Guide to foreign income tax offset rules 2009–10

Check if you can claim a foreign income tax offset (FITO), how to calculate the amount and what rules apply.

29 June 2010

Overview

If you have assessable income from overseas, you must declare it in your Australian income tax return. If you have paid foreign tax in another country, you may be entitled to an Australian foreign income tax offset, which provides relief from double taxation.

These rules apply for income years that start on or after 1 July 2008. Different rules apply for income periods up to 30 June 2008 (refer to How to claim a foreign tax credit, NAT 2338).

You can claim a tax offset for the foreign tax you have paid on income, profits or gains (including gains of a capital nature), that are included in your Australian assessable income. In some circumstances, the offset is subject to a limit.

To be entitled to a foreign income tax offset:

- you must have actually paid an amount of foreign income tax
- the income or gain on which you paid foreign income tax must be included in your assessable income for Australian income tax purposes.

Differences between the Australian and foreign tax systems may lead to you paying foreign income tax in a different income year from that in which the income or gain is included in your assessable income for Australian income tax purposes. You could have paid the foreign tax in

an earlier or later income year. However, the offset can only be claimed after the foreign tax is paid.

If you paid foreign income tax after the year in which the related income or gains have been included in your Australian tax return, you can claim the offset by lodging an amended assessment for that year. You have up to four years to request an amendment to your assessment from the date you paid the foreign income tax. You should also request an amendment if there is an increase or reduction in the amount of foreign income tax you paid that counts towards the offset.

The foreign income tax offset applies to foreign income tax imposed on all forms of income, profits and gains, (including gains of a capital nature) and to all taxpayers, whether individuals or other entity types.

Note that:

- while the offset mainly applies to Australian resident taxpayers, in the limited circumstances where the foreign income of a foreign/non-resident is taxed as assessable income in Australia, they may be able to claim the offset
- in very limited circumstances, foreign tax imposed on Australian source income may count towards a foreign income tax offset.

For a comparison of the foreign income tax offset rules and the foreign tax credit rules, refer to *Changes to foreign loss quarantining and foreign tax credit calculation rules - overview*.

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Calculating the offset

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You claim the foreign income tax offset in your income tax return.

If claiming an offset of $1,000 or less, you only need to record the actual amount of foreign income tax paid on your assessable income (up to $1,000).

If claiming a foreign income tax offset of more than $1,000, you will first need to work out your foreign income tax offset limit.

Before you calculate your net income, you must convert all foreign income deductions and foreign tax paid to Australian dollars - refer to Converting foreign income to Australian dollars.

Unlike the previous system of foreign tax credits (applying up to 30 June 2008), you no longer have to quarantine your foreign income into separate classes to work out the amount of the offset. All types of income are treated the same for the purposes of working out the foreign income tax offset.

For a comparison of the foreign income tax offset rules and the foreign tax credit rules, refer to *Changes to foreign loss quarantining and foreign tax credit calculation rules - overview.*

Record keeping

To claim a foreign income tax offset, you will need to keep adequate records of your foreign income and tax paid.

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Transitional rules

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Any excess amount of foreign tax that cannot be recouped as an offset in an income year cannot be carried forward (unlike the previous system of foreign tax credits). However, transitional rules enable a taxpayer with pre-existing excess foreign tax credits to use some of these amounts in certain circumstances.

Attributed foreign income

If you have interests in a foreign entity, your share of its income may be attributed to you for income tax purposes, even if the income has not yet been distributed.

If you have attributed foreign income, you may be entitled to a foreign income tax offset for foreign income tax, income tax, or withholding tax paid by a controlled foreign company (CFC) or foreign investment fund (FIF) in which you hold an interest. The treatment of attributed foreign income under the foreign income tax offsets system is simpler than under the previous foreign credits system. Also, attributable taxpayers will no longer need to maintain attributed tax accounts.

For more information on the tax treatment of attributed income, refer to the publication Attributed foreign income.

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Legislation and related measures

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The foreign income tax offset system was introduced by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007*, and replaces the foreign tax credit rules in former Divisions 18, 18A and 19 of the ITAA 1936.

The foreign income tax offset rules apply to income years starting on or after 1 July 2008. For most taxpayers, that means it will apply to their 2008-09 income year onwards. However, for taxpayers with substituted accounting periods that have early balancing dates (in lieu of 30 June), the rules will not apply until their 2009-10 income year.

The amending Act also repealed the quarantining of foreign losses, which are no longer quarantined according to particular classes of foreign assessable income, or quarantined against other income. There are also transitional rules that permit certain pre-existing foreign losses of a taxpayer to be converted into an ordinary tax loss and deducted against a taxpayer's assessable income, subject to an annual deduction limit.

For more information on the repeal of the foreign loss quarantining rules and the transitional rules, refer to the Foreign income tax return form guide 2008-09. More detailed information on the treatment of foreign losses is contained in the 2010 Losses schedule instructions and the 2010 Consolidated groups losses schedule instructions.

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When a foreign income tax offset applies

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To be entitled to a foreign income tax offset:

- the foreign tax must be foreign income tax
- you must have actually paid, or be deemed to have paid, the foreign income tax, and

- the income or gain on which you paid foreign income tax must be included in your assessable income in Australia.

The offset is available in the income year in which the income or gain (on which the foreign income tax has been paid) forms part of your assessable income in Australia.

The foreign tax must be foreign income tax

You must have actually paid, or be deemed to have paid, the foreign income tax

Foreign income tax must have been paid on assessable income

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The foreign tax must be foreign income tax

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To count towards a tax offset, foreign income tax must be imposed under a law other than an Australian law and be:

- a tax on income
- a tax on profits or gains, whether of an income or capital nature, or
- any other tax that is subject to an agreement covered by the *International Tax Agreements Act 1953* (Agreements Act).

The foreign income tax includes taxes similar to Australian withholding tax that is imposed in place of a tax on the net amount of income.

(For examples, refer to Taxes imposed by Australia's major trading partners for which a foreign income tax offset is available.)

The foreign income tax must be correctly imposed under the relevant foreign law and in accordance with any tax treaty the country has with Australia. For example, if country A is limited under a tax treaty to taxing interest derived in that country by an Australian resident to 10% but imposes a domestic tax rate of 25% for interest derived by all foreign residents, only 10% of the tax counts towards the tax offset. The taxpayer would need to seek a refund of the balance (that is, 15%) from country A's tax authority.

The foreign income tax may be imposed at a supra-national, national, state/provincial or local/municipal level. An example of a supra-national tax is that imposed by the European Union on pensions paid to its former employees.

Foreign taxes not included

The following types of foreign tax do not count towards a foreign income tax offset:

- inheritance taxes
- annual wealth taxes
- net worth taxes
- taxes based on production
- credit absorption taxes - that is, a tax that is payable only because the taxpayer or another entity is entitled to foreign income tax offset in Australia
- unitary taxes - that is, a tax on income, profits or gains of a company derived from sources within the country where the tax is imposed that takes into account income, losses, outgoings or assets of the company (or of an associated company) derived, incurred or situated outside that country, except where the tax only takes those factors into account:

  – if such an associated company is a resident of the foreign country for the purposes of the law of the foreign country, or

- for the purposes of granting any form of relief in relation to tax imposed on dividends received by one company from another company.

Penalties, fines and interest do not qualify as foreign income tax.

If you are unsure about whether a specific foreign tax is a foreign income tax, you can write to us and request a private binding ruling.

Taxes imposed by Australia's major trading partners for which a foreign income tax offset is available

A foreign income tax offset may be available for the foreign taxes listed below. This list is not exhaustive nor, except for India, does it include local or state taxes.

Argentina

Income tax (Impuesto a las ganancias)

Canada

Income taxes imposed by the Government of Canada under the Income Tax Act.

