

¹⁶⁵ ITAA 53 Sch. 2 (USA Convention) Article 10(1), (2) and (5). See the same provisions in Sch. 1 (UK agreement) Article 10(1), (2) and (5) – save for the provision in relation to independent personal services; Sch. 28 (Chinese agreement) Article 10(1), (2) and (4) and Sch. 35 (Indian agreement) Article 10(1), (2) and (4).

¹⁶⁶ For the purposes of subsection 128B(3E)(b).

establishment,¹⁶⁷ it must be determined whether the dividend is assessable in the hands of the non-resident. This issue is considered first in relation to a situation where there is no relevant DTA.

There is a note to subsection 128B(3E) that the subsection 'not only ensures that this section does not apply to that income to make withholding tax payable on it, but also (as a result) ensures that none of that income is non – assessable non – exempt income under s 128D. Subsection 44(1) makes that income assessable income'.¹⁶⁸

Section 44(1) of the ITAA 36 provides that the assessable income of a non – resident shareholder includes dividends to the extent to which they are paid out of profits derived by the company from sources in Australia and non – share dividends to the extent to which they are derived from sources in Australia. If the non – resident shareholder is carrying on business through an Australian permanent establishment and the dividends are derived from a resident company, assessable income includes dividends attributable to the permanent establishment to the extent to which they are paid out of profits derived from sources outside Australia.¹⁶⁹

In some respects the note to subsection 128B(3E) is misleading. On the basis that subsection 128B(3E) overrides all prior provisions in subsection 128B(3), its effect is to place all non – resident dividends attributable to a non – resident's Australian permanent establishment, within the assessment regime. To be assessable, a dividend must satisfy the requirements for assessability in subsection 44(1), including the principal requirement that it is paid out of profits derived by the company. Furthermore it must not be exempt or non – assessable non – exempt income under a provision other than that in s 128D. PDF dividends, demerger dividends, dividends declared to be conduit foreign income and dividends paid to certain institutions and superannuation funds are exempt or non – assessable under provisions outside Division 11A¹⁷⁰ and are not made assessable income under subsection 44(1) where they are attributable to a non – resident's Australian permanent establishment.

Australian dividends and non – share dividends derived by non – resident trustees or beneficiaries

An Australian dividend or non – share dividend, derived by a trustee or beneficiary, that is subject to withholding tax, or that would be subject to withholding tax, under

¹⁶⁷ For the purposes of a relevant DTA.

¹⁶⁸ Notes form a non – operative part of the ITAA 36. In relation to the ITAA 97 there is a special provision to this effect in s 2 – 45.

¹⁶⁹ ITAA 36 s 44(1)(b).

¹⁷⁰ See the various dividends discussed above.

subsections 128B(1) and (4), but for the fact that it is franked or derived by a foreign superannuation fund,¹⁷¹ is not assessable income and is not exempt income of a person.¹⁷² So a trust dividend to which s 128D applies is not part of the net income of the trust estate¹⁷³ for the purposes of Division 6 in ITAA 36.¹⁷⁴

Apart from the general exclusions in relation to dividends and non – share dividends discussed above, s 128B does not apply to dividends or non – share dividends that are income in respect of which a trustee is liable to be assessed under ss 99, 99A or 102 of the ITAA 36¹⁷⁵ or that are income derived by a trustee and that are not included in the income of a trustee beneficiary of the trust estate because of s 102UK(2)(b) or 102UM(2)(b).¹⁷⁶ A non – resident trustee or beneficiary that derives taxable trust dividends or non – share trust dividends to which s 128D does not apply is required to lodge an Australian tax return on account of such dividends.¹⁷⁷

In cases where there is no relevant DTA, subsection 128B(3E)¹⁷⁸ does not exclude trust dividends and non – share dividends, derived by a non – resident beneficiary, from the operation of s 128B in circumstances where the trustee is carrying on a business in Australia and the dividends are attributable to the trustee's Australian permanent establishment. Such dividends are either subject to s 128D, in which event they are not part of the net income of the trust,¹⁷⁹ or they are assessable in the hands of the trustee pursuant to s 98. If they are assessable to the trustee under ss 99, 99A or 102, s 128B does not apply to them by virtue of subsection 128B(3)(d) and (e).

