TR 2005/18 - Income tax: foreign loss quarantining and foreign tax credit system - taxation of Australian resident individual members of Lloyd's

Taxation Ruling

Income tax: foreign loss quarantining and foreign tax credit system – taxation of Australian resident individual members of Lloyd's

Contents Para

What this Ruling is about 1
Date of effect 4
Previous Rulings 5
Background 7
Ruling 9
Explanation 12
Detailed contents list 83

Preamble

*The number, subject heading, **What this Ruling is about** (including **Class of person/arrangement** section), **Date of effect**, and **Ruling** parts 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. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Taxation Ruling provides guidance to Australian resident individuals who are 'underwriting members' of Lloyd's (Names) who have suffered losses in respect of their participation in the Lloyd's insurance market. The Ruling explains the application of the 'foreign loss quarantining' rules. Specifically, whether section 79D of the *Income Tax Assessment Act 1936* (ITAA 1936) operates to limit the deduction of the Names' Lloyd's losses against their other domestically sourced assessable income.

2. The Ruling also clarifies the operation of the foreign tax credit system as it interacts with the foreign loss quarantining rules in respect of the Names' Lloyd's activities.

Class of person/arrangement

3. The class of persons/arrangements to which this Ruling applies are Australian resident individuals who have been or are participating as a Name in the Lloyd's insurance market.

Date of effect

4. This Ruling applies from 28 Febuary 2003. However, the Ruling 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 issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Previous Rulings

5. The following Rulings in respect of the taxation of Australian resident members of Lloyd's were withdrawn effective from 28 February 2003, namely: IT 2610; IT 2638; TR 93/5; and TR 93/41. TR 94/31 is withdrawn effective 2 November 2005.

6. Relevantly, IT 2610 ruled at paragraph 12 that a Name's Lloyd's losses would:

> be subject to foreign loss quarantining under former subsection 51(6) or subsection 79D of the *Income Tax Assessment Act 1936* (the Assessment Act), so as to be carried forward for offset against Lloyd's business income of later years of income pursuant to section 160AFD.

Background

7. Subsequent to the withdrawal of the previous rulings the Commissioner has reviewed the application of the foreign loss quarantining rules in relation to the Names' Lloyd's losses.[1]

Glossary of terms used in this Ruling[2]

8. This Ruling uses a number of terms that are specific to the arrangements pertaining to the Lloyd's insurance market and are described as follows:

(a) Underwriting members

An individual wishing to underwrite insurance through Lloyd's must first be admitted as an underwriting member of the Society of Lloyd's. Secondly, the Name must join an underwriting syndicate. Underwriting members accept insurance business (risk) through syndicates for their own profit or loss. Each Name is severally liable for their portion of the risk assumed by the syndicate. That is, the Names are not jointly responsible for the losses of other members of the syndicate. The membership of Lloyd's is currently made up of individuals, companies and Scottish Limited Partnerships. This Ruling only considers tax consequences relating to Australian resident individuals.

[1] There had been an application by a Name that was before the Administrative Appeals Tribunal which was settled before the matter proceeded to a hearing. Therefore the Administrative Appeals Tribunal did not review the merits of the application and as a consequence the finalisation of that case is non precedential.

[2] Factual material, other than specifically referenced in this Ruling is based on information provided directly by Lloyd's and/or obtained via their website, <http://www.Lloyds.com>.

(b) Underwriting syndicates

There are a substantial number of syndicates, some specialising in a particular type or class of insurance. Syndicates operate as independent business units within the Lloyd's market and are run by Managing Agents, who appoint the underwriting team which accept risk and underwrite insurance on behalf of the Names.

(c) Capacity and Auctions

Having been a member of a syndicate in a particular year, a Name has the right to remain a member of that syndicate for the following year. Before the start of each calendar year, Lloyd's hold auctions at which syndicate capacity is bought and sold. Names can sell all or part of their rights to underwrite in that syndicate at the auctions. All Names have the opportunity to acquire the right to be a member of any syndicate, where there is capacity available at the auctions.

This Ruling does not deal with the capital gains or income tax implications for Names who dispose of their capacity at auction.

(d) Managing Agents

Syndicates are run by Managing Agents who are given a franchise to operate within the Lloyd's market. Section 12 of the *Lloyd's Act 1982* (UK) refers to Managing Agents as follows:

(a) 'managing agent' shall mean a person who is permitted by the Council [of Lloyd's] in the conduct of his business as an underwriting agent to perform for an underwriting member one or more of the following functions:

  (i) underwriting contracts of insurance at Lloyd's;

  (ii) reinsuring such contracts in whole or in part; and

  (iii) paying claims on such contracts.

