IT 2597 - Income tax: Foreign Tax Credit System: foreign loss quarantining - meaning of 'foreign source'

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TAXATION RULING NO. IT 2597

INCOME TAX FOREIGN TAX CREDIT SYSTEM : FOREIGN LOSS QUARANTINING - MEANING OF "FOREIGN SOURCE"

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1 1012168	FOREIGN TAX CREDIT SYSTEM FOREIGN LOSS QUARANTINING GENERALLY	6AB(1), 51(1), former 51(6) and (7), 79D, 160AE(3), 160AF(1), 160AFD

OTHER RULINGS ON TOPIC : IT 2446, IT 2518, IT 2523, IT 2598

PREAMBLE This Ruling is designed to generally clarify the operation of the foreign loss quarantining provisions of the foreign tax credit system (FTCS). In particular, the Ruling addresses the interpretation of the statutory prescription in subsection 160AFD(7) of the Income Tax Assessment Act 1936 ("the Assessment Act") of "foreign source" for foreign loss quarantining purposes.

2. Subsection 160AFD(7) effectively defines "foreign source" for those purposes to mean, in relation to a taxpayer -

(a) a business carried on by the taxpayer at or through one or more permanent establishments in a foreign country; or

(b) any other business, commercial or investment activity carried on by the taxpayer in a foreign country.

3. In broad terms, former subsections 51(6) and (7) of the Assessment Act continue to operate in relation to the 1987/88 year of income to quarantine allowable deductions under subsection 51(1) that relate exclusively to, or may appropriately be related to, a "class of income" derived from a "foreign source" within the meanings of those expressions in subsections 160AFD(6) and (7) respectively. Section 79D operates to similarly quarantine relevant subsection 51(1) and other allowable deductions for subsequent years of income.

4. The relevant allowable deductions for a year of income are quarantined to the extent that they cannot exceed the amount of the relevant class of income derived from such a "foreign source" that is included in the taxpayer's assessable income for that year. However, in general terms, the excess of the relevant allowable deductions for a year of income represents an overall foreign loss available for carry-forward for offset,

under section 160AFD, against the same class of income derived by the taxpayer in subsequent income years from the same "foreign source" (subject to a seven year carry-forward limitation in the case of an overall foreign loss for a year of income before the 1989-90 year of income). Those provisions of the Assessment Act are generally referred to in this Ruling as "the foreign loss quarantining provisions".

RULING Per country basis for application of paragraphs (a) and (b) of definition of "foreign source" in subsection 160AFD (7).

5. Paragraph (a) of the definition of "foreign source" in subsection 160AFD(7) was amended by section 33 of the Taxation Laws Amendment Act (No 2) 1988, with effect from the commencement of the 1987/88 income year, to make it clear that the paragraph operates on a per country basis, so that several permanent establishments in the same foreign country constitute in total the one "foreign source" for foreign loss quarantining purposes. (See further paragraphs 14 and 15 below concerning the meaning of "permanent establishment" for these purposes).

6. Paragraph (b) of the definition is likewise interpreted as applying on a per country basis, so that where more than one other business, commercial or investment activity (or a combination of such activities) is carried on by the taxpayer in the one foreign country, those activities in total would constitute one "foreign source" for foreign loss quarantining purposes.

7. However, although paragraphs (a) and (b) of the definition are interpreted as each having application on a per country basis, the insertion by the legislature of the conjunction "or" between the two paragraphs is taken as requiring that each paragraph be applied separately in relation to a taxpayer. This means that the application of the respective paragraphs on a per country basis will not always result in all of the various categories of income of the same class (see subsections 160AE(3) and 160AFD(6)) derived by a taxpayer from the same foreign country having the same "foreign source" for foreign loss quarantining purposes.

8. Take, for example, the situation of a resident taxpayer who carries on a business through a permanent establishment in country X and who derives rental, dividend and interest income from the same country from activities that, although carried on in country X, are not attributable to or associated with the business carried on through the permanent establishment. In those circumstances, the rental, dividend and interest income would be treated for foreign loss quarantining purposes as derived from any other business, commercial or investment activity carried on by the taxpayer in country X.

9. In that example, the business income derived through the permanent establishment would be a class of foreign income from one "foreign source" pursuant to paragraph (a) of the definition in subsection 160AFD(7). The rental and dividend income, although of the same class of income as the business income,

would be treated as derived from a separate "foreign source" for foreign loss quarantining purposes pursuant to paragraph (b) of that definition. The interest income, on the other hand, while treated as income derived from the same "foreign source" as the rental and dividend income pursuant to paragraph (b) of the definition, would normally, in the circumstances described, be a different class of income for foreign loss quarantining purposes (see subsection 160AE(3) and Taxation Ruling No. IT 2518).

