IT 2523 - Income tax: Foreign Tax Credit System: application of subsection 51(6) and section 79D to quarantine 'current year foreign losses' where the taxpayer does not derive any foreign income in the year of income

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TAXATION RULING NO. IT 2523

INCOME TAX : FOREIGN TAX CREDIT SYSTEM : APPLICATION OF SUBSECTION 51(6) AND SECTION 79D TO QUARANTINE "CURRENT YEAR FOREIGN LOSSES" WHERE THE TAXPAYER DOES NOT DERIVE ANY FOREIGN INCOME IN THE YEAR OF INCOME.

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1011092	FOREIGN TAX CREDIT SYSTEM	51(6) & (7)
		79D
	QUARANTINING OF FOREIGN LOSSES	160AFD

OTHER RULINGS ON TOPIC : IT 2446

PREAMBLE Clarification has recently been sought about the operation of subsections 51(6) and (7) and section 79D of the Income Tax Assessment Act (the Assessment Act) where, in a year of income, a taxpayer would (but for the operation of those sections) be entitled to allowable deductions that relate to the derivation of "a class of income" from a "foreign source" but the taxpayer has not derived any such income in that year.

2. In broad terms, subsections 51(6) and (7) operate in relation to the 1987/88 year of income, and section 79D operates in relation to subsequent years of income, where expenditure is incurred in relation to the derivation of an amount of a "class of income" from a "foreign source" within the meanings of those expressions in subsections 160AFD(6) and (7) respectively. By reason of subsections 51(6) and (7), the deductions allowable under subsection 51(1) in relation to the derivation of such income cannot exceed the assessable amount of that income for that year. Section 79D operates similarly to limit any deductions allowable to a taxpayer under the Assessment Act, for the years of income to which it applies, to the assessable amount of such income.

3. In either case, where the sum of the deductions otherwise allowed or allowable exceeds the amount of a relevant "class of income" derived by the taxpayer in the year of income from a "foreign source", the excess is available for carry-forward for offset under section 160AFD against the same "class of income" derived by the taxpayer in any of the seven subsequent income years from the same "foreign source".

4. Those provisions give effect to the foreign loss quarantining features of the foreign tax credit system (FTCS), which are broadly designed to -

(a) preclude a "current year loss" incurred by a taxpayer in a year of income in respect of a foreign income producing activity from being offset against any Australian or other foreign income derived by the taxpayer in that year; and

(b) provide for such a loss to be carried-forward for offset against foreign income of the same "class of income" and from the same "foreign source" in a later year.

5. In effect, those foreign loss quarantining provisions recognise, and provide relief for, losses incurred by a resident taxpayer in respect of a foreign income producing activity but only where commensurate tax revenues may subsequently be obtained from that activity.

RULING

6. Subsections 51(6) and (7), section 79D and section 160AFD establish separate rules for the treatment of losses incurred by a taxpayer in respect of a foreign income producing activity. Those rules vary somewhat from, but are nevertheless broadly parallel to and consistent with, the approach that generally applied prior to the introduction of the FTCS in respect of losses incurred by a taxpayer in relation to the derivation of assessable income, and which is now generally limited in its application to losses incurred in deriving Australian source income, pursuant to section 80 of the Assessment Act. In this regard, it has never been suggested that a current year loss would not arise for carry-forward under section 80 where, in a year of income, a taxpayer has incurred allowable deductions but has not derived any amount of assessable income in that year.

7. As indicated earlier, subsections 51(6) and (7) relate to deductions allowed or allowable under subsection 51(1), while section 79D relates more generally to deductions allowed or allowable under that subsection or other provisions of the Assessment Act. In that respect, it is well established that, as a general proposition, deductions are allowed or allowable under subsection 51(1) and other provisions of the Assessment Act in respect of expenditure incurred for the purposes of producing assessable income although the expenditure in question does not produce assessable income of the same year.

8. When read in that context, it is clear that the legislature intended subsections 51(6) and (7), and section 79D, to effectively quarantine relevant current year losses or outgoings notwithstanding that no amount of a related class of income was derived by the taxpayer in a year of income from a foreign source. That outcome is supported by the situation that would arise if the terms of subsections 51(6) and (7), and section 79D, were to be interpreted on a strict literal basis, so as to give the opposite result. This would mean that those provisions would operate to quarantine relevant losses and outgoings as reduced by an amount of related assessable income derived in the same year, but not the full amount of such losses and outgoings if no amount of related assessable income was derived in the

same year. That result could clearly not have been intended.

9. Given that situation, and the underlying scheme of foreign loss quarantining as described in the preamble to this Ruling, it is considered that subsections 51(6) and (7), and section 79D, apply to effectively preclude the offset against other assessable income derived by a taxpayer in a year of income of relevant deductions that would otherwise be allowed or allowable in relation to the derivation of a "class of income" from a "foreign source" notwithstanding that no amount of such income is derived by the taxpayer in that year of income.

10. It follows that the taxpayer would be treated as having derived an overall foreign loss in respect of that "class of income" from a "foreign source" for the year of income in those circumstances. The taxpayer would thus be entitled to have that loss carried-forward in reduction of an amount of the same "class of income" from the same "foreign source" in a later year of income in accordance with the terms of section 160AFD of the Assessment Act.

COMMISSIONER OF TAXATION
23 March 1989