The position is different in cases where a DTA applies. Section 3(11) of the ITAA 53 relates to foreign beneficiaries of Australian business trusts. It provides, in relation to the business profits article,¹⁸⁰ that the beneficiary is deemed to carry on, through an

¹⁷¹ For the purpose of s 128B(3)(jb).

¹⁷² ITAA 36 s 128D.

¹⁷³ ITAA 36 s 95(1) – 'net income'.

¹⁷⁴ The Commissioner endorses this view of the operation of s 128D in Interpretative Decision ATO ID 2002/95.

¹⁷⁵ ITAA 36 s 128B(3)(d)(e).

¹⁷⁶ ITAA 36 s 128B(3)(l).

¹⁷⁷ LI 08; Tables D and F(2).

¹⁷⁸ See the discussion of subsection 128B(3E) above.

¹⁷⁹ See discussion above.

¹⁸⁰ ITAA 53 Sch. 1 (UK agreement) Articles 7 and 10(5); Sch. 2 (USA Convention) Articles 7 and 10(5); Sch. 28 (Chinese agreement) Articles 7 and 10(4) and Sch. 35 (Indian agreement) Articles 7 and 10(4).

Australian permanent establishment, the business the trustee carries on in Australia and the beneficiary's share of the income is deemed to be attributable to that permanent establishment.¹⁸¹

THE OBLIGATION TO WITHHOLD S 128B(4) INCOME TAX

Subdivision 12 – F in Schedule 1 of the TAA distinguishes dividend payments to overseas persons and dividend payments received for foreign residents.

By s 12 – 210, an Australian resident company must withhold an amount from a dividend it pays when making the payment¹⁸² if according to its register of members, the entity, or any of the entities, holding the shares on which the dividend is paid has an address outside Australia; or that entity, or any of those entities, has authorized or directed the company to pay the dividend to an entity or entities at a place outside Australia. A 'share' is a share in the capital of the company.¹⁸³

Section 12 – 215 requires a person in Australia or an Australian government agency¹⁸⁴ that receives a payment of a dividend of an Australian resident company, to withhold an amount from the dividend if a foreign resident is, or becomes, entitled to receive it, or to be credited with it or to direct how it is to be dealt with. The obligation to withhold arises immediately after receipt, if the foreign resident is so entitled when the payment is received, or immediately after the foreign resident becomes so entitled.¹⁸⁵

The amount to be withheld is to be worked out under the regulations to the TAA.¹⁸⁶ Regulation 40 provides that the amount to be withheld from a dividend under s 12 – 210 or 12 – 215 is 30% of the amount of the dividend or an amount calculated at the rate provided for in a relevant DTA except where the dividend is paid to a US resident and it falls within a class of dividends that is exempt from tax under US law. Not surprisingly, the regulation applies the rate in a relevant DTA, failing which, the rate declared by Parliament.

¹⁸¹ ITAA 53 s 3(11)(c) and (d).

¹⁸² TAA Sch. 1; s 16 – 5.

¹⁸³ ITAA 97 s 995 – 1(1) – 'share'. An expression has the same meaning in Schedule 1 as in the ITAA 97 and the rules for interpreting ITAA 97, in Division 950 of that Act, apply to Schedule 1; TAA ss 3AA(2) and (3).

¹⁸⁴ The Commonwealth, a State or a Territory or their authorities, ITAA 97; s 995 – 1(1) – 'Australian government agency'.

¹⁸⁵ TAA Sch. 1 ss 12 – 215(2), 16 – 5.

¹⁸⁶ TAA Sch. 1 s 15 – 10(2).