10. Alternatively, the same taxpayer may not carry on the business through a permanent establishment in country X but the circumstances relating to that business may be such that the taxpayer is treated as carrying on a business activity in that country (see further paragraphs 13 to 18 below). In that event, the income from that activity and the rental and dividend income would all be income of the same class derived from the same "foreign source" for foreign loss quarantining purposes pursuant to paragraph (b) of the definition of "foreign source" in subsection 160AFD(7). The interest income would also be income from the same "foreign source", but depending on the circumstances, may be of a different class for foreign loss quarantining purposes pursuant to subsection 160AE(3).

11. Another taxpayer may derive income from a business carried on through a permanent establishment (or other business, commercial or investment activity carried on) in more than one foreign country. In that event, the taxpayer would derive the same class of foreign income from more than one "foreign source" pursuant to subsection 160AFD(7).

12. Those examples refer only to the basis of quarantining foreign income for the purposes of those provisions. However, it needs to be borne in mind that relevant expenditure and other allowable deductions are likewise quarantined for those purposes on both a class of income and "foreign source" basis and that a statutory formula has been provided for the allocation (and apportionment where appropriate) of allowable deductions against each class of income from a "foreign source" - see former subsection 51(6), subsection 79D(1) and subsection 160AFD(5), together with the guidelines for such allocations provided in Taxation Ruling No. IT 2446.

Application of paragraph (b) of the definition of "foreign source" in subsection 160AFD(7) in relation to any other business activity.

13. To the extent that it relates to a business activity, paragraph (b) of the definition of "foreign source" in subsection 160AFD(7) complements paragraph (a) of the definition and is essentially directed at business income, and related expenses, where the taxpayer does not carry on the business at or through one or more permanent establishments in a foreign country.

14. The definition of "permanent establishment" in subsection 6(1) of the Assessment Act would normally apply for these purposes. However, it is pertinent in relation to a country

with which Australia has concluded a comprehensive taxation treaty, that business profits derived by an Australian resident enterprise from sources in the treaty partner country may be taxed by that country only where the enterprise carries on business in that country through a permanent establishment (as defined for the purposes of the relevant treaty) situated therein.

15. Although in particular cases the relevance for present purposes of the respective definitions of "permanent establishment" in the tax treaties may be debatable, their essential characteristics coincide with the subsection 6(1) definition concept of a place at or through which a person carries on business, including through certain dependent agents. Accordingly, for practical purposes, where business profits of an Australian resident taxpayer are taxed by a treaty partner country, those profits and relevant expenses may be generally treated as attributable to a "foreign source" in relation to the taxpayer according to paragraph (a) of the definition in subsection 160AFD(7). A consequence of this general rule is that it would not normally be necessary to consider the application of paragraph (b) of the definition in relation to such business profits and related expenses.

16. Although expected to be comparatively rare, cases might nevertheless arise where it may not be appropriate for that general rule to apply. An example of such a case (which might also raise a question over the right under the treaty of the treaty partner country to tax the business profits) may be where there is a genuine doubt over whether the taxpayer does indeed have a permanent establishment in that country, or over whether the profits concerned are properly attributable to the business carried on by the taxpayer in that country through a permanent establishment.

17. Where it is determined that paragraph (a) of the definition in subsection 160AFD(7) does not operate to give business profits, and relevant expenses, a "foreign source" for foreign loss quarantining purposes, it is the view of this Office that it will be a question of fact - to be determined in the light of the circumstances of each particular case on how and where the business activity of the taxpayer is essentially managed, controlled, organised and conducted - as to whether the business activity is carried on in a foreign country for the purposes of paragraph (b) of the definition. Support for this view is to be found in the ordinary dictionary meaning of "carried on" in relation to a trade or business, being to conduct, undertake or prosecute that activity. The consideration that the business activity results, or may result, in the derivation of income that would be foreign income for foreign tax credit purposes under section 160AF and subsection 6AB(1), will not be the sole determinant of the matter (see also paragraphs 27 to 29 below).

18. In that regard, one of the relevant considerations would be whether there is some active involvement in the foreign country of the taxpayer, the taxpayer's employees or appointed representatives (not being independent agents, or dependent

agents of the type that would constitute a permanent establishment) in the business activity giving rise to foreign income. Where, for example, the business activity of the taxpayer is essentially managed, controlled, organised and conducted by the taxpayer in Australia, and foreign income is derived from sales arranged in a foreign country (or countries) through independent agents of goods manufactured by the taxpayer in Australia, or of industrial property rights or know-how developed by the taxpayer in Australia, it would normally be accepted that relevant deductible expenditure is not incurred in respect of the derivation of income from a "foreign source" for the purposes of paragraph (b) of the definition.

19. The expenditure would not in those circumstance be subject to foreign loss quarantining. It would therefore be available for set off against Australian source and other foreign income of the taxpayer for the year of income. As indicated earlier, however, this result does not mean that the taxpayer would be denied foreign tax credit relief under subsection 160AF(1) in respect of foreign income (pursuant to subsection 6AB(1)) that is generated by the business activity (see also paragraphs 27 to 29 below).

