TD 2020/7 - Income tax: can capital gains be included under subparagraph 770-75(4)(a)(ii) of the Income Tax Assessment Act 1997 in calculating the foreign income tax offset limit?

Taxation Determination

Income tax: can capital gains be included under subparagraph 770-75(4)(a)(ii) of the *Income Tax Assessment Act 1997* in calculating the foreign income tax offset limit?

Relying on this Ruling

This publication (excluding appendix) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

Further, if we think that this Ruling disadvantages you, we may apply the law in a way that is more favourable to you.

Table of Contents **Paragraph**

Ruling

1. Capital gains are not included under subparagraph 770-75(4)(a)(ii) of the *Income Tax Assessment Act 1997*[1] when calculating the foreign income tax offset (FITO) limit.

Example

2. *In an income year, an Australian taxpayer (the taxpayer) disposed of a number of CGT assets and recognised the following CGT events (assume all capital assets have been held for less than 12 months):*

- *a foreign capital gain of $3,000 in respect of which $630 of foreign income tax was paid*

[1] All legislative references in this Determination are to the *Income Tax Assessment Act 1997*.

- *a foreign capital gain of $20,000, in respect of which no foreign income tax was paid*
- *an Australian capital gain of $10,000, and*
- *a capital loss of $15,000.*

3. *In determining their net capital gain, the taxpayer applies the $15,000 capital loss against the $10,000 Australian capital gain and $5,000 of their foreign capital gain in respect of which no foreign income tax was paid.*

4. *The resulting net capital gain is $18,000 which includes $15,000 of foreign capital gain in respect of which no foreign tax was paid and a $3,000 foreign capital gain in respect of which foreign income tax was paid. This net capital gain does not have a source.*

5. *The entire $3000 foreign capital gain in respect of which foreign income tax was paid has been included in the taxpayer's assessable income. That $3,000 foreign capital gain will be disregarded under subparagraph 770-75(4)(a)(i) for purposes of the FITO limit calculation in section 770-75.*

6. *The foreign capital gain amount of $15,000 in respect of which no foreign income tax was paid that was not absorbed by the capital loss cannot be included under subparagraph 770-75(4)(a)(ii) for purposes of the FITO limit calculation in section 770-75, as it is neither an amount of ordinary income nor an amount of statutory income.*

Date of effect

7. This Determination applies both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

8. It is appropriate to apply the view in this Determination retrospectively as the view has been consistently applied by the Commissioner since the commencement of the relevant provision. The Commissioner has not previously issued any publications or demonstrated any conduct that could reasonably be seen as conveying a different view of the law.[2] The view expressed in this Determination is also reflected in generally accepted industry practice.

Commissioner of Taxation
26 August 2020

[2] The Commissioner's policy on retrospective and prospective views is set out in Law Administration Practice Statement PS LA 2011/27 *Determining whether the ATO's views of the law should be applied prospectively only*.

Appendix – Explanation

This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.

9. Following the publication of this Determination as a draft for public comment, the Commissioner received a number of submissions with detailed arguments as to why the position adopted was not correct. In light of these submissions, it is necessary to explain in greater detail the reasons for the position adopted by the Commissioner.

10. The object underlying Division 770 is to provide taxpayers with a FITO that enables relief from double taxation where a taxpayer has paid foreign income tax on amounts included in assessable income and where the taxpayer would, but for Division 770, pay Australian income tax on the same amounts. The amount of the FITO is based on the foreign income tax paid that counts towards your offset, subject to the FITO limit.

11. The FITO limit is determined under section 770-75.

12. The FITO limit calculation involves a comparison between Australian tax actually payable and the Australian tax that would be payable if certain income and deductions reasonably related to that income were disregarded.

13. The income to be disregarded is set out in paragraph 770-75(4)(a) which states that assessable income does not include:

> (i) so much of any amount included in your assessable income as represents an amount in respect of which you paid *foreign income tax that counts towards the *tax offset for the year; and
>
> (ii) any other amounts of *ordinary income or *statutory income from a source other than an *Australian source …

14. Generally, the higher the amount of income captured under paragraph 770-75(4)(a), the higher the FITO limit.

15. Amounts are disregarded under subparagraph 770-75(4)(a)(ii) if they are amounts of 'ordinary income' or 'statutory income' from a 'source other than an Australian source'.

16. The Commissioner's view is that the relevant statutory income is a taxpayer's net capital gain and that a net capital gain does not have a source. Furthermore, subparagraph 770-75(4)(a)(ii) does not allow the disaggregation of a net capital gain (the singular amount of statutory income) to identify specific capital gains that have been included in working out your net capital gain. The reasons for this view are set out in paragraphs 17 to 27 of this Determination.

A net capital gain does not have a source

17. A net capital gain is calculated under specific legislative provisions that take into consideration one or more capital gains events which may result in capital gains and/or capital losses made during the income year from Australian and non-Australian sources and, where available, the application of unapplied net capital losses from earlier income years and applicable discounts.

