TR 2004/D13 - Income tax: the meaning of 'foreign income' in subsection 6AB(1) of the Income Tax Assessment Act 1936 - inclusion of statutory income

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This document has been finalised by TR 2005/2.

Draft Taxation Ruling

Income tax: the meaning of 'foreign income' in subsection 6AB(1) of the *Income Tax Assessment Act 1936* – inclusion of statutory income

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Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office.*

What this Ruling is about

1. This ruling considers whether the term 'foreign income' defined in subsection 6AB(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) covers statutory income amounts not specifically listed in the definition.

Class of Persons/Arrangements

2. This ruling applies to taxpayers who derive income from sources in a foreign country that is included in their assessable income under a statutory provision.

Date of effect

3. It is proposed that when the final Ruling is issued, it will apply both before and after its date of issue. However, the final Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the final Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Related Rulings

4. IT 2562: foreign tax credit system: interaction of foreign tax credit provisions with capital gains and capital losses provisions of Part IIIA.

Ruling

5. The word 'income' in the definition of foreign income in subsection 6AB(1) of the ITAA 1936 is to be interpreted widely. It can include both income according to ordinary concepts (whether assessable or not) and amounts included in assessable income under a statutory provision. However, the term does not encompass net capital gains included in a taxpayer's assessable income under Part 3-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Explanation

Background

6. The term 'foreign income' is defined in subsection 6AB(1) of the ITAA 1936 as follows:

> Foreign income is income (including eligible termination payments as defined in subsection 27A(1)) derived from sources in a foreign country or foreign countries, and includes a reference to an amount included in assessable income under section 26D, 27CAA, 102AAZD, 456, 457, 458, 459, 459A or 529.

7. 'Foreign income', as defined, is relevant in the context of the foreign tax credit provisions in Division 18 of Part III of the ITAA 1936 and for applying the foreign loss quarantining rule in section 79D of the ITAA 1936. Notably subsection 6AB(1) was enacted contemporaneously with the foreign tax credits regime. Division 18 was inserted into the ITAA 1936 to replace the various unilateral double taxation relief arrangements of the income tax law with a world-wide general foreign tax credit system.[1]

'Income' in subsection 6AB(1)

8. The reference to 'income' in the definition is to be interpreted broadly to include both income according to ordinary concepts (whether assessable or not) and amounts that become income under a statutory provision.

[1] See Explanatory Memorandum to *Taxation Laws Amendment (Foreign Tax Credits) Act 1986*

9. This interpretation accords with the object and intent of the provision as set out in the Explanatory Memorandum to its introduction as part of the *Tax Laws Amendment (Foreign Tax Credit) Act 1986*. It states that:

> "Sub-section 6AB(1) provides that a reference to "foreign income" is a reference to income derived from sources in a foreign country or more than one foreign country. It ensures that **all income** derived from sources out of Australia will be subject to the provisions of the Principal Act. Specific detailed rules have not been included for this purpose, and the source of income will be determined on the same basis as under the existing income tax laws " (*emphasis added*)

10. Subsection 6AB(1) is one example of a provision where the term 'income' is used broadly to cover both ordinary income and amounts that become income under a statutory provision. Another example is section 23L of the ITAA 1936. This section provides that when a taxpayer derives income by way of the provision of a fringe benefit, then the benefit is exempt from income tax. The term 'income' in this context must refer to statutory income if the provision is to have any practical application. Fringe benefits would generally be included in a taxpayer's assessable income under paragraph 26(e) of the ITAA 1936 and not as income according to ordinary concepts.

'*Foreign income' does not include net capital gains*

11. While the Commissioner considers that the term 'income' in subsection 6AB(1) can include both ordinary income and amounts included in assessable income under a statutory provision, the definition does not capture foreign-sourced capital gains that are included in a taxpayer's assessable income under Part 3-1 of the ITAA 1997.

12. Capital gains have always been distinguished from income under the general operation of the income tax law, and it is this distinction that led to the particular treatment given to gains and profits of a capital nature under the foreign tax credits regime. Capital gains (other than gains on revenue account) are taxed under a separate and somewhat self-contained regime in Part 3-1 and 3-3 of the ITAA 1997.