China

Income tax

France

Income tax and corporation tax, including any related withholding tax, prepayment (precompte) or advance payment.

Germany

Income tax (einkommensteuer)

Corporation tax (korperschaftsteuer)

India

Income tax, including any surcharge

Capital gains tax

Non-resident withholding tax

State government imposed taxes on various agriculture incomes

Italy

Individual income tax (l'imposta sul reddito delle persone fisiche)

Corporate income tax (l'imposta sul reddito delle societ , formerly l'imposta sul reddito delle persone giuridiche)

Japan

Income tax

Corporation tax

New Zealand

Income tax

Non-resident withholding tax

Tax on profits from property sales

Singapore

Income tax

South Africa

Normal tax

Secondary tax on companies (due to be replaced with a withholding tax on dividends)

Withholding tax on royalties.

South Korea

Income tax

Corporations tax

Inhabitant tax

United Kingdom

Income tax

Capital gains tax

Corporations tax

United States

Federal income taxes imposed by the Internal Revenue Code

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You must have actually paid, or be deemed to have paid, the foreign income tax

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To count towards a tax offset, the foreign income tax must have actually been paid by the taxpayer or be deemed to have been paid by them. It is not enough that the tax is payable.

If the taxpayer is entitled to a refund of the foreign income tax, or if another benefit worked out by reference to the amount of the foreign income tax (other than a reduction in the amount of the foreign tax) is received as a result of a tax payment, the tax is not considered to have been paid.

It is not necessary for you to have paid the foreign income tax in the same income year in which the income or gain on which the tax has been paid is included in your assessable income. The tax could be paid before or after the income year in which you derive the assessable income. However, the offset can only arise when the foreign income tax is paid, and it is applied to the income year in which the relevant income or gain is included in your assessable income - refer to Special amendment rules for foreign income tax offsets.

Example

> A resident taxpayer holds a qualifying security (Division 16E of Part III of the ITAA 1936) for the income years ending 30 June 2010 through to 30 June 2015. The taxpayer pays foreign income tax on the income from the security in the income year ending 30 June 2015.
>
> Under Australian tax law, the taxpayer includes amounts in their assessable income for the 2010 to 2015 income years on an

accruals basis. Only when the taxpayer pays the foreign income tax are they eligible for a tax offset. However, the offset arises in each of the income years in which the taxpayer's assessable income includes an amount on which foreign income tax is later paid.

Once the foreign tax is paid, the taxpayer is required to apportion the paid foreign income tax among the income years in which the amount is included in their assessable income. As a result, once they have paid the foreign income tax they will need to lodge amended assessments for the earlier income years in order to claim an offset for the foreign income tax paid.

The tax may have been effectively paid by someone else

A taxpayer is treated as having paid foreign income tax on all or part of their assessable income where the tax has been paid in respect of that income by someone else on their behalf under an arrangement with the taxpayer or under the law relating to that tax.

This tax-paid deeming rule ensures that the right taxpayer obtains the tax offset. It applies in situations where the foreign income tax has actually been paid by someone else in a representative capacity for the taxpayer, with the latter bearing the economic burden of the tax. Specifically, it applies where foreign income tax has been paid by:

- deduction or withholding
- a trust in which the taxpayer is a beneficiary
- a partnership in which the taxpayer is a partner, or
- the taxpayer's spouse.

Example 1

Tim, an Australian resident, derives interest income of $1,000 from a foreign country. As that country's laws require the payer of the interest to withhold tax at a rate of 10%, Tim receives $900 (that is, $1,000 less tax of $100). Although he has not directly paid the foreign income tax, Tim is taken to have paid that tax because it was paid under the law relating to the foreign income tax. Tim includes $1,000 in his Australian assessable income and claims a tax offset of $100.

Example 2

A partnership of two Australian partners with equal interests in all income of the partnership derives net income of $1,000 on which it pays $100 of foreign income tax.

The partners each include $500 in their assessable income, being their share of the net income of the partnership. They will both be entitled to a tax offset to the extent that foreign income tax is paid on the amount that is part of their assessable income.

The foreign income tax paid is apportioned according to each partner's share of the net income of the partnership included in their assessable income. Therefore, each claims an offset for $50 of foreign income tax, as this is the proportionate amount of foreign income tax they are taken to have paid on the amount included in their assessable income (that is, (500/1,000) $100).

Example 3

Married couple Arthur and Lucy, both Australian residents, derive net rental income from a foreign country. Under that country's laws, joint filing of tax returns is allowed. Consequently, the net rental income is included in their jointly-filed return and income tax is paid jointly on that income. However, under Australian tax law, each person must show their share of the net rental income in their own tax return. Although the foreign income tax has been jointly paid under the laws of the foreign country, Arthur and Lucy are each deemed to have paid their relevant share of the foreign income tax that has been paid jointly

Example 4

The S trust estate derives rental income from commercial property investments in a foreign country, on which the trustee pays foreign income tax. Samantha, an Australian resident, is the sole beneficiary of the S trust estate and is presently entitled to all of its income. As such, she is assessed on the whole of the trust's net income. Although Samantha hasn't directly paid the foreign income tax, she is deemed to have paid it.

Special tax-paid deeming rules for beneficiaries of trust estates

A specific rule deems a taxpayer to have paid the relevant foreign income tax where they are presently entitled to a share of the trust income that can be directly or indirectly attributed to income received by the trust on which foreign income tax has already been paid by an entity other than the trust itself. This tax-paid deeming rule applies where:

- section 6B of the ITAA 1936 treats an amount of assessable income as being attributable to another amount of income having a particular character or source
- foreign income tax has been paid in respect of the other amount of income, and
- the assessable income attributed under section 6B is less than it would have been if the foreign income tax had not been paid.

When applied together, these rules ensure that a beneficiary of a trust can be deemed to have paid any tax on its share of trust income that is attributable to income that flows through the trust (or chain of trusts) on which foreign income tax is paid by another entity.

The amount of the foreign income tax that is taken to have been paid by the taxpayer is the amount by which the income included in their assessable income has been reduced because of the payment of the foreign income tax paid.

Example 1

> Holly is the sole beneficiary of the B trust estate and is presently entitled to all of its income. B derives foreign dividend income of $100,000 on which foreign dividend withholding tax of $10,000 is paid. B subsequently distributes all its income to Holly (that is, $90,000 net of withholding). As Holly's share of the trust income is attributable to the dividend income received by B (by virtue of section 6B of the ITAA 1936), she can treat the withholding tax paid on the dividend as having been paid by her. Holly includes $100,000 in her assessable income.

Example 2

> Tim, an Australian resident, is the only unit holder in Managed Fund A, which in turn is the only unit holder in Managed Fund B, which has an interest in a US company. Both managed funds are unit trusts. The US company pays a dividend of $1,000 to Managed Fund B, on which withholding tax of $150 is payable,

making the net distribution $850. This amount of $850 flows through both managed funds to Tim. The terms and conditions of the two managed funds are such that Tim is the beneficial owner of the shares on which the dividend was paid.

Tim grosses up the $850 by the amount of the $150 withholding tax and includes $1,000 in his assessable income. As Tim's share of the trust income is attributable to the dividend income received by Managed Fund B, he can treat the withholding tax paid on the dividend as having been paid by him (even though the amount included in his assessable income is attributable to the dividend income that has flowed through a chain of trusts).

When foreign income tax is not treated as paid by the taxpayer

A taxpayer is not entitled to a tax offset for foreign income tax to the extent they, or any other entity, are entitled to:

- a refund of the foreign tax, or
- any other benefit worked out by reference to the amount of foreign income tax (other than a reduction in the amount of the foreign income tax).

