TD 2004/29 - Income tax: can section 79D of the Income Tax Assessment Act 1936 operate to limit deductions available under Division 10B or Division 10BA of Part III of the Income Tax Assessment Act 1936 ?

Taxation Determination

Income tax: can section 79D of the *Income Tax Assessment Act 1936* operate to limit deductions available under Division 10B or Division 10BA of Part III of the *Income Tax Assessment Act 1936*?

Preamble

The number, subject heading, date of effect and paragraphs 1 to 4 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

1. Yes, section 79D of the *Income Tax Assessment Act 1936* (ITAA 1936) would operate to the extent to which the deductions relate to foreign source income.

Section 79D

2. Section 79D operates where there are one or more 'foreign income deductions' of a taxpayer that 'relate' to a class of 'assessable foreign income' in relation to a year of income, and the taxpayer either:

- did not derive any assessable foreign income of that class; or
- derived assessable foreign income of that class, and the amount of that income is less than the sum of foreign income deductions.

3. Where there is no assessable foreign income, the foreign income deductions are reduced to nil. If, however, there is assessable foreign income, the foreign income deductions are reduced to the amount of that assessable foreign income.

4. Where there are foreign income deductions and no assessable foreign income of that class, or where the foreign income deductions exceed the assessable foreign income of that class, the taxpayer is taken, under section 160AFD of the ITAA 1936, to have incurred a foreign loss in relation to the deductions or part of the deductions which have been reduced by section 79D. The loss can be carried forward indefinitely and applied against future assessable foreign income of the same class. The foreign loss provisions of the ITAA 1936 are commonly referred to as a 'foreign loss quarantining' mechanism.

5. The precursor of section 79D was the former subsection 51(6) of the ITAA 1936. This provision was repealed and replaced in 1988 by section 79D to, among other things, extend the operation of the foreign loss quarantining provisions to deductions other than

those allowable by the general deduction provision, now contained in section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Source

6. The term 'assessable foreign income' is defined in subsection 160AFD(9) as 'foreign income' that is included in a taxpayer's assessable income. Broadly, section 6AB of the ITAA 1936 defines 'foreign income' as income derived from sources in a foreign country. An Australian produced film or television series may ordinarily be distributed both in Australia and overseas. Accordingly, royalty income derived from exploiting the copyright may have an Australian or foreign source. At common law, the source of a particular class of income is a practical hard matter of fact: *Nathan v. FCT* (1918) 25 CLR 183 at 190. However, the common law source rules may be modified by the *International Tax Agreements Act 1953* (ITAA 1953).

7. Therefore, the source of the royalties may ultimately be determined by the application of an International Agreement made pursuant to the ITAA 1953. The Australia/United States (US) Double Tax Convention (the treaty) provides an illustration. Article 27 of the treaty deems certain income over which the US has the primary taxing right to have a US source for the purposes of Australia's domestic law. Where a US resident makes a royalty payment to an Australian resident, and where the US has the primary taxing right under Article 12 of the treaty in relation to that payment, the royalty will be deemed by Article 27 to have a US source for the purposes of Australia's domestic law.

8. Where the relevant income has an Australian source, section 79D has no application. Income which has a foreign source will be assessable foreign income for the purposes of section 79D.

'Relates to'

9. The term 'foreign income deduction' is defined by subsection 160AFD(9) as any deduction, other than those specifically excluded, that is allowed or allowable from a taxpayer's assessable income to the extent that the deduction 'relates to' the assessable foreign income of a particular class of income. Division 10B and 10BA deductions are not specifically excluded from the operation of section 79D.

10. The term 'relates' is not defined in the ITAA 1936. The *Macquarie Dictionary* (3rd Edition) defines the term to mean 'to bring into or establish association, connection or relation'. In *Case 67,* 96 ATC 598; 34 ATR 1034 the Administrative Appeals Tribunal considered the meaning of 'may appropriately be related' in the context of the definition of 'net foreign income' in subsection 160AF(8) of the ITAA 1936. Mr J Block (Senior Member) held that to be related the deductions must be connected, have reference to, or stand in some relation to the foreign income.

Division 10B

11. Under Division 10B, taxpayers are entitled to deduct the cost of capital expenditure incurred in acquiring rights in, or under, copyright in the year in which the rights are first used for the purpose of producing assessable income. The deduction may be claimed over two years or taxpayers may elect to deduct the costs over the effective life of the copyright.

Division 10BA

12. A deduction is available under Division 10BA where a taxpayer incurs capital expenditure in producing, or as a contribution to the production of, an Australian film and as a consequence acquires an interest in the initial copyright of the film. The concession is available to Australian residents in the year in which the expenditure is incurred provided the film is completed and the copyright used by the taxpayer for the purpose of producing assessable income within 24 months of the end of the financial year in which the funds are expended.

