IT 2446 - Income tax : foreign tax credit system : allowable deductions referable to foreign income

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TAXATION RULING NO. IT 2446

INCOME TAX : FOREIGN TAX CREDIT SYSTEM : ALLOWABLE DEDUCTIONS REFERABLE TO FOREIGN INCOME

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1211148	FOREIGN TAX CREDIT SYSTEM : FOREIGN INCOME AND RELATED DEDUCTIONS	51(6) 80(8) 160AF(8) 160AFA(4) 160AFD(5)

PREAMBLE This Ruling is concerned with a matter relevant to the operation of the general foreign tax credit system (FTCS) of double taxation relief. It deals with the practical application of various provisions of the income tax law which set out the basis for the allocation to foreign income derived by a taxpayer in a year of income of deductions allowed or allowable from assessable income.

2. The provisions of the Assessment Act which are primarily the subject of this Ruling are subsection 51(6) (which deals with current year foreign losses), subsection 80(8) (carry-forward of prior year domestic losses), the definition of "net foreign income" in subsection 160AF(8) (foreign tax credits) and subsection 160AFD(5) (quarantining of prior year foreign losses). Subsection 35(2) of the Taxation Laws Amendment (Foreign Tax Credits) Act 1986, which relates to the carry-forward of pre-FTCS foreign losses, is also relevant.

3. Those provisions, while serving different purposes, follow a similar pattern and essentially require the offset against relevant foreign income of allowable deductions that relate exclusively to the derivation of that income, as well as so much of any other allowable deductions from assessable income (other than apportionable deductions) as, in the opinion of the Commissioner, may appropriately be related to the foreign income. The definition of "net foreign income" in subsection 160AF(8) specifically provides for the offset also against relevant foreign income of any amount of a prior year domestic loss which a taxpayer elects, under subsection 80(2C), for deduction against the relevant foreign income. Read in context, therefore, the reference to "deductions allowed or allowable" in that definition and in the other provisions referred to in paragraph 2 above are required to be construed as not including prior year domestic losses allowable as deductions under subsection 80(2). Nor will the rules contained in section 50 of the Assessment Act apply for the purposes of the allocation of

deductions to foreign income under those provisions.

4. Apportionable deductions as defined in subsection 6(1) of the Assessment Act are precluded from consideration for those purposes because they represent deductions of a concessional or semi-concessional nature which are not, strictly speaking, directly related to income producing activities and cannot therefore be said to relate to any particular part or class of a taxpayer's assessable income.

5. Each of those provisions is, with necessary modifications, modelled on provisions that previously applied for the purposes of determination of credits for tax paid in Papua New Guinea under former Division 18 of Part III of the Assessment Act or for foreign tax paid in respect of certain income derived from a treaty partner country under former section 15 of the Income Tax (International Agreements) Act 1953.

6. Although subsection 6AB(1) of the Assessment Act provides that a reference in the Act to foreign income is a reference to income derived from sources in a foreign country or countries, it is important to note that the definition of "net foreign income" in subsection 160AF(8), when read with subsection 160AF(7), applies separately in relation to foreign income which is quarantined interest income (as defined in subsection 160AE(3)) and in relation to all other foreign income. This result is in keeping with the general scheme of section 160AF which separates world-wide foreign income into two classes for purposes of ascertaining the amount of foreign tax credit that is to be allowed. One effect is that the rules contained in that definition for the offset of allowable deductions against foreign income also apply separately in respect of each of those classes of foreign income.

7. The other provisions referred to in paragraph 2 of this Ruling are concerned with the treatment under the FTCS of losses incurred in deriving domestic or foreign source income. Each of those provisions applies on both a "class of income" and "foreign source" basis, within the special meanings ascribed to those expressions in subsections 160AFD(6) and (7). The rules for the offset of allowable deductions contained in those provisions apply, therefore, separately in respect of each such class of foreign income derived by a taxpayer in a year of income from each such foreign source. The references in this Ruling to "relevant foreign income" should be read accordingly, as the context requires, in the light of the explanation given in this paragraph and in the preceding paragraph.

8. The purpose of this Ruling is to provide guidelines for the practical application of the provisions referred to in paragraph 2 above and, in particular, for the basis upon which the Commissioner could normally be expected to form an opinion as to the extent to which allowable deductions that do not relate exclusively to relevant foreign income may be treated as appropriately related to that income. It essentially confirms the practice that has applied in the past for those purposes in relation to the determination of tax credits in respect of income

from Papua New Guinea or from a treaty partner country.