18. Consequently, the Commissioner's view is that a net capital gain does not have a source. Further, there are no statutory provisions or case law that suggests a net capital gain can have a source.

19. The Commissioner has accepted in some contexts, such as the taxation of trusts, that an individual capital gain itself can have a source.

Subparagraph 770-75(4)(a)(ii) does not allow for disaggregation of a net capital gain to identify specific foreign sourced capital gains

20. Where foreign income tax is paid in respect of an individual capital gain, then, subject to certain criteria, the capital gain may be disregarded, in whole or in part, by subparagraph 770-75(4)(a)(i). Although the individual capital gain subject to foreign tax is in itself not included in Australian assessable income (rather, it is a net capital gain that is assessable), the drafting of subparagraph 770-75(4)(a)(i) allows a taxpayer to disregard ' …so much of any amount included in your assessable income as represents an amount in respect of which you paid *foreign income tax …'. This language quite specifically allows for tracing of the components of an amount of assessable income, such as a net capital gain, which in turn allows for specific capital gains to be disregarded under this subparagraph.

21. The drafting of subparagraph 770-75(4)(a)(ii) is notably different in that it omits the language used in subparagraph 770-75(4)(a)(i) that allows for tracing to an underlying capital gain. Subparagraph 770-75(4)(a)(ii) only allows taxpayers to disregard whole 'amounts' of statutory income, and not components of amounts of statutory income.

22. The contrast in language between subparagraphs 770-75(4)(a)(i) and (ii) evidences an intention to allow disaggregation in the case of the first subparagraph but not in the case of the second subparagraph.

23. The example included at the end of subsection 770-75(4) reinforces the difference of the language used between subparagraphs 770-75(4)(a)(i) and (ii) by demonstrating that the ability to look through to an underlying capital gain was in contemplation and an intended feature of only subparagraph 770-75(4)(a)(i). That example reads:

> If an entity has paid foreign income tax on a capital gain that comprises part of its net capital gain, only that capital gain on which foreign income tax has been paid is disregarded.

24. Although the example does not address the application of subparagraph 770-75(4)(a)(ii), its inclusion further explains the mechanism in subparagraph 770-75(4)(a)(i) allowing for disaggregation of amounts of assessable income. The Commissioner considers that, if capital gains in respect of which no foreign tax has been paid but which are foreign sourced were intended to be disregarded, the example would have either covered this scenario or made it clear that other capital gains could be disregarded. Contextually, the example provides support, albeit not definitive, for the view in this Determination, because the proposition in the example is not qualified by reference to other capital gains in respect of which foreign tax has not been paid.

25. Paragraph 1.140 of the Explanatory Memorandum to Tax Laws Amendment (2007 Measures No.4) Bill 2007 (EM) provides additional support to this view. It reads:

> In the event that a taxpayer has paid foreign income tax on a capital gain that comprises part of their net capital gain, only that capital gain on which foreign income tax has been paid will be disregarded ***[Schedule 1, item 1, subparagraph 770-75(4)(a)(i)]***. That is, the taxpayer in this situation does not disregard the entire net capital gain. This is consistent with the current treatment afforded to foreign tax paid on capital gains which form all or part of a taxpayer's net capital gain. If the disregarded amount in this example was the entire net capital gain, the proxy for the Australian tax payable would be inaccurate and in particular, the result would give rise to an increased cap…

26. The Commissioner considers that if capital gains in respect of which no foreign income tax has been paid were also intended to be disregarded, the EM would have addressed that scenario, rather than only referring to disaggregation of amounts of assessable income in subparagraph 770-75(4)(a)(i). The EM would also not have contained exhaustive language such as '… only that capital gain on which foreign income tax has been paid will be disregarded'.

27. Further, disregarding capital gains in respect of which no foreign tax has been paid would be a change in approach from the treatment under the former foreign tax credit regime. Such a change is not noted in the EM. Rather there are statements, such as in the quote in paragraph 25 of this Determination, which indicate no such change in approach.

Capital gains in respect of which foreign tax has been paid

28. For the avoidance of doubt, this Determination applies to capital gains in respect of which you have not paid any foreign income tax. You can disregard capital gains in respect of which you have paid foreign income tax under subparagraph 770-75(4)(a)(i) to the extent that the requirements of that subparagraph are met.

References

Previous draft:
TD 2019/D10

Related Rulings/Determinations:
TR 2006/10

Legislative references:
- ITAA 1997 Div 770
- ITAA 1997 770-75
- ITAA 1997 770-75(4)
- ITAA 1997 770-75(4)(a)
- ITAA 1997 770-75(4)(a)(i)
- ITAA 1997 770-75(4)(a)(ii)

Other references:
- Explanatory Memorandum to Tax Laws Amendment (2007 Measures No.4) Bill 2007
- PS LA 2011/27

ATO references
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