13. Under subsection 124ZAFA(1) of the ITAA 1936, the Commissioner must be satisfied that, amongst other things, the taxpayer *intends* to use the copyright for the purpose of producing assessable income from exhibiting the film. The deduction remains available provided that within two years, that intended use becomes actual use. If actual use does not arise, then under subsection 124ZAFA(2) the deduction is deemed never to have been allowable.

Application of section 79D

14. Since their enactment, both Division 10B (per section 124Z) and Division 10BA (per section 26AG) of the ITAA 1936 respectively, have recognised that the use of the copyright may give rise to the derivation of foreign source income. Australian resident individuals and companies are subject to tax on income from all sources. The references in Divisions 10B and 10BA to assessable income must be read in conjunction with Division 6 of the ITAA 1997 to include both Australian and foreign source income. Where a deduction relates to both Australian and foreign source income section 79D allows for an apportionment of the deduction.

Division 10B

15. Division 10B applies to a unit of industrial property that the owner 'has used … for the purpose of producing assessable income': subsection 124L(1) of the ITAA 1936. Such use is sufficient to create the necessary relationship between the deduction and the assessable income. Where the taxpayer derives assessable foreign income, or enters into a pre-sale agreement under which it will derive assessable foreign income, section 79D will apply.

Division 10BA

16. The necessary connection for section 79D to operate will be established where it was intended at the time the expenditure was made that the copyright would be used by the taxpayer to derive foreign source income. The existence of pre-sale agreements, distribution agreements or other contractual arrangements that are aimed at exploiting the copyright to produce foreign source income would evidence such an intention.

17. Where the intended use of the copyright is only to derive assessable *Australian* sourced income, at no point in the two year period could the deduction under section 124ZAFA be described as one that 'relates' to assessable *foreign* income. The required nexus between the deduction and assessable foreign income is not created. Fortuitous later use of the copyright from which assessable foreign income is derived would not change the position in earlier years in which deductions were allowed. However, it would need to be clear from the circumstances of the particular case that the later use

which gave rise to the foreign source income was in fact unexpected and not intended at the time the deduction was claimed.

Apportioning Deductions

18. A deduction is limited by section 79D only 'to the extent that' it relates to assessable foreign income. In some cases a deduction may only partly relate to assessable foreign income and must therefore be apportioned. Section 79D does not prescribe an apportionment method. Therefore the determination of the amount of the deduction that relates to assessable foreign income will be a question of fact to be decided on the basis of the circumstances of each particular case.

19. There are a number of variables and timing factors that impact on the ultimate break-up between Australian and foreign source income derived from the exploitation of the copyright. In recognition of this, where a taxpayer has entered into pre-sale agreements an apportionment of Australian and foreign source income based on the proportions reflected in those agreements will be considered acceptable where the parties are dealing with each other at arm's length and the relevant proportions are a reasonable estimate of the expected income flows.

Alternative View

20. It might be argued that deductions under Divisions 10B and 10BA are 'concessional' and are able to be offset against the assessable income generally, irrespective of the kind of income derived. That is, they are like a deduction for a gift: the expenditure qualifies as a deduction because it has specifically been legislated that it will be allowable and that it doesn't depend on the derivation of, or relate to, any particular kind or class of income at all.

21. The difficulty with this proposition is that for expenditure to be an allowable deduction under either Division the owner of the copyright must have 'used' it for the purpose of producing assessable income (Division 10B) or the owner of the copyright 'intended to use' it for the purpose of producing assessable income (Division 10BA). That is, just like many of the other deductions for capital expenditure there needs to be a clear and direct connection between the expenditure incurred in acquiring the relevant property and the use of that property in deriving assessable income. A deduction would only be allowable where it is possible to demonstrate an actual use of the property for income producing purposes (Division 10B) or the intended use of the property to enliven the potential for income to be derived (Division 10BA). In this sense the relevant expenditure has a direct and obvious connection to a particular amount, or source, or kind of income that is produced (or would be expected to have been produced) that other deductions, like a gift, do not.

22. Moreover, the Explanatory Memorandum accompanying the *Taxation Laws Amendment Act 1988* which introduced section 79D into the ITAA 1936 provided an example that included a reference to apportioning depreciation deductions otherwise then allowable under section 54 of the ITAA 1936. There is no reason in principle why other deductions for capital expenditure should not also be subject to the same quarantining provisions.

The Film Offset

23. The film offset concession available under Division 376 of the ITAA 1997 for certain films completed on or after 4 September 2001 is not affected by section 79D.