20. Questions of degree will arise, of course, in the application of those general guidelines in particular cases. The taxpayers concerned should ensure that full details to support a claim that foreign loss quarantining does not apply in accordance with paragraph (b) of the definition of "foreign source" in subsection 160AFD(7) are available for inspection if required.

Application of paragraph (b) of the definition of "foreign source" in subsection 160AFD(7) in relation to a commercial or investment activity.

21. The variety of commercial or investment activities that may fall for consideration under paragraph (b) of the definition are too numerous for the position of each to be specifically addressed in this Ruling. It is considered that the terms of paragraph (b) and established principles of statutory interpretation require that the basic guidelines set out in paragraph 17 of this Ruling, for determining when any other business activity should be regarded as carried on by a taxpayer in a foreign country, should generally apply equally with respect to commercial or investment activities. The key test, therefore, against which all the circumstances of each such activity are to be measured is whether those circumstances lead to the conclusion that the activity is essentially managed, controlled, organised and conducted by the taxpayer in Australia or in the foreign country.

22. As a general rule, it is considered that the activity of renting out real property situated in a foreign country would fall under that test to be treated as a commercial or investment activity carried on in a foreign country for the purposes of paragraph (b) of the definition.

23. Conversely, a "passive" investment undertaken from Australia, for example by an Australian resident investor who acquires shares in a foreign company listed on a foreign stock exchange by means of instructions placed from Australia with an independent stockbroker, located either in Australia or in the other country, could normally be expected to be not regarded under that test as a commercial or investment activity carried on by the taxpayer in a foreign country.

24. On the other hand, an Australian resident investment company or other taxpayer investing in foreign shares and/or securities may appoint or engage a manager or investment advisor in a foreign country or countries to facilitate and transact those investments. Providing the significant decisions with respect to the management, control, organisation and conduct of those investments remain with the resident taxpayer in Australia, the dividends and interest income derived from the foreign shares and/or securities, and related expenses, could normally also be expected to be treated as attributable to an activity carried on by the taxpayer in Australia. They would not, therefore, be subject to the foreign loss quarantining provisions of the Assessment Act.

25. However, the dividends and interest income and related expenses would be treated as related to an activity carried on in a foreign country or countries - and thus be subject to the foreign loss quarantining provisions - if the investment power accorded to the overseas manager or investment adviser is so wide as to effectively delegate to that person the essential management, control, organisation and conduct of the foreign investment portfolio.

26. Similar considerations would apply in the case of a resident taxpayer who is engaged in the business of dealing in foreign shares and/or securities (other than through one or more permanent establishments in a foreign country), in determining whether paragraph (b) of the definition of "foreign source" in subsection 160AFD(7) would be applicable in respect of trading profits and losses arising from those dealings, as well as dividends and interest derived from the foreign shares and/or securities (and related expenses).

Different meaning of foreign source for foreign tax credit purposes.

27. As previously indicated in this Ruling, a distinction needs to be drawn between the statutory definition of "foreign source" in subsection 160AFD(7) for foreign loss quarantining purposes, and the meaning of foreign source for the purposes of determining whether income qualifies as foreign income for foreign tax credit relief under subsection 160AF(1) or for other purposes of the Assessment Act. Pursuant to subsection 6AB(1), the latter reference to foreign income is to income derived from sources in a foreign country or countries according to ordinary concepts of source of income, or where a double tax treaty concluded by Australia with another country is relevant, pursuant (by reason of section 4 of the Income Tax

(International Agreements) Act 1953) to the deemed source rules applicable in relation to the relevant treaty.

28. That distinction needs to be considered, however, in the context that foreign loss quarantining forms an integral part of the FTCS. Accordingly, it may be stated, as a general proposition, that income that is subject to foreign loss quarantining could be expected to also qualify as foreign income pursuant to subsection 6AB(1) for assessment and foreign tax credit purposes. However, not all income that is foreign income pursuant to subsection 6AB(1) would fall to be subject to the foreign loss quarantining provisions.

29. Foreign earned salary and wage income is an example of the latter category of income. The performance outside Australia by a taxpayer of the duties of an employee obviously does not fall within the scope of paragraph (a) of the definition of "foreign source" in subsection 160AFD(7), nor does it represent the carrying on by the taxpayer in a foreign country of any other business, commercial or investment activity for the purposes of paragraph (b) of that definition. Nevertheless, it is clear that salary and wage income can be foreign income and be included in the class of "other income" for foreign tax credit purposes to the extent that it is not exempted from Australian tax (for example, by section 23AG of the Assessment Act) and is included in the taxpayer's assessable income - see subsections 160AF(1) and (6).

COMMISSIONER OF TAXATION
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