The entitlement to a benefit may arise from the exploitation of arbitrage opportunities resulting from mismatches in debt and equity classifications and the different status granted to foreign hybrid entities (for example, where an enhanced yield is obtained by a taxpayer entering into a structured financing arrangement).

However, the taxpayer may still be entitled to a tax offset where the only benefit is a reduction in the tax liability of the taxpayer or another entity, such as that provided by an imputation credit, a rebate of tax or a similar type of concession, provided that the concession does not result in a refund to the taxpayer or other entity.

Example

In a foreign country, Austco derives net rental income on which income tax of $50,000 is paid in that country.

Austco later finds out that it is entitled to a special concession in the foreign country, under which the $50,000 is fully refunded.

Accordingly, Austco is taken to not have paid foreign income tax on that income.

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Foreign income tax must have been paid on assessable income

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To count towards a tax offset, the foreign income tax must have been paid on income, profits or gains that are included in your assessable income.

Where, for example, a person receives a dividend from a foreign company, the foreign income tax on the underlying company profits (the source of the dividend) is not paid in respect of the shareholder's dividend income. Similarly, a person receiving a pension from a foreign superannuation fund has not paid the foreign income tax levied on the income of the superannuation fund. In both of these cases the tax that has been paid relates to the income or gains of the other entity, which is being taxed in its own right.

However, where an entity has been formed under a foreign country's laws that treat the entity as 'fiscally transparent' (that is, its profits are taxed in the hands of its members), income tax imposed by that country on a distribution to an Australian member may be counted towards their tax offset. This is the case even where the entity is treated as a company for Australian tax purposes and the distribution is characterised as a dividend.

This situation could arise, for example, where an Australian taxpayer is a member of a US limited liability company (LLC) that is treated as fiscally transparent under US tax law, but under Australian tax law the Australian member of the US LLC does not elect to treat the LLC as a foreign hybrid.

Example

Aust Super Fund is a trustee of a complying superannuation entity and an Australian resident taxpayer with a 2% interest in a US limited partnership (a foreign investment fund interest).

Under US tax law, the US limited partnership is treated as fiscally transparent; that is, it is not taxed on its profits but rather tax is borne by the partners on their share of the partnership distribution.

Aust Super Fund's share of the US limited partnership's profits is $1 million, on which tax of $350,000 is withheld by the partnership (under US tax law). The tax is imposed in accordance with the Australia-US tax treaty.

Under Australian tax law, Aust Super Fund does not make an election under subsection 485AA(1) of the ITAA 1936 to treat the US limited partnership as a foreign hybrid limited partnership. Accordingly, the US limited partnership is taxed under Australian tax law as a company in accordance with Division 5A of Part III of the ITAA 1936.

Although the absence of an election under section 485AA means that the interest held by the taxpayer in the US limited partnership is still a foreign investment fund interest, the taxpayer (being a trustee of a complying superannuation entity) is exempt from foreign investment fund tax by virtue of Division 11A of Part XI of the ITAA 1936.

The net amount of $650,000 received by Aust Super Fund is characterised as a dividend for Australian tax law purposes and is included in its assessable income. Although Aust Super Fund has not paid the US tax of $350,000 personally (as the US limited partnership has been taxed on the distribution on a withholding basis), it will be treated as having paid it, as the US tax is imposed on the distribution rather than on the underlying profits of the US limited partnership out of which the distribution is made.

Aust Super Fund is also required to gross-up its assessable income by the $350,000 of foreign income tax that it is deemed to have paid in relation to the dividend distribution.

Foreign income tax paid on part of an amount included in assessable income

In some situations, only part of an amount on which foreign tax has been paid is included in Australian assessable income. In this situation, only that proportion of the foreign income tax which equates to the

proportion of foreign income included would be available as a tax offset.

In other situations, the foreign income tax paid relates to only part of an amount included in the taxpayer's assessable income. This typically applies where a foreign source gain on which foreign income tax has been paid is part of a net amount included in a taxpayer's assessable income. In these situations, the foreign income tax counts towards the tax offset only to the extent that it is paid in respect of that part of the amount that is included in the taxpayer's assessable income.

This may be relevant where, for example, a taxpayer has both a capital gain and a capital loss and only the net amount is included in their assessable income. Under the capital gains tax rules, a taxpayer can choose the order in which capital losses are offset against gains. In particular, a taxpayer can choose to offset capital losses (whether current year or prior-year) firstly against domestic capital gains or foreign gains on which no foreign tax has been paid. Such an ordering of the losses maximises the foreign source capital gain component of a net capital gain on which foreign income tax has been paid.

Example

> Company C derives the following capital gains and losses on disposals of assets during the year:
>
> | | |
> |---|---|
> | Domestic capital gain on land: | $100,000 |
> | Foreign capital gain on asset B: | $50,000 (no foreign tax paid) |
> | Foreign capital gain on asset C: | $20,000 (on which foreign income tax of $2000 is paid) |
> | Domestic capital loss on asset A: | ($150,000) |
> | Net capital gain: | $20,000 |
>
> As the foreign income tax offset can only apply where foreign income tax has been paid on an amount included in the taxpayer assessable income, company C chooses to offset its domestic capital loss on asset A of $150,000 first against the domestic gain

on land of $100,000, and the balance of $50,000 against the foreign capital gain on asset B on which no foreign income tax has been paid. Therefore, the net capital gain of $20,000 relates to the foreign capital gain on asset C. As this is the amount included in assessable income on which foreign income tax has been paid, the tax paid of $2,000 counts towards company C's foreign income tax offset.

Where foreign income tax is paid on a foreign source gain but the taxpayer is in an overall capital loss situation for the income year because of other capital losses, none of the foreign income tax paid counts towards a tax offset because the gain is not included in the taxpayer's assessable income.

Example

On the sale of an asset, an Australian-resident taxpayer makes a foreign source capital gain of $10,000, on which foreign income tax of $2,000 has been paid.

The taxpayer also realises a capital loss of $10,000 on the disposal of an Australian asset.

The loss of $10,000 is offset against the foreign gain of $10,000, which results in no net capital gain being included in the taxpayer's assessable income. As their assessable income does not include an amount on which foreign income tax has been paid, the taxpayer is not eligible for a foreign income tax offset for the foreign income tax paid on the foreign source capital gain.

The same principle applies where foreign income tax has been paid on an amount that forms part of a partnership or trust's assessable income, but because there is an overall partnership or trust loss for the year (rather than there being net income), the relevant foreign income is not included in the partner or beneficiary's assessable income.

Foreign income tax on exempt or non-assessable non-exempt income

Foreign income tax paid on amounts that are exempt or non-assessable non-exempt (NANE) income in Australia does not count towards a tax offset (except where the taxpayer derives NANE income under section 23AI or 23AK of the ITAA 1936).

Example

Austco, an Australian-resident company, wholly owns Foreignco, which pays a dividend of $10 million to Austco out of which foreign income tax of $2 million is paid. The dividend is not paid out of previously attributed income. As the dividend is NANE income of Austco under section 23AJ of the ITAA 1936, the foreign income tax paid of $2 million does not count towards Austco's tax offset.

Foreign income must be grossed up

Where you have paid foreign income tax on an amount that forms part of your assessable income, you must include the gross amount (including any tax paid by you) in your assessable income on your tax return.

Example

An Australian-resident taxpayer invests directly in a foreign company, which pays a dividend of $100 from which it deducts $15 withholding tax.

The taxpayer must gross-up the net distribution of $85, adding the foreign income tax withheld of $15, to show $100 in their tax return. This is the amount on which the taxpayer is assessed for income tax purposes.

