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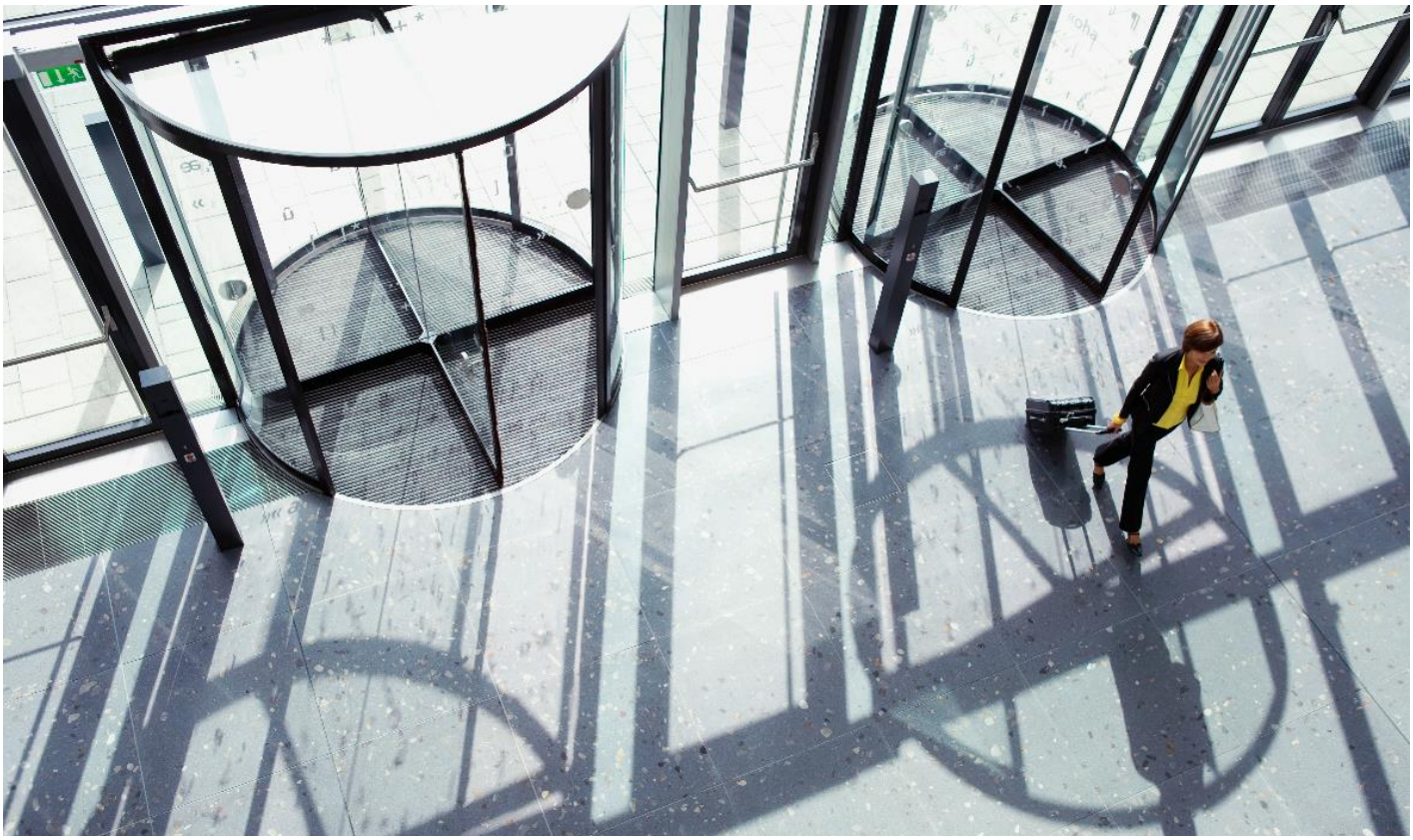

Tax Insights

When is interest paid? The wide view versus the narrow view

Snapshot

Recently in *Millar* v *Commissioner of Taxation* [2016] FCAFC 94 (**Millar's case**), the Full Federal Court considered whether interest capitalised at the discretion of the lender was a "constructive payment" for the purposes of the withholding provisions in the *Taxation Administration Act* (**TAA**).

The main issue before the court was whether the loan arrangement upon which interest accrued (and was then capitalised) was a sham; the majority holding that it was. However, the noteworthy issue in this case is the constructive payment issue, which potentially has far reaching application. The majority gave the constructive payment provision a broad interpretation and application.

The constructive payment issue potentially has far reaching application

Background

Millar's case involved a number of issues:

1. **Fraud or evasion**: Whether there had been fraud or evasion for the purpose of s 170 of the *Income Tax Assessment Act* (**ITAA**) 1936?
2. **Sham**: Whether the purported loan arrangement was a sham?
3. **Constructive payment**: Whether the taxpayers had a withholding obligation when interest was capitalised, due to the constructive payment provision in s 11-5(1) in Schedule 1 of the TAA?

The Commissioner argued the Millars impermissibly accessed funds from their SMSF

Key facts

The taxpayers (**the Millars**) borrowed $600,000 from a Samoan entity, Hua Wang Bank Berhad (**HWBB**), to finance the acquisition of an investment property. As a part of the arrangement, the Millars' complying self-managed superannuation fund (**SMSF**) also deposited $600,000 with HWBB.

The Commissioner treated the loan documentation as a sham, and contended the substance of the arrangement involved the Millars impermissibly accessing funds from their SMSF for private purposes.