(e) Members' Agents

Members' Agents advise Names on their underwriting commitments including the choice of syndicate through which the Names will conduct their insurance business, place names on the syndicates chosen by them, and provide general advice. The Lloyd's rules require that all Names must appoint a Member's Agent. Member's Agents provide a link between the Name and their insurance syndicates.

(f) Funds at Lloyds

Each Name is required to provide capital as security to support their total Lloyd's underwriting business. This is known as 'Funds at Lloyd's'. The level of funds at Lloyd's determines the amount of insurance business a Name can underwrite. Names must have a Premiums Trust Fund.

This Ruling does not deal with the income credited to or arising from, the Name's trust funds which may jointly comprise the Names Funds at Lloyd's. That is, the Lloyd's deposit and Personal Reserve Funds (also know as Ancillary Trust Funds for the purposes of UK taxation) or Special Reserve Fund.

(g) Premiums Trust Fund

Each Name must execute a Lloyd's Premiums Trust Deed. All premiums and associated investment income received by the Managing Agent on behalf of the Name must be held on trust. Reinsurance premiums, claims and syndicate expenses are paid from the Name's Premiums Trust Fund by the Managing Agent on the Name's behalf.

This Ruling does not deal with the income credited to or arising from, the Name's Premiums Trust Fund.

Ruling

Losses are subject to foreign loss quarantining rules

9. To the extent that the Names derive assessable income from carrying on business at the Lloyd's insurance market, that income will have a foreign source for Australian tax purposes (refer paragraphs 49 to 77).

10. A loss from carrying on business at Lloyd's in respect of a Lloyd's year of account will be subject to foreign loss quarantining under section 79D of the ITAA 1936. These losses can be carried forward for offset against future Lloyd's business income or other assessable foreign income of the same class pursuant to section 160AFD. The effect of these provisions is that foreign losses from carrying on business at Lloyd's are not deductible against domestic source income (refer paragraphs 38 to 48).

Foreign tax credits

11. The Names will be entitled to a foreign tax credit for foreign tax paid in respect of income derived from carrying on business at Lloyd's subject to the Foreign Tax Credit rules contained at Division 18 of Part III of the ITAA 1936 (refer paragraphs 78 to 82).

Note: In the 2005 Federal Budget, it was announced that:

> The Government will simplify the foreign source income tax rules by removing foreign loss and foreign tax credit quarantining. The measure will allow foreign losses to be deducted from domestic income and will eliminate the need for foreign tax credits and revenue losses of controlled foreign companies to be quarantined into separate classes.
>
> …
>
> These changes will apply to the income years beginning on or after Royal Assent of the enabling legislation.[3]

This Ruling only deals with the law as presently enacted[4] and does not extend to the proposed changes (as above).

Explanation

12. This Ruling deals with the following taxation issues in respect of the Names' participation in the Lloyd's insurance market:

- the nature of the Names' business;
- whether the foreign loss quarantining provisions apply to limit the Names' allowable deductions;
- whether the Names' Lloyd's income has a foreign source;
- the application of the Australia – United Kingdom Double Tax Convention in relation to source; and
- the application of the Foreign Tax Credit System.

The nature of the Names' business

13. The Names conduct their Lloyd's insurance activities through a complex structure and set of arrangements which have evolved from the late 17th century. In order to understand the nature of these activities it is necessary to understand the operation of the Lloyd's insurance market and the contractual arrangements which form the basis of the relationships and legal obligations of the parties.

---

[3] Budget Paper No. 2 Part 1: Revenue Measures Treasury. For further detail see the Treasurer's Press Release of 10 May 2005, No. 44.
[4] As at the date this Ruling issued.

14. The Society of Lloyd's is a statutory corporation, incorporated under UK legislation. The Society of Lloyd's itself is not permitted to underwrite insurance business. Lloyd's as it is commonly referred to, is a unique insurance market-place comprised of a society of members, both corporate and individual, who conduct their insurance business by underwriting insurance in syndicates.

15. The term market-place is not just metaphorical. The market is a physical place, the 'underwriting room' located within Lloyd's premises at Lime Street in London. The market is the place where insurance business is transacted between on the one side, Lloyd's brokers seeking insurance for their clients, and on the other hand, underwriters who accept risk on behalf of Names operating through syndicates. Lloyd's provides the venue and facilities for the syndicates and regulates the activities of participants in the market.