Attributed income

A special grossing-up rule applies to attributable taxpayers that are deemed to have paid foreign income tax that is actually paid by their controlled foreign company (CFC) or foreign investment fund (FIF). In respect of the attributed income of a CFC or FIF (where the calculation method is used), a notional deduction is allowed for any foreign income tax, income tax or withholding tax it pays. The attributable taxpayer includes in their assessable income this net amount multiplied by their attribution percentage. Thus, the attributable taxpayer is effectively entitled to a deduction for foreign income tax, income tax or withholding tax paid on an amount included in the CFC's or FIF's attributed income.

Where the attributable taxpayer is deemed to have paid the foreign income tax that is actually paid by the CFC or FIF and counts that towards their tax offset, they have to gross-up their attributed income by the amount of foreign income tax (including withholding tax) they are deemed to have paid.

Note that there are special rules for claiming an offset for foreign income tax paid on attributed income.

Example

> A co is an Australian-resident company with a 100% interest in Y co, a CFC. Y co works out its notional assessable income as $1.2 million and claims a notional allowable deduction of $200,000 for foreign tax paid by it, thereby resulting in attributed income of $1 million. A co includes the amount of $1 million in its assessable income under section 456, as its attribution percentage is 100%. A co is also required to treat the foreign income tax paid by Y co as having been paid by it under the special tax-paid deeming rules that apply to attributable taxpayers. Accordingly, A co is required to gross-up its attributed income of $1 million by the $200,000 of foreign income tax that it is deemed to have paid.

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Calculating and claiming your foreign income tax offset

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You claim the foreign income tax offset in your income tax return.

Before you calculate your net income, you must convert all foreign income deductions and foreign tax paid to Australian dollars - refer to Converting foreign income to Australian dollars.

To claim a foreign income tax offset of up to $1,000, you only need to record the actual amount of foreign income tax paid on your assessable income (up to $1,000).

If you are claiming a foreign income tax offset of more than $1,000, you have to work out your foreign income tax offset limit. This may result in your tax offset being reduced to the limit. Any foreign income tax paid in excess of the limit is not available to be carried forward to a later income year and cannot be refunded to you.

If you paid foreign income tax after the year in which the related income or gains have been included in your assessable income, you

may amend your assessment for that year to claim the offset.

As a non-refundable tax offset, the foreign income tax offset reduces your income tax payable (excluding Medicare levy). Under the tax offset ordering rules, it is applied after all other non-refundable tax and non-transferable offsets. Once your tax payable has been reduced to nil, any unused foreign income tax offset is not refunded to you, nor can it be carried forward to later income years.

Calculating your offset limit

Record keeping

Written evidence

You must keep the evidence

We may ask you to get information from overseas

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Calculating your offset limit

29 June 2010

If you are claiming a foreign income tax offset of more than $1,000, you will first need to work out your foreign income tax offset limit. This amount is based on a comparison between your tax liability and the

tax liability you would have if certain foreign-taxed and foreign-sourced income and related deductions were disregarded.

Step 1

Work out the income tax payable by you (including Medicare levy and Medicare levy surcharge), for the relevant income year excluding penalties and interest and disregarding any tax offsets.

Step 2

Work out the income tax that would be payable by you (including Medicare levy and Medicare levy surcharge), excluding penalties and interest and disregarding any tax offsets, if the following assumptions were made:

- your assessable income did not include:
  - any amount included in your assessable income on which foreign income tax has been paid that counts towards your foreign income tax offset, and
  - any other income or gains from a non-Australian source, and
- you were not entitled to the following (where such deductions are actually allowable):
  - debt deductions attributable to your overseas permanent establishment
  - any other deductions (other than debt deductions) that are reasonably related to any amount covered by the first dot point above, and
  - an amount of the foreign loss component of one or more tax losses deducted in the income year.

For the purpose of this step, where deductions relate exclusively to the disregarded income amounts, you should assume that you were not entitled to the deductions. Whether a deduction reasonably relates to the disregarded assessable income amounts will be a question of fact depending on the circumstances of the taxpayer. Where deductions

relate to both disregarded income amounts and other assessable income (as would typically be the case with head office and general administration expenses), you will need to apportion the deductions on a reasonable basis.

Allowable deductions for items such as gifts, contributions, superannuation and tax agent's fees are not considered to be reasonably related to any amount on which foreign income tax has been paid or other non-Australian source income.

Step 3

Take away the result of step 2 from step 1. If the result is greater than $1,000, this is your offset limit.

Example

Anna, an Australian-resident taxpayer, has income and expenses and pays foreign income tax for the income year as follows:

	(A$)
Employment income from Australia	22,000
Employment income from United States	6,000
Employment income from United Kingdom	4,000
Rental income from United Kingdom	1,000
Dividend income from United Kingdom	600
Interest income from United Kingdom	400
Total assessable income	**34,000**
Expenses incurred in deriving employment income from Australia	2,000
Expenses incurred in deriving employment income from United States	450

Expenses incurred in deriving rental income from United Kingdom	250
Interest (debt deduction) incurred in deriving dividend income from United Kingdom	70
Expenses (debt deduction) incurred in deriving interest income from United Kingdom	30
Gift to deductible gift recipient	70
Total allowable deductions	**2,870**
Taxable income	**31,130**
Foreign income tax paid:	
Employment income from United States	1,800
Dividend income from United Kingdom	60
Interest income from United Kingdom	40
Rental income from United Kingdom	300
Total foreign income tax paid	**2,200**

Anna calculates her foreign income tax offset limit as follows:

Step 1:Work out the tax payable on her taxable income

Tax on $31,130: $4,236.45 (includes Medicare levy)

Step 2:Work out the tax that would be payable if:

(a) Her assessable income does not include any amount of foreign income in respect of which foreign income tax has been paid, provided that the tax counts towards her foreign income tax offset. Other non-Australian source amounts are also disregarded as follows:

	(A$)
Employment income from United States	6,000
Employment income from United Kingdom	4,000
Rental income from United Kingdom	1,000
Dividend income from United Kingdom	600
Interest income from United Kingdom	400
Total	**12,000**

Although Anna has not paid foreign income tax on her employment income of $4,000 from the United Kingdom, it is subtracted from her assessable income at this step as it is from a non-Australian source.

(b) Certain expenses are disregarded. These are any expenses that relate to amounts included in her assessable income on which foreign income tax has been paid, provided that tax counts towards her foreign income tax offset, or expenses relating to other non-Australian amounts that are part of her assessable income (excluding debt deductions).

Expenses	**(A$)**
Expenses incurred in deriving employment income from United States	450
Expenses incurred in deriving rental income from United Kingdom	250
Total expenses	**700**

Note: that the debt deductions of $100 that relate to the United Kingdom dividend and interest income are not disregarded as Anna does not have an overseas permanent establishment. Nor is the deduction of $70 for the gift to a deductible gift recipient disregarded, as it does not reasonably relate to the excluded assessable income amounts at step 2(a).

Calculation	
Taxable income (disregarding step 2(a) amount):	$22,000
Less allowable deduction (disregarding step 2(b) amount):	2,170
Taxable income under step 2 assumptions:	19,830
Tax on $19,830: $2,208.70 (includes Medicare levy)	

Step 3: Take away the result of step 2 from step 1

$4,236.45 - $2,208.70 = $2027.75

This is Anna's foreign income tax offset limit. Although she has paid foreign income tax of $2,200, her foreign income tax offset is limited to $2,027.75.

The difference between the foreign income tax that Anna has paid and the offset limit cannot be refunded or carried forward to a future income year.