13. Gains and profits of a capital nature that are derived from sources in a foreign country are specifically brought into the foreign tax credit system in Division 18 by subsection 160AE(2). This provision deems such gains to be income derived from sources in that foreign country for the purposes of Division 18 (except for the purposes of section 160AFD). The inclusion of subsection 160AE(2) in Division 18 points to an interpretation that foreign-sourced capital gains are not covered by the definition of 'foreign income' in subsection 6AB(1). The definition of 'foreign income' must never have been intended to include foreign-sourced capital gains, otherwise, the specific provision in subsection 160AE(2) would not have any practical effect.

14. If foreign-sourced capital gains were to be treated as 'foreign income' within the meaning of subsection 6AB(1) a conflict would arise between the provisions in Part 3-1 of the ITAA 1997 which quarantine net capital losses and section 79D of the ITAA 1936 which quarantines foreign income losses.

15. The view that the definition of 'foreign income' in subsection 6AB(1) does not include net capital gains assessed under Part 3-1 accords with the position expressed in Taxation Ruling IT 2562 at paragraph 3.[2]

Foreign Tax – supporting meaning

16. The term 'foreign tax' is also broadly defined. Subsection 6AB(2) states that:

> "A reference in this Act to foreign tax is a reference to:
>
> (a) tax imposed by a law of a foreign country, being:
>
> (i) tax upon income; or
>
> (ii) tax upon profits or gains, whether of an income or capital nature; or
>
> (iii) tax deemed by section 160AFC to have been paid in respect of a dividend;
>
> (iv) any other tax, being a tax that is subject to an agreement having the force of law under the International Tax Agreements Act 1953.
>
> ……."

17. The definition of 'foreign tax' refers to tax paid on income and profits or gains under a law of a foreign country. The definition is intended to be as broad as possible to cover all possible taxes imposed by the law of a foreign country on income that may be subject to tax in Australia.[3] The definition must therefore cover amounts that are included in a taxpayer's assessable income either as ordinary or statutory income and enables tax paid on those amounts to fall within the definition of 'foreign tax'.

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[2] The Income Tax Assessment Amendment (Capital Gains) Act 1986 which introduced the CGT regime indicated in a variety of other ways that capital gains were not to be regarded as "income" under the 1936 Act. For example, certain exemptions of income in Division 1 of Part 3 of the ITAA 1936 were not applicable to capital gains and were therefore necessarily replicated to some extent within the CGT regime itself, via section 160K, the definition of "relevant exempting provision", and section 160Z(8) of the 1936 Act. In the 1997 Act, the similar exemptions in Division 50 apply to ordinary income and statutory income so there was no need to repeat them in Part 3-1 or 3-3. The one exception was section 23(q) which was amended in 1986 to exempt capital gains as well as income. That provision was repealed with effect from 1 July 1987 with the introduction of the foreign tax credit system.

[3] For further guidance on amounts covered by the definition of 'foreign tax', refer to Taxation Ruling IT 2507 and Taxation Ruling IT 2437.

18. Read in conjunction with the definition of 'foreign income' in subsection 6AB(1), the broad definition of 'foreign tax' supports the view that 'foreign income' is also to be broadly interpreted.

Alternative views

19. There is an argument that the definition of foreign income in subsection 6AB(1) should be limited to income according to ordinary concepts (called ordinary income) and those amounts of statutory income specifically referred to in the subsection (such as assessable amounts under section 456 of the ITAA 1936). As such, other amounts of statutory income not specifically referred to, such as attributed personal services income, do not fall within the definition of foreign income.