9. The guidelines set out in this ruling should be regarded as having application also (as appropriate) in relation to the provisions of subsection 160AFA(4) of the Assessment Act. Those provisions apply for the purposes of the application of the substantive provisions of section 160AFA, and are concerned with the allocation of deductions allowable under any law (viz, a foreign country's law) against quarantined interest income (as defined in subsection 160AE(3)) derived by a foreign company.

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10. The determination of allowable deductions that relate exclusively to relevant foreign income will be a question of fact to be decided on the basis of the circumstances of each particular case. The proportion of other allowable deductions to be set off against the relevant foreign income will similarly need to be determined according to the circumstances of each case and no hard and fast rule can be laid down that will cover all situations. The formation of the requisite opinion by the Commissioner in relation to other allowable deductions may present more difficulty in practice, however, and needs to be approached against the background that the relevant provisions are designed to permit an appropriate apportionment between the relevant foreign source income derived by a taxpayer, and other income of the taxpayer, of expenses and other tax deductible items that can reasonably be regarded as in part related to the derivation of each of those categories of income.

11. Deductions that clearly relate exclusively to income other than the relevant foreign income should be excluded from consideration. Only those allowable deductions which can clearly be viewed as related to the derivation by the taxpayer of both the relevant foreign income and other income are to be subject to apportionment. An example would be general administration or head office expenses incurred by a taxpayer who conducts business activities both in Australia and overseas and which are incidental or relevant to the conduct of each of those activities. Another example may be an expense such as interest on borrowed funds which have been used to purchase income-producing assets, including assets used to derive foreign income.

12. Branch Offices will necessarily have to rely in the first instance on information provided by a taxpayer to support the method of apportionment or allocation of the relevant expenses. A broad, practical, approach on a reasonable basis is required. Providing the method used can, on an objective basis, be regarded as one which results in a reasonable and appropriate break-up of the expenses, it would normally be acceptable.

13. What will constitute a reasonable and appropriate basis of apportionment or allocation of expenses will be dependent on a variety of factors, including such things as the nature and size of the respective businesses or other activities of the taxpayer in Australia and abroad, the types of income concerned and the methods used by the taxpayer to generally account for foreign income and expenses. The same method of allocation of expenses

may not be appropriate for all classes or categories of expenses or income. For example, the method of allocation of head office expenses may be different from that which is appropriate for the allocation of interest expenses. However, where a resident of Australia carries on business in another country at or through a permanent establishment, a relevant consideration would be that the method used should give a result that is consistent with an "arm's length" apportionment of expenses between the taxpayer's business operations in Australia and those outside Australia. It would also be expected that the same method or methods of allocation of expenses would be used from year to year unless the taxpayer can advance sufficient reasons to justify a change.

14. For the reasons outlined above, this Ruling does not attempt to specify any formal expense allocation rules. Each case will have to be decided on the basis of all the relevant circumstances and the broad guidelines outlined. Another Ruling will be issued at a later date to elaborate on acceptable methods of allocation of deduction items as experience develops with administration of the FTCS and decisions are made in relation to methods of allocation of particular categories of deduction items in particular circumstances.

15. It will be necessary for all claims for allocation of deductions to foreign income to be accompanied by a statement showing the basis of that allocation. The basis of allocation used could be expected to be subject to review, and adjustment where necessary, either at the time of assessment or upon post-issue examination and audit. It should be also noted that section 136AE contains specific provisions that permit claims for expenses relating to the derivation of foreign income, in the circumstances to which the section applies, to be adjusted in accordance with the requirements of those provisions. A taxpayer who is dissatisfied with an adjustment made would, of course, have the usual rights of objection and review.

16. One example of a situation where an adjustment could be expected is where there has been a "loading" of deductions by the taxpayer against either Australian source or the relevant foreign income component of the assessable income in order to obtain an unwarranted tax advantage. For instance, there may be an excessive allocation of allowable deductions against Australian source income so as to reduce the tax payable in respect of that income and/or to either reduce the amount of a quarantined foreign loss or increase the Australian tax attributable to the relevant foreign income in order to fully utilise available foreign tax credits.

17. The normal tests for deductibility of expenses in a particular year of income will apply. Nevertheless, instances of contrived foreign expenditure deferral (or income advancement) arising in the transitional period surrounding the termination of the exemption provided by paragraph 23(q) of the Assessment Act and the commencement of the FTCS could be expected to be closely examined with a view to the application of anti-avoidance provisions of the Assessment Act in appropriate cases.

COMMISSIONER OF TAXATION
10 September 1987