Example

Foreign income tax offset limit and net capital gains

Resident company X's taxable income for the income year is worked out as follows, including the realisation of the following capital gains and losses from a mix of domestic and foreign sources:

Assessable income	Domestic (A$)	Foreign (A$)	Total (A$)
Sales revenue	60,000		60,000
Net capital gain as calculated below		125,000	125,000
Gross assessable income			185,000
Less			

Allowable deductions from sales revenue (under Australian law)			20,000
Taxable income			**165,000**

Foreign country capital gains and losses	**(A$)**
Foreign country A assessment	
Purchase price of foreign asset A	70,000
Proceeds from sale of foreign asset A	200,000
Net foreign gain on sale of foreign asset A	130,000
Foreign tax payable (30% of $130,000)	39,000
Foreign country B (nil assessment)	
Purchase price of foreign asset B	50,000
Proceeds from sale of foreign asset B	65,000
Net foreign gain on sale of foreign asset B	15,000

Foreign country B does not impose tax on capital gains made on the disposals of assets.

Foreign country C (capital loss)	
Purchase price of foreign asset C	90,000
Proceeds from sale of foreign asset C	$50,000
Loss on sale of foreign asset C	(40,000)
Australian capital gains and losses	

Cost base of asset 1	90,000
Capital proceeds from sale price of asset 1	150,000
Gain on sale of asset 1	60,000
Reduced cost base of asset 2	65,000
Capital proceeds of asset 2	25,000
Loss on sale of asset 2	(40,000)

To calculate the net capital gain, the taxpayer can choose the order in which capital gains are reduced by any capital losses to yield the greatest foreign tax offset as follows:

Capital gain on sale of foreign asset A		130,000
Add Capital gain on sale of foreign asset B	15,000	
Add Capital gain on sale of Australian asset 1	60,000	
Deduct Capital loss on sale of foreign asset C	(40,000)	
Deduct Loss on sale of Australian asset 2	(40,000)	
		(5,000)
Net capital gain		**125,000**

The company calculates the net capital gain to ensure the maximum foreign income tax offset by:

- firstly, adding together the domestic capital loss and the foreign capital loss
- secondly, deducting this from the sum of the domestic capital gain and the foreign capital gain on which no foreign tax has

been paid.

Finally, as this yields a capital loss of $5,000, the taxpayer deducts this amount from the foreign capital gain on which foreign tax has been paid. Accordingly, the net capital gain of $125,000 relates entirely to the foreign source gain component on which foreign income tax has been paid.

The foreign income tax offset limit calculation is as follows:

Step 1:Work out the tax payable on taxable income.

$165,000 × 0.30 = $49,500

Step 2:Work out the tax that would be payable if the net capital gain on which foreign income tax has been paid is not included in the taxpayer's assessable income.

As all of the net capital gain relates to the foreign source gain component on which foreign income tax has been paid, the amount of $125,000 is treated as if it is not included in assessable income.

There are no deductions that need to be disregarded.

Thus, the taxable income under this step would be $165,000 - $125,000 = $40,000.

Tax payable on $40,000 would be 0.30 x $40,000, that is $12,000.

This is the result of step 2.

Step 3:Take away the result of step 2 from step 1.

$49,500 - $12,000 = $37,500

This is X's foreign income tax offset limit. Although X has paid foreign income tax of $39,000 on the net capital gain included in its assessable income, its foreign income tax offset is limited to $37,500.

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Record keeping

29 June 2010

Special amendment rules for foreign income tax offsets

Differences between the Australian and foreign tax systems may lead to you paying foreign income tax in a different income year to that in which you include the related income or gains in your Australian assessable income.

If you paid foreign income tax after the year in which the related income or gains have been included in your Australian assessable income, you can amend your assessment for that year to claim the offset. You can lodge an amended assessment within four years of paying foreign income tax that counts towards your tax offset. This time period applies irrespective of when the income or gains were included in your Australian assessable income. In this situation, the foreign income tax must be paid after you have lodged your Australian income tax return for the relevant year.

The four-year amendment period also applies where there has been an increase or decrease in the amount of foreign income tax paid that counts towards your tax offset. The special amendment rules also apply to amendments initiated by the ATO, which may have the effect of extending the normal period of review. In these cases, the four year period starts when the increase in foreign income tax has been paid or when the foreign income tax has been reduced (for example by way of a refund).

The special amendment rules apply only where you have paid foreign income tax or there has been an increase or decrease in the tax paid that counts towards your tax offset. In all other circumstances, the normal amendment rules apply.

For example, where an audit by the ATO has detected an incorrect calculation of the foreign income tax offset limit affecting the amount of the foreign income tax offset previously claimed, we can only amend a taxpayer's assessment within the usual time limits set out in section 170 of the ITAA 1936.

Example 1

> Aust Co, an Australian resident company, sells a rental property in the US, making a gain in the 2009-10 income year. The gain is

taxed in the US and Australia. Aust Co pays the US income tax before lodging its Australian return for the 2009-10 income year.

In February 2012, Aust Co receives a refund of part of the US tax paid because of the favourable outcome of a dispute over the calculation of the gain. An amendment to Aust Co's 2009-10 assessment to reflect the reduction in US tax paid, and consequently its foreign income tax offset, can be made on or before February 2016.

As with your tax affairs generally, you need written evidence to support a claim for a foreign income tax offset, and you must keep such evidence so you can provide it to the ATO on request. If we require information that is held overseas we will advise you in writing, giving you time to provide it.

If you use a tax agent to prepare and lodge your return, you need to advise them if you have earned any assessable income on which foreign income tax has been paid and provide them with evidence of payment of the tax.

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Written evidence

29 June 2010

Written evidence of foreign tax paid should include the following details:

- the amount of foreign income or gains in the foreign currency
- the foreign tax year in which the income or gains were derived
- the nature and amount of foreign tax levied on the foreign income or gains
- the date on which the foreign tax was paid
- whether the tax paid represents an advance, instalment, or final foreign tax payment in relation to the relevant foreign income or gains.

You should provide the best available evidence to show that foreign tax has been paid. You are not entitled to a credit for foreign tax when that foreign tax has been refunded to you.

The following documents are acceptable evidence of the payment of foreign tax:

- a statement from the foreign tax authority setting out the particulars that would normally be recorded on a notice of assessment, a similar official receipt or other document evidencing payment of foreign income tax. If the foreign notice has no provision for a cash register receipt, taxpayers will be required to provide a separate receipt to indicate that the foreign tax liability has been paid. A notice of assessment which does not show that the foreign tax has been paid will not constitute sufficient proof that the tax shown on such a notice has been paid
- a certificate for deduction of withholding tax issued by the person who pays the interest, dividends or any other income that is subject to a deduction of foreign tax
- a distribution statement, or a similar document from a trustee of a managed fund or unit trust, stating the amount of foreign tax paid - for example, the details of foreign tax paid shown in trust distribution advices provided to beneficiaries or unit-holders will generally be sufficient to support a claim for a foreign income tax offset
- payslips, payment summaries or similar documents that shows the amount of foreign tax paid will be accepted where there is no requirement in a foreign country to lodge an income tax return
- a copy of the foreign income tax return accompanied by a receipt verifying that the foreign tax, as calculated on the basis of the return, has been paid, or
- a letter from the relevant foreign tax authority stating all taxes for that income year have been paid.

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You must keep the evidence

29 June 2010

You don't need to provide the written evidence with your tax return, but you must retain the original documents because we may need to see them at a later date.

Generally, you must keep records for five years after you prepared or obtained them, or after you completed the relevant transactions or acts, whichever is later.

We may generally amend an income tax assessment for an income year within two years of issuing the notice of assessment for that year in the case of individuals and very small businesses or four years for other taxpayers.

This period of review may be extended by an order of the Federal Court of Australia or with your consent. Where this occurs, you must keep your records for five years or to the end of the period during which the assessment may be amended, whichever is later.