The HWBB loan agreement

Clause 5.1 of the loan agreement required the Millars to pay interest on the balance of the loan outstanding on 30 June each year. Clause 5.4 provided that the lender (HWBB) may, at its discretion, capitalise any interest that became due and owing but not paid on the due date.

Decision: fraud or evasion

The Commissioner issued the amended assessments, after the normal amendment period had expired, having formed the opinion that "there has been … evasion". The AAT (and Griffiths J (Federal Court, single judge) agreed) regarded as "blameworthy" the claiming of interest deductions in respect of a sham arrangement, and also noted that the taxpayers' advisers had most likely withheld information. As a result, the taxpayers failed to prove that there had not been evasion. The amended assessments stood.

The fraud or evasion issue was not challenged by the taxpayers in the Full Federal Court.

Decision: sham issue

The majority Pagone and Davies JJ, in separate judgements, dismissed the taxpayers' appeal, holding the loan arrangement between HWBB and the Millars was a sham. The majority found "serious discrepancies between what [was] said in the loan documents and what actually happened".

Decision: constructive payment

Since 1 July 2000, s 11-5(1) governs constructive payments. Unlike the predecessor provision (s 221YK(3) of the ITAA 1936), s 11-5(1) does not specifically deem interest that has been capitalised to be "paid".

Notwithstanding their decision that the arrangement was a sham, Pagone and Davies JJ went on to consider the constructive payment issue. Pagone and Davies JJ were clearly influenced in their interpretation of s 11-5(1) by the language adopted in the predecessor provision, s 221YK(3). So too was Griffiths J (Federal Court, single judge) who identified the fundamental issue as whether s 11-5(1) is narrower in scope than its predecessor. His Honour concluded that it was not, observing that the terminology in s 11-5 is "substantially similar to the catch all clause in s 221YK(3)(a)" and "That broader concept [s 11-5(1)] encompasses the particular instances which were identified in the earlier legislation [s221YK(3)]."

Subsection 11-5(1) does not specifically deem interest that has been capitalised to be "paid"

Pagone J respectfully agreed with Griffiths J's reasons and conclusions. Davies J concluded:

The taxpayers' agreement that Hua Wang may capitalise interest as provided for in cl 5.4 of the loan agreement is apt to fall within the ordinary language of the provision of s 11-5 as an amount applied or dealt with by the taxpayers on behalf of Hua Wang or as Hua Wang directed.

In other words, the bank having a contractual entitlement to capitalise the interest was sufficient to activate the provision. The requisite applying or dealing by the Millars was effectively actioned at the time they entered into the loan agreement (including clause 5.4), and such application or dealing by the taxpayers [borrowers] was taken to be on behalf of, or as directed by, the lenders.

In working out whether an entity [borrower] has paid an amount to another entity [lender], and when the payment is made, the amount is taken to have been paid to the other entity [lender] when the first entity [borrower] applies or deals with the amount in any way on the other's [lender] behalf or as the other [lender] directs

Logan J took a different approach to statutory interpretation:

The correct approach to statutory construction is not to begin with the past but rather to begin with the text of the present … to begin with the text of s221YK(3)(a) is fraught with the risk of colouring the construction of the present text of s 11-5 with a priori assumptions based on the past text of s 221YK(3)(a).

Logan then asked whether the taxpayers [borrowers] were applying or dealing with their interest liability either on behalf of the lender or as the lender directs? In other words, what act (application or dealing) was done by the taxpayers and was it on behalf of, or as directed by, the lender.

Logan J reasoned that the capitalisation by the lender did not entail any act by the Millars. As a result, the Millars did not apply or deal with that interest as was necessary under s 11-5(1).

The Millars have not filed an application to seek special leave to appeal the decision to the High Court.

Some implications

The case serves to illustrate that if the Commissioner is of the opinion that there has been fraud or evasion, and so is able to issue amended assessments after the normal time limits have expired, the taxpayer bears the onus to show that the relevant conduct does not amount to fraud or evasion.

The broad interpretation given to the constructive payment rule in s 11-5(1) will need to be considered by taxpayers. Are there circumstances where the view has been taken that there has been no constructive

payment, but which based on the approach taken in this decision could now be regarded as a constructive payment?

The decision also puts the spotlight on the fact that there is a difference in the legislative language as between the time when a lender's liability to interest withholding tax arises (s 128A(2) ITAA) and the time of the borrower's obligation to withhold (s 11-5(1) TAA). In particular, s 128A(2) deems interest to be "paid" when it is capitalised.

Whilst the majority interpreted s 11-5(1) to be activated in this case, there could be circumstances where interest is capitalised in a way where there is no relevant application or dealing by the borrower on behalf of, or as directed by, the lender.

The decision focused on whether there was a constructive payment under s11-5(1) and hence an obligation under the TAA to withhold and remit an amount to the Commissioner. This is relevant to whether s 26-25 of the *Income Tax Assessment Act* 1997 may operate to prevent a deduction, however, there was no analysis of the operation of s 26-25.

The Commissioner has indicated that cross border financing is a key focus area. This raises a range of issues including transfer pricing, thin capitalisation, interest withholding tax, and the general anti avoidance rule amongst others.

The ATO's position has been strengthened in a series of recent cases: Chevron (transfer pricing), Orica (loan-ups and the general anti avoidance rule), D Marks (limited partnership provisions) and now this decision in respect of the interest withholding tax rules.

Taxpayers should be reviewing cross border financing arrangements in light of these recent Court decisions and the current practice and views of the ATO.

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