20. It is argued that the view is supported by the statutory construction of subsection 6AB(1). The first part of the definition of foreign income states that 'a reference in this Act to foreign income is a reference to income (including eligible termination payments as defined in subsection 27A(1)) derived from sources in a foreign country or foreign countries…'. It is argued that the words 'income derived' in this context should be read as being limited to ordinary income. Therefore, amounts specifically included in a taxpayer's assessable income under a statutory income provision such as subsection 86-15(1) that cannot be characterised as ordinary income fall outside the first part of the definition of foreign income. Notably, section 6-5 refers to 'ordinary income that is derived' whilst there is no corresponding requirement in section 6-10 for statutory income to be derived. The argument is that only ordinary income can be 'derived'.

21. It is further argued that the second part of the definition of foreign income complements the narrow view of the base definition of foreign income by 'including' certain amounts of assessable income that constitute statutory income. It is argued that because a number of specific sections creating statutory income are referred to expressly, by implication, other kinds of statutory income are excluded.

22. The Commissioner disagrees with the view that the base definition of 'foreign income' should be limited to ordinary income for a number of reasons.

23. Firstly, the reference to the phrase 'income derived from sources in a foreign country' was intended to be interpreted broadly to include all forms of income, including statutory income – see paragraphs 8 to 10 of the explanation.

24. Secondly, the word 'derived' in the context of subsection 6AB(1) should not be read to refer only to amounts of ordinary income. It is relatively common to use 'derived' in reference to income generally. In some cases the usage is a reference to amounts included in assessable income generally, such as section 79D

(except capital gains), and in other contexts, it may have different meanings, such as in section 128B where it refers to dividends and royalties which may not be ordinary income (see section 128A(1AA) which covers non-assessable, non exempt income under section 128D). 'Derived' is also used in relation to profits in a number of provisions which may go beyond ordinary income (for example, section 44(1) of ITAA 1936 and section 110-55(7)). Similarly it is used in relation to 'income, profits or gains' as in section 96C. In this particular context, the ATO considers that 'income derived' is a shorthand reference to an amount that is treated as some form of income for the purposes of income tax. The focus of the provision is on source, not the nature of income. The one exception is capital gains for reasons explained in paragraphs 11 to 15.

25. Thirdly, the ATO does not accept the view that the specific inclusion of some statutory provisions by implication excludes other kinds of statutory income not referred to. The inclusion by subsequent amendments of references to specific sections in subsection 6AB(1) was to deal with cases where it was desired to characterise an amount as foreign income, but the kind of income in question may in some cases have been Australian sourced under the judge made rules on source. In other words, the references to specific provisions are intended to deem the relevant income to be foreign where it is not, rather than deem it to be ordinary income where it is not.

26. This interpretation is supported in the Explanatory Memorandum to the *Income Tax Assessment Amendment (Foreign Investment) Act 1992* at Chapter 22 which states:

> With the introduction of the CFC measures, the FTCS was modified and certain new exemptions were introduced for the purposes of relief from double taxation.
>
> Credit is available to a resident company for tax paid by a related CFC against any amount of the CFC's attributable income that is included in the resident company's assessable income. The credit is allowed on a similar basis as credit is allowed for taxes paid on dividends received by a resident company from a related foreign company.
>
> Amounts of income of the CFC that have already been taxed in full in Australia – for example, Australian sourced income derived by a branch of the CFC and taxed by assessment in Australia – are excluded from the calculation of the CFC's attributable income.
>
> Attributed income is treated as foreign income. The foreign tax and Australian tax paid by the CFC on that amount are creditable foreign taxes. This effectively allows any Australian withholding tax paid by the CFC to be creditable on attribution for foreign tax credit purposes if the resident taxpayer is entitled to a foreign tax credit.

The wording in the Explanatory Memorandum serves to explain the reasons for the references to those specific attribution sections under the CFC measures.

27. In addition, the reference to eligible termination payments as defined in subsection 27A(1) and section 27CAA were inserted into subsection 6AB(1) by *Taxation Laws Amendment Act (No. 4) 1994* which introduced the current international rules in relation to the taxation of superannuation fund payments. These sections apply to certain payments by eligible non-resident non-complying superannuation funds. Under the definition of resident superannuation fund in section 6E, it is possible for a fund which is mainly based in Australia to be treated as a non-resident superannuation fund and hence to make payments caught by section 27CAA which are Australian sourced in accordance with the principles in IT 2168 paragraph 45 (because the fund is based in Australia). As these payments may be taxed overseas it is necessary to deem them to be foreign-sourced in order to allow a foreign tax credit for the foreign tax.