The period of review may also be extended by the effect of special amendment rules that allow an assessment to be amended within four years of a payment of foreign income tax or an increase or decrease in the tax paid.

You do not need to keep records where the Commissioner has notified you that they are not required or where your company has gone into liquidation and been finally dissolved.

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We may ask you to get information from overseas

29 June 2010

If we believe that information relevant to your assessment is held overseas, you may receive an offshore information notice asking you to get the information for us within 90 days.

If you need extra time, you should apply in writing before the time runs out.

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Transitional rules for using excess foreign tax credits

29 June 2010

Transitional rules allow taxpayers to use certain excess foreign tax credits that existed when the foreign tax offset rules came into effect on 1 July 2008.

At this time, taxpayers with unused excess foreign tax credits belonging to any class of foreign assessable income from the previous five income years can convert these amounts to one bundle of **pre-commencement excess foreign income tax** for each of those five years subject to the following limits:

- for company taxpayers, excess foreign tax credits in the 'other income' class cannot be converted where they relate to amounts that would be non-assessable non-exempt income if derived in the commencement year
- offshore banking units - existing excess foreign tax credits in the 'offshore banking income' class are converted by multiplying them by the offshore banking eligible fraction (currently one-third).

Using pre-commencement excess foreign income tax

A taxpayer must use pre-commencement excess foreign income tax within five years of the year of income in which the pre-commencement excess foreign income tax arises. For example, any pre-commencement excess foreign income tax that relates to the 2004-05 income year can only be used in the 2008-09 and 2009-10 income years.

The amount used in any one income year cannot exceed the amount by which the foreign tax paid for that year is less than the taxpayer's

foreign income tax offset limit. In effect, the taxpayer can top-up the amount of foreign income tax paid to the foreign tax offset limit using pre-commencement excess foreign income tax amounts.

Given the five-year limitation rule, taxpayers should use pre-commencement excess foreign income tax on a first-in first-out basis. For example, a taxpayer with pre-commencement excess foreign income tax relating to both the 2003-04 and 2005-06 income years should use those that relate to the 2003-04 income year first as they will expire in 2008-09. Any pre-commencement excess foreign income tax that has not been used within the five year time limit cannot be offset as it has expired.

Example

> Austco is an Australian resident company that converts excess foreign tax credits of $5,000 relating to the 2005-06 income year into pre-commencement excess foreign income tax of $5,000 for that income year.
>
> For the 2009-10 income year, Austco pays foreign income tax of $7,000 on income included in its assessable income and calculates its foreign income tax offset limit as $10,000. As the tax offset of $7,000 (before the application of the pre-commencement excess foreign income tax) is less than the tax offset limit of $10,000, Austco can add pre-commencement excess foreign tax of $3,000 to the tax offset for 2009-10.
>
> This leaves $2,000 of unused pre-commencement excess foreign tax.
>
> For the 2010-11 income year, Austco pays foreign income tax of $4,000 on income included in its assessable income and calculates its foreign income tax offset limit as $5,000. As the tax offset of $4,000 (before the application of any pre-commencement excess foreign income tax) is less than the tax offset limit of $5,000, Austco can add pre-commencement excess foreign income tax of $1,000 to the tax offset for 2010-11.
>
> This leaves $1,000 of unused pre-commencement excess foreign income tax.
>
> For the 2011-12 income year, Austco pays foreign income tax of $8,000 on income included in its assessable income and calculates its foreign tax offset limit as $10,000. Although the tax offset of $8,000 (before the application of any pre-

commencement excess foreign income tax) is less than the tax offset limit by $2,000, the unused $1,000 of pre-commencement excess foreign income tax cannot be used to increase the tax offset for 2011-12 as it expired in the previous year.

Attributed foreign income

If you have attributed foreign income, you may be entitled to a foreign income tax offset for foreign income tax, income tax or withholding tax paid by the controlled foreign company (CFC) or foreign investment fund (FIF) in which you hold an interest.

Specifically, a foreign income tax offset may arise:

- for a resident company that is an attributable taxpayer with a CFC or foreign company FIF interest and includes an amount in its assessable income under section 456, 457 or 529 of the ITAA 1936 (in the case of the FIF interest, the section 529 amount must be worked out using the calculation method)
- for all attributable taxpayers that have a foreign trust FIF interest and include a section 529 amount in their assessable income worked out using the calculation method, and
- for resident taxpayers that receive a distribution that is treated as non-assessable non-exempt (NANE) income under section 23AI or 23AK of the ITAA 1936.

In these circumstances, the attributable taxpayer is deemed to have paid foreign income tax in respect of their CFC or FIF interest, with the tax paid counting towards their tax offset. In their assessable income, the section 456, 457 and section 529 amounts must be grossed up by the amount of the foreign income tax that is deemed to have been paid.

For more information on the tax treatment of attributed income, refer to the publication Attributed foreign income.

Resident company with interest in CFC or foreign company FIF ›

Foreign trust FIF interests

Foreign income tax paid on NANE income

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Resident company with interest in CFC or foreign company FIF

29 June 2010

A resident company with a CFC or foreign company FIF interest can treat foreign income tax as having been paid by them in respect of their attributed income if the following conditions are met:

- their assessable income includes an amount under sections 456, 457 or 529 of the ITAA 1936 in relation to their CFC or foreign company FIF interest
- where the income is included in the company's assessable income under section 457, foreign income tax, income tax, or withholding tax has been paid by the CFC
- where the income is included in the company's assessable income under sections 456 or 529, foreign income tax, income tax or withholding tax has been paid by the CFC on part or all of its notional assessable income for its relevant statutory accounting period or by the foreign company FIF on part or all of its notional income for the relevant notional accounting period
- they have an attribution percentage of 10% or more, worked out at the end of the CFC's statutory accounting period for a section 456 amount, at residence-change time for a section 457 amount or at the end of the notional accounting period for a section 529 amount.

If these conditions are met, the amount of foreign income tax they are deemed to have paid is worked out as follows:

- for a section 456 amount, the sum of the foreign income tax, income tax or withholding taxes paid for the statutory accounting period of the CFC multiplied by the attributable taxpayer's attribution percentage (worked out at the end of the CFC's statutory accounting period)
- for a section 457 amount, the sum of the foreign income tax, income tax or withholding taxes paid, to the extent that they are attributable to the section 457 amount included in the company's assessable income
- for a section 529 amount, according to the following formula:

Sum of all of the tax amounts for the notional accounting period		Entity's share of calculated profit FIF's calculated profit

where:

- 'entity's share of calculated profit' is the share of the foreign company/trust's calculated profit for the notional accounting period to which the entity is entitled, as determined under the calculation method
- 'FIF's calculated profit' means the foreign company/trust's calculated profit for the notional accounting period, as determined under the calculation method.

The tax that is deemed to have been paid by the resident company counts towards its tax offset. The section 456, 457 and 529 amounts must be grossed up by the amount of the foreign income tax that is deemed to have been paid.

Example

Austco owns 50% of the paid-up capital of Foreignco, a CFC. Foreignco's attributable income for the statutory accounting period is worked out as $1 million, which takes into account a notional allowable deduction for foreign income tax that Foreignco has paid of $200,000. As Austco's attribution percentage is 50%, it includes $500,000 under section 456 in its assessable income for the income year in which the CFC's statutory accounting period ends.

Austco meets the conditions for the tax-paid deeming rules to apply in relation to its interest in the CFC, namely that:

- it is a resident company
- foreign income tax has been paid by the CFC in respect of the amount included in its notional assessable income for the relevant statutory accounting period, and
- it has an attribution percentage of 10% or more at the end of the relevant statutory accounting period.