Barton: Australian Dividend Withholding Tax
AUSTRALIAN DIVIDEND WITHHOLDING TAX

By s 12 – 300, an entity is not required to withhold an amount from a dividend if no withholding tax is payable in respect of it or to withhold more than the withholding tax payable reduced by each amount already withheld from it.¹⁸⁷ ‘Withholding tax’ in the context of s 12 – 300 is income tax payable under s 128B of the ITAA 36.¹⁸⁸ The combined effect of ss 12 – 210 and 12 – 300 is unclear. Section 12 – 210, considered without reference to s 12 – 300, imposes an obligation on an Australian resident company paying a dividend, to withhold an unquantified amount from the dividend if the payee shareholder has given an address outside Australia for the purposes of its share register or has authorized or directed payment at an address outside Australia. It reflects a collection policy of ‘withhold now and ask questions later’ in cases where these conditions are met.¹⁸⁹ The withholding obligation in s 12 – 210, however, is irreconcilable with subparagraph 12 – 300(a) which limits the amount to be withheld to the amount of income tax payable under s 128B of the ITAA 36. A liability to income tax under s 128B(4) depends, amongst the other matters discussed above, on whether the dividend is paid to a non – resident, a question of fact and degree that, for all practical purposes, will not turn exclusively on an address recorded in a share register or an address for payment. An alternative approach, to resolve the conflict, is to read down s 12 – 210 to mean that an Australian resident company paying a dividend has a withholding obligation if the shareholder’s address is outside Australia, or the dividend is payable at a place outside Australia, and it has determined that an amount of dividend withholding tax under s 128B is payable by the payee. If the payee is not liable for dividend withholding tax the company has no obligation to withhold. This approach relieves the company of any withholding obligation in cases where non – resident shareholders have provided an Australian address but, somewhat unrealistically, imposes a burden of determining the dividend withholding liability, if any, of a shareholder with a foreign address.

‘Dividend’ in subdivision 12 – F, as in Division 11A of the ITAA 36, has the general meaning given by subsections 6(1) and (4) and 6BA(5) and s 94L of the ITAA 36 and s 375 – 872 of the ITAA 97.¹⁹⁰ Subdivision 12 – F applies to a part of a dividend in the same way it applies to a dividend.¹⁹¹ It applies to a liquidation distribution that is taken to be a dividend under s 47 of the ITAA 36 in the same way as a dividend paid by the company and as if the liquidator or person making the distribution were the

¹⁸⁷ TAA Sch. 1 s 12 – 300(a) and (b).

¹⁸⁸ TAA ss 3AA(2) and (3).

¹⁸⁹ In contrast to the position under s 12 – 215 in relation to payments received for a ‘foreign resident’.

¹⁹⁰ ITAA 97 s 995 – 1(1) – ‘dividend’; TAA ss 3AA(2) and (3).

¹⁹¹ TAA Sch.1 s 12 – 220.

company.¹⁹² As discussed above in relation to non – share dividends, a non – equity share distribution is not a s 128B dividend and is treated as an amount of interest for the purposes of Division 11A. In similar vein, a reference in a DTA to income from shares, or to income from other rights participating in profits, does not include a reference to a return on a Division 974 - B debt interest. Whilst there is no dividend withholding obligation under s 12 - 210 on an Australian company in respect of a non – equity share distribution, there is an interest withholding obligation under s 12 – 245.

GENERAL COMMENT

The Australian federal government has initiated a comprehensive review of the Australian income tax system principally because of the complexity of current arrangements. The tax technical issues that confront international investors in Australian companies, and their advisers, in determining the reach of Australia's dividend withholding tax, and any liability for income tax in respect of distributions not subject to the withholding provisions, are symptomatic of the shortcomings under review. Any effective simplification of the general law that governs the meaning, and practical application, of subsections 128B(1) and (4) is to be welcomed. This paper is conceived as a collation of the rules and some of the technical issues relating to the current position, to assist local and overseas advisers and their clients.

¹⁹² TAA Sch. 1 s 12 – 225.