Example 1 – Division 10B

24. *In the 2004 financial year XYZ Pty Ltd ('XYZ') acquires the existing copyright to an episodic television series to derive foreign source income. The 20 year copyright costs XYZ $11 million. Under Division 10B, XYZ would be able to claim a deduction for the capital expenditure over two years at $5.5 million per year. However, as all royalty income from the film will be from a foreign source, section 79D operates to reduce the deduction to the amount of assessable foreign income.*

25. *During the 2004 financial year XYZ derives $3.8 million in foreign source royalties from the exploitation of the copyright. Section 79D operates to reduce the $5.5 million deductible under Division 10B to the amount of foreign source income ($3.8 million). XYZ can claim a deduction of $3.8 million in the 2004 financial year. The remaining $1.7 million ($5.5 million - $3.8 million) is carried forward as a foreign loss under s160AFD.*

26. *XYZ derives assessable foreign income of $4.0 million in the 2005 income year. Subsection 160AFD(2) operates to reduce the assessable foreign income to $2.3 million ($4.0 million - $1.7 million). Section 79D operates to reduce the $5.5 million deductible under Division 10B to the amount of foreign source income ($2.3 million). The remaining $3.2 million ($5.5 million - $2.3 million) is carried forward as a foreign loss and may be applied in future years.*

27. *XYZ derives assessable foreign income of $5.0 million in the 2006 income year. XYZ can deduct its carry forward foreign loss of $3.2 million against this foreign income resulting in foreign assessable income of $1.8 million in the 2006 income year*.

Example 2 – Division 10BA

28. *DEF Pty Ltd ('DEF') has taxable income of $22 million in the 2004 financial year. DEF acquires the original copyright for a qualifying Australian film. DEF's capital expenditure on the film in the 2004 financial year is $12 million which qualifies for a deduction under Division 10BA. Pre-sale agreements guarantee that $6 million of royalty income will be received in two years when the film has been delivered. The agreements provide that 80% of the royalty income will come from Australian sources and the remaining 20% will have a source in the United States. DEF believes that these are reasonable estimates of the income flows. At this point in time DEF has not derived any assessable foreign income. However, the pre-sale agreements evidence an intention to derive both Australian and foreign source income.*

29. *The total Division 10BA deduction of $12 million is reduced by section 79D. The reduction is equal to $2.4 million (20% of $12 million) as it relates to the derivation of assessable foreign income. The remaining part of the deduction $9.6 million (80% of $12 million) is applied against DEF's 2004 Australian sourced income. The $2.4 million will be carried forward as a foreign loss under s160AFD to be applied against the same class of assessable foreign income in future years.*

Example 3 – Source of Income

32. In the 2004 financial year RTY Pty Ltd ('RTY') acquires the copyright to a film which will be distributed both in Australia and offshore. RTY grants an exclusive licence to CHT Pty Ltd (CHT), the Australian producer of the film, covering all marketing rights in the film. The licence agreement between RTY and CHT is executed and performed in Australia. CHT in turn enters into a distribution agreement with NFC Inc, a US resident, that grants a sub-licence to distribute the film offshore.

33. The royalty payments made by CHT to RTY will have an Australian source under ordinary common law principles. However, royalty payments made by NFC Inc to CHT will be deemed to have a US source under the Australia/US Double Tax Convention. The fact that CHT will derive foreign source royalties from exploiting its licence offshore is not in itself relevant to determining the source of the income in the hands of RTY in these circumstances.

Date of Effect

34. This Determination applies to years commencing both before and after its date of issue. However, this Determination does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
14 July 2004

Previous draft:

TD 2004/D7

Related Rulings/Determinations:

TR 92/20

Subject references:

- apportionment of foreign income deductions
- assessable foreign income
- foreign source income

Legislative references:

- ITAA 1936 6AB
- ITAA 1936 26AG
- ITAA 1936 51(6)
- ITAA 1936 54
- ITAA 1936 79D
- ITAA 1936 Pt III Div 10B
- ITAA 1936 124L(1)
- ITAA 1936 124Z
- ITAA 1936 Pt III Div 10BA
- ITAA 1936 124ZAFA
- ITAA 1936 124ZAFA(1)
- ITAA 1936 124ZAFA(2)
- ITAA 1936 160AF(8)
- ITAA 1936 160AFD
- ITAA 1936 160AFD(9)
- ITAA 1997 Div 6
- ITAA 1997 Div 376
- ITAA 1997 8-1
- TAA 1953 Pt IVAAA
- International Tax Agreements Act 1953 Sch 2 USA Convention Art 12
- International Tax Agreements Act 1953 Sch 2 USA Convention Art 27
- Taxation Laws Amendment Act 1988

Case references:

- Nathan v. FCT (1918) 25 CLR 183
- Case 67, 96 ATC 598; 34 ATR 1034

Other references:

- Macquarie Dictionary, 3rd Edition

ATO references
NO: 2003/14994
ISSN: 1038-8982