The amount of foreign income tax that Austco is deemed to have paid on its attributed income is the $200,000 paid by Foreignco multiplied by Austco's attribution percentage of 50% (that is, $100,000). Austco must also gross-up its assessable income by the $100,000 of foreign income tax that it is deemed to have paid.

Tax paid deeming rule applies only to a resident company directly subject to attribution

The tax-paid deeming rule only applies to resident companies that are directly subject to attribution under section 456, 457 or 529. Where a resident company is a partner in a partnership or a beneficiary in an Australian trust with a CFC or foreign company FIF interest, the resident company is assessed on their share of the partnership or trust net income under sections 92 or 97 of the ITAA 1936 rather than under sections 456, 457 or 529.

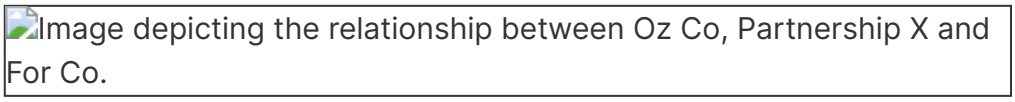
In this case, the partnership or Australian trust is the attributable taxpayer and it includes in its net income the relevant attribution amount under sections 456, 457 or 529. As the partnership or Australian trust is not a resident company and the resident company is not the attributable taxpayer, the tax-paid deeming rules cannot apply to the CFC or foreign company FIF interests held by the resident company through a partnership or Australian trust.

Example

Oz Co Pty Ltd, a Part X Australian resident, has a 50% interest in partnership X formed in Foreign Country 1. Partnership X wholly

owns For Co, a company that is resident in Foreign Country 2. For Co is a CFC for Australian tax purposes.

During the income year, For Co pays income tax under the laws of Country 2.



As partnership X is a partnership for Australian income tax purposes, Oz Co's assessable income will include its share of the partnership's net income, calculated as if it were an Australian resident.

As For Co is a CFC and partnership X is an attributable taxpayer by virtue of it being an Australian partnership for the purposes of Part X of the ITAA 1936, the partnership net income includes attributed income under section 456 of the ITAA 1936.

In calculating For Co's attributed income, a notional allowable deduction is allowed for the foreign income tax paid. However, the foreign income tax paid by For Co does not count towards Oz Co's foreign income tax offset for the relevant income year because Oz Co is not treated, pursuant to section 770-135 of the ITAA 1997, as having paid the foreign income tax for the purposes of subsection 770-10(1) of the ITAA 1997.

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Foreign trust FIF interests

29 June 2010

Where an attributable taxpayer with a foreign trust FIF interest includes an amount in their assessable income under section 529, they can treat foreign income tax as having been paid by them on their attributed income if the following conditions are met:

- the section 529 amount is worked out under the calculation method, and
- foreign income tax, income tax or withholding tax has been paid by the foreign trust FIF on part or all of their notional income for the

relevant notional accounting period.

If the relevant conditions are met, the foreign income tax they are deemed to have paid is worked out using the same formula as for a foreign company FIF interest.

Example

AB Co has a 30% interest in CD unit trust, a foreign trust FIF. AB Co works out its attributed income under section 529 using the calculation method. CD unit trust's calculated profit or notional income for the relevant notional accounting period is $2 million, after a notional deduction of $200,000 is allowed for foreign income tax actually paid by CD unit trust on its notional income. AB Co includes an amount of $600,000 in its assessable income under section 529, being the notional income of CD unit trust, multiplied by AB Co's attribution percentage of 30%.

AB Co meets the conditions for the tax-paid deeming rules to apply in relation to its interest in CD unit trust, a foreign trust FIF, in that:

- it includes an amount in its assessable income under section 529 which is worked out using the calculation method, and
- foreign income tax has been paid by CD unit trust on its notional income for the relevant notional accounting period.

The foreign income tax that AB Co is deemed to have paid on its attributed income is worked out by multiplying $200,000, the tax actually paid by CD unit trust, by AB Co's share of CD unit trust's calculated profit (as worked out using the calculation method), divided by CD unit trust's calculated profit of $2 million. As AB Co's share of the calculated profit of CD unit trust, worked out under the calculation method, is 30%, the amount of foreign income tax that it is taken to have paid is $200,000 multiplied by 30% (that is, $60,000). AB Co must also gross-up its assessable income by the $60,000 of foreign income tax that it is deemed to have paid.

Tax paid deeming rules apply only in respect of first-tier FIF interests

The tax-paid deeming rules only apply to attributable taxpayers in respect of first-tier FIF interests. Where an attributable taxpayer has an interest in a FIF that in turn has an interest in another FIF, or an attributable taxpayer has an interest in a CFC that in turn has a FIF interest, the tax paid by the second-tier FIF does not come within the scope of the tax-paid deeming rules that apply to attributable taxpayers.

Specifically, this is because the tax-paid condition only applies to foreign income tax actually paid by the first-tier FIF or CFC, not any foreign income tax paid by the second tier FIF. This is the case even though the notional income of the first tier FIF or CFC may include an amount in its notional income or notional assessable income that relates to its interest in the second tier FIF and the attributable taxpayer in turn includes the relevant attributed income amount that relates to the second tier FIF interest in its assessable income under sections 529 or 456.

Example

> A Co has a 100% interest in a CFC, which in turns holds a 30% interest in a FIF. In working out the CFC's attributed income, $1 million is included in its notional assessable income for income attributable to its FIF interest, worked out under the calculation method. Foreign income tax of $100,000 is paid by the FIF but the CFC pays no foreign income tax.
>
> As A Co is the attributable taxpayer in relation to the CFC and an amount is included in its assessable income under section 456, it is only the tax paid by the CFC on its notional assessable income for the statutory accounting period that A Co is deemed to have paid. As the foreign income tax of $100,000 is paid by the FIF, none of it is deemed to have been paid by A Co.

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Foreign income tax paid on NANE income

29 June 2010

Resident taxpayers are entitled to a foreign income tax offset for foreign income tax they pay on an amount that is non-assessable non-exempt (NANE) income of the taxpayer under sections 23AI or 23AK of the ITAA 1936.

For more information on how the attribution account rules work in relation to attributable taxpayers with CFC or FIF interests, refer to chapter 1 of the Foreign income return form guide and chapter 4 of the Foreign investment fund guide.

Only foreign income tax amounts that are paid in respect of income that is NANE under sections 23AI or 23AK count towards a tax offset. Also, the amount of foreign income tax taken to be paid on the distribution is not affected by the tax-paid deeming rules that apply to previously attributed income amounts included in the taxpayer's assessable income.

Usually, the foreign income tax will be a withholding amount on a dividend distribution. In such a case, where the tax is paid by someone else under the law of a foreign country, the tax-paid deeming rules apply to treat the attributable taxpayer as having paid the foreign income tax, providing it can be demonstrated that such tax is paid in respect of the section 23AI or 23AK amounts.

The tax offset limit is increased by the relevant amount of foreign income tax paid in respect of section 23AI or 23AK amounts.

Example

> Lynette owns 100% of Forco paid-up capital. She has previously included in her assessable income $1 million in respect of Forco under section 456. Forco subsequently declares and pays a dividend of $1 million to Lynette, on which withholding tax of $100,000 is imposed.
>
> As the dividend amount does not exceed her attribution account surplus in relation to Forco, it is treated as her NANE income under section 23AI. Lynette is also deemed to have paid the $100,000 foreign income tax withheld (which counts towards her tax offset), as it is paid in respect of the dividend income.

Where a resident taxpayer is a partner in a partnership or a beneficiary of an Australian trust with a CFC or FIF interest, the partnership or trust is the attributable taxpayer. These entities include, in their net income, the relevant attributed amount under sections 456, 457 or 529. In turn, the partner or beneficiary includes, in their assessable

income, their share of the partnership or trust net income that relates to the attributed amount.