Examples

Example 1

28. Jody, an Australian resident for tax purposes, is a computer programmer. Jody is the director, sole shareholder and sole employee of an Australian resident company, Techo Pty Ltd (Techo). Techo enters into a contract with a Hong Kong company, Ficus Ltd (Ficus) to provide the services of Jody. Jody performs the services in Hong Kong for 6 months under the contract and in return, Ficus pays fees to Techo for Jody's services on a monthly basis. Techo promptly pays Jody a monthly salary equal to half the fees derived.

29. The fee paid to Techo by Ficus constitutes the personal services income of Jody under section 84-5 of the ITAA 1997, Assuming that Techo does not satisfy any of the personal services business tests set out in section 87-15 of the ITAA 1997, the balance of the fees derived by Techo (assuming there are no allowable deductions), ie. the amount not paid to Jody as salary, is included in Jody's assessable income under subsection 86-15(1) of the ITAA 1997.

30. Provided that the statutory income included in Jody's assessable income under subsection 86-15(1) of the ITAA 1997 is derived from sources in a foreign country, based on the judicial rules of source, the amount will be considered to be 'foreign income' for the purposes of subsection 6AB(1) of the ITAA 1936.

Example 2

31. Ronald, an Australian resident for tax purposes, operates a building and construction business in New Caledonia. As part of that business, Ronald acquires a crane for $900,000 on 1 July 2001. The crane is utilised by the business from the date of acquisition until Ronald disposes of the crane by selling it on 30 June 2003 for $900,000. If the effective life of the crane is 15 years, and Ronald chooses to use the prime cost method to work out the crane's decline in value', the adjustable value of the crane (worked out under Division 40 of the ITAA 1997) at the date of disposal is $780,000. Ronald must therefore include a balancing adjustment amount of $120,000 in his assessable income for the 2003 income year, being the difference between the adjustable value and the termination value ($900,000) of the crane.

32. The amount is included in Ronald's assessable income under subsection 40-285(1) of the ITAA 1997. Provided this amount is derived from sources in a foreign country, based on judicial rules of source, the amount will be considered to be 'foreign income' for the purposes of subsection 6AB(1) of the ITAA 1936.

Your comments

33. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date.

Due date: **17 September 2004**

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Detailed contents list

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Commissioner of Taxation
4 August 2004

Previous draft:
Not previously issued in draft form

Related Rulings/Determinations:
TR 92/20; IT 2562; IT 2507;
IT 2437; IT 2168

Subject references:
- Foreign income
- Statutory Income
- Assessable income

Legislative references:
- TAA 1953 Part IVAAA
- ITAA 1936 6AB(1)
- ITAA 1936 6AB(2)
- ITAA 1936 79D
- ITAA 1936 23L
- ITAA 1936 26(e)
- ITAA 1936 27A
- ITAA 1936 27A(1)
- ITAA 1936 27CAA
- ITAA 1936 44
- ITAA 1936 160AE(2)
- ITAA 1936 160AF(1)
- ITAA 1936 160AFC
- ITAA 1936 160AFD
- ITAA 1936 160K
- ITAA 1936 160OZ(8)
- ITAA 1936 456
- ITAA 1997 6-5
- ITAA 1997 6-10
- ITAA 1997 Div 50
- ITAA 1997 84-5
- ITAA 1997 86-15(1)
- ITAA 1997 87-15
- ITAA 1997 110-55(7)

Case references:

Other references:
- Explanatory Memorandum to its introduction as part of the Tax Laws Amendment (Foreign Tax Credit) Act 1986
- Explanatory Memorandum to the Income Tax Assessment Amendment (Foreign Investment) Act 1992
- Taxation Laws Amendment Act (No. 4) 1994

ATO references
NO: 2004/8798
ISSN: 1039-0731