However, where a CFC makes a distribution to the partnership or trust out of profits that have been previously subject to attribution, the attribution account rules ensure that the resident partner or beneficiary with an interest in the partnership or trust will get the benefit of section 23AI or 23AK.

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Special circumstances

29 June 2010

Superannuation funds

Consolidated groups

Life insurance companies

Offshore banking units

Foreign/non-residents

Australian source income

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Superannuation funds

29 June 2010

Limits apply to the foreign income tax offset allowed for foreign income taxes paid by a superannuation fund or approved deposit fund where the fund changes:

- from a complying superannuation fund to a non-complying superannuation fund, or
- from a non-resident superannuation fund to a resident superannuation fund.

Where a non-complying fund or a resident fund includes an amount in assessable income under items 2 and 3 in the table in section 295-320 of the ITAA 1997, and the fund paid foreign income tax on that amount (before the start of the income year), the fund is not entitled to a tax offset for the foreign income tax paid by the provider.

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Consolidated groups

29 June 2010

Only the head company of a consolidated group or multiple entry consolidated (MEC) group is entitled to a foreign income tax offset for foreign income tax paid on income or gains that are included in its assessable income under the single entity rule. Where a subsidiary member pays foreign income tax on income or gains included in the head company's assessable income, the head company is treated as having paid the tax.

The head company's foreign income tax offset is determined in the same way as for taxpayers outside the consolidation regime.

Special transitional rules allow a joining entity to transfer any unused pre-commencement excess foreign income tax to the head company at joining time. The pre-commencement excess foreign income tax transferred from the joining entity is pooled with any other pre-commencement excess foreign income tax of the head company and subsidiary members. If the head company has unused pre-commencement excess foreign income tax which arose in the same year as the joining entity's unused pre-commencement excess foreign income tax, the amounts are pooled. The head company is subject to the five-year limitation rule on using pre-commencement excess foreign income tax. Pre-commencement excess foreign tax in the pool must be separately identified according to the income years in which it arose.

The head company can apply pre-commencement excess foreign income tax transferred from a joining entity in an income year starting at or after the joining time, subject to the general transitional rules.

If an entity leaves a consolidated or MEC group, it will not have access to any pre-commencement excess foreign income tax that it transferred to the head company when it joined the group.

More detailed information on the operation of the foreign income tax offset rules for consolidated groups or MEC groups, including the special transitional rules for pre-commencement excess foreign income tax, is contained in the Consolidation reference manual.

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Life insurance companies

29 June 2010

The core rules for the foreign income tax offset apply to life insurance companies. However, as the income of a life insurance company is taxed at two different rates (ordinary class, taxed at 30%, and complying superannuation/FHSA class, taxed at 15%), at step 2 of the foreign income tax offset limit calculation, it is necessary to determine the amount of assessable income in each class on which foreign income tax has been paid.

Example:

Life Insurance Co derives assessable income of $5 million in the ordinary class and $5 million in the complying superannuation/FHSA class. The ordinary class of income includes $1 million on which foreign income tax of $200,000 is paid and the complying superannuation/FHSA class of income includes $2 million on which foreign income tax of $400,000 has been paid. Assume there are no allowable deductions in relation to the classes of assessable income.

The limit is worked out as follows:

Step 1: Work out the tax payable on Life Insurance Co's taxable income

Tax on ordinary class of assessable income: $5m x 30% = $1.5m

Tax on complying superannuation/FHSA class: $5m x 15% = $750,000

Total tax payable: $2.25m

This is the result of step 1.

Step 2:Work out the tax that would be payable if the income of the two classes on which foreign income tax has been paid is not included in Life Insurance Co's assessable income

There are two income amounts on which foreign income tax has been paid that need to be excluded from assessable income for the purposes of this step:

- $1m that belongs to the ordinary class of assessable income
- $2m that belongs to the complying superannuation/FHSA class.

In working out the tax that would have been payable had these amounts not been included in assessable income, it is necessary to identify the relevant class to which such amounts belong as follows:

Tax on ordinary class (excluding $1m): ($5m - $1m) x 30% = $1,200,000

Tax on complying superannuation/FHSA class ($5m - $2m) x 15% = $450,000

Total tax that would be payable: $1,650,000

This is the result of step 2.

Step 3:Take away the result of step 2 from step 1

$2.25m - $1.65m = $600,000

This is the offset limit. As the actual foreign income tax paid on the two income amounts is also $600,000, the foreign income tax offset of Life Insurance Co is $600,000.

Foreign income tax paid on non-assessable non-exempt income derived from segregated exempt assets does not count towards a tax offset.

27994

Offshore banking units

29 June 2010

Specific rules apply to calculating the tax offset for foreign income tax paid on the assessable offshore banking income of an offshore banking unit (OBU).

The foreign income tax paid on the offshore banking income of an OBU is taken to be one-third (the current offshore banking eligible fraction) of the amount of tax actually paid. This approach mirrors the tax treatment of assessable offshore banking income, which results in only one-third of that amount actually being included in assessable income, with the other two-thirds being treated as non-assessable non-exempt income.

Example

Big Bank Ltd is an Australian resident bank that is declared an OBU. Big Bank Ltd derives offshore banking income and pays foreign income tax of $21,000 in respect of such income as follows:

Source	Income (A$)	Expenses (A$)	Foreign tax paid (A$)

Borrowing and lending activity - commission	15,000	900	1,500
Borrowing and lending activity - interest	20,000	600	3,000
Advisory activity	50,000	6,000	16,500
Total foreign income tax paid on assessable offshore banking income	**85,000**	**7,500**	**21,000**

The amount of foreign income tax paid on the assessable portion of offshore banking income is the amount of foreign income tax paid multiplied by the eligible fraction:

$21,000 × 10/30 = $7,000

This is the amount of foreign income tax that counts towards Big Bank Ltd's tax offset for the income year.

27994

Foreign/non-residents

29 June 2010

While the offset mainly applies to residents, where the foreign income of a foreign/non-resident is taxed in Australia, they may be able to claim an offset.

These circumstances apply where a foreign resident pays income tax in a foreign country on an amount that is included in their assessable income (under Australian tax law) and such tax is imposed because the income is sourced in that country. By contrast, where a foreign country imposes tax on the amount included in an entity's assessable income merely because it is a resident of that country (that is residence-based taxation), a foreign income tax offset entitlement

does not arise if the tax is imposed on income from a source outside the foreign country.

Example

> XYZ PLC is a United Kingdom resident that carries on a business through a permanent establishment (PE) in Australia. In carrying on such activities, it derives US source income, which is subject to tax in that country. The US source income is derived in connection with the PE activity in Australia, and a combination of Articles 7 and 21 of the Australia-UK tax treaty permits Australia to tax the income and treat it as being derived from sources within Australia, and therefore subject to Australian tax. Given that the US source income is taxed in that country on a source basis, the US tax paid counts towards a tax offset in Australia.
>
> If XYZ pays UK tax on the US source income that is attributable to the Australian PE activity, the tax would be imposed on a residence basis on the non-UK sourced income and would not count towards the taxpayer's tax offset.

27994

Australian source income

29 June 2010

While Australian residents are normally subject to foreign income tax only on their foreign source income, the foreign income tax offset applies to all income on which foreign income tax has been correctly applied. This situation will arise in very limited circumstances.

For example, foreign income tax imposed by East Timor in accordance with Annexure G (the taxation code) of the Timor Sea treaty (refer to the *Petroleum (Timor Sea Treaty) Act 2003*) on assessable income derived by an Australian-resident taxpayer from certain activities carried out in the Joint Petroleum Development Area of the Timor Sea will count towards the taxpayer's tax offset.

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