16. The established view of the Names' participation in the Lloyd's insurance market is that each Name conducts their own insurance underwriting business. This view is reflected in the decision of the Supreme Court of Victoria in *Commonwealth Bank of Australia v. White*[5] (White's case) where Byrne J found at paragraph 22:

> The starting point is to identify the nature of the business conducted by Lloyd's on the date of service. The evidence shows that Lloyd's is a body established under the Lloyd's Acts 1871-1982 (UK) and is charged under those statutes with the power and authority to regulate and direct the business of insurance in the Lloyd's market: Lloyd's Act 1982 s.6(1). Notwithstanding Mr White's suggestion to the contrary I am satisfied that Lloyd's itself does not engage in the business of insuring. This business is engaged in by its underwriting members, or names, who in groups or syndicates of varying sizes accept risks from proposers under policies of insurance issued on their behalf by the managing agent of the syndicate. Each syndicate member underwrites only a portion of the risk assumed by the syndicate, a line, and in the event of claim each member is severally liable for that proportion only. The managing agent also receives premiums on trust for syndicate members and invests them and settles claims. The managing agent which may act for a number of syndicates is paid a fee for these services by the syndicate members. The work performed by the managing agent is, therefore, no part of the business carried on by Lloyd's. (emphasis added)

17. The Lloyd's market is regulated under British Acts of Parliament, primarily the *Financial Services and Markets Act 2000* (UK) (FSMA) and various Lloyd's Acts from 1871 to 1982 (UK) which established the Council of Lloyd's as the governing body.

[5] [1999] 2 VR 681; [1999] VSC 262. For further judicial consideration of the nature of the Lloyd's insurance market, see also *Williams v. The Society of Lloyd's* [1994] 1 VR 274 and *P & B (Run-Off) Ltd v. Woolley* [2002] All ER (D) 89 (Feb); [2002] EWCA Civ 65; [2002] 1 All ER (comm.) 577.

18. Lloyd's adopted a franchise model in 2003. This has redefined the relationship between the Corporation of Lloyd's, the Franchisor, and the Managing Agents, the Franchisees. It recognises that Lloyd's role has changed from that of regulating to commercially managing the market.[6] Both this reform and the other changes that have been effected since the decision in *White's case* which have been directed at improving confidence in the market, have not altered the fundamental way that Lloyd's operates nor the contractual relationships between the parties involved. That is, it remains an insurance market based on agency law principles whereby Names join together in syndicates which are managed by Managing Agents to underwrite insurance on their behalf.

19. The relevant UK legislation recognises the legal foundations of the Lloyd's market and has formalised its structure. The legislation provides the rules governing the activities of the Names, including the fundamental requirement that a Name's underwriting business is carried on solely on the Name's own account.

20. Section 8 of the *Lloyd's Act 1982* (UK) describes a Name's insurance business as follows:

> (1) An underwriting member shall be a party to a contract of insurance underwritten at Lloyd's only if it is underwritten with several liability, each underwriting member for his own part and not one for another, and if the liability of each underwriting member is accepted solely for his own account.
>
> (2) An underwriting member (not himself an underwriting agent) shall underwrite contracts of insurance at Lloyd's only through an underwriting agent.
>
> (3) An underwriting member shall in the course of his underwriting business at Lloyd's accept or place business only from or through a Lloyd's broker or such other person as the Council may from time to time by byelaw permit.

21. Section 6 of the *Lloyd's Act 1982* (UK) empowers the Council of Lloyd's to make byelaws to regulate the Lloyd's insurance market in accordance with the purposes listed in Schedule 2 of the Act. Paragraph 19 of Schedule 2 of the *Lloyd's Act 1982* relevantly provides as a purpose:

> For regulating as among and between underwriting members, Lloyd's brokers, underwriting agents and any other person transacting with underwriting members the business of insurance (whether as principal or agent) or interested therein, the mode in which insurance shall be effected with underwriting members and the periods at which settlements in respect of insurances so effected shall be made.

[6] Lloyd's Review 2004 at page 16.

22. The explanatory note to the *Agency Agreements Byelaw No. 8 of 1988* outlines the purpose of the byelaw as follows:

> This byelaw prescribes the contractual terms upon which Names will appoint their underwriting agents to carry on their underwriting business at Lloyd's for the 1990 and subsequent years of account.

The Names and their agents must act in accordance with the standard agreements which are schedules to the byelaw. The standard agreements can only be varied by subsequent byelaw or with the written consent of the Council of Lloyd's.[7] Essentially, the byelaw brings about certainty in the agency law relationships between the Names (the principals) and their Members' and Managing Agents (the agents).

23. In regard to a Name's insurance underwriting business, the three standard agreements ('agency agreements') which are executed are as follows:

- the Members' Agent's Agreement (Schedule 1);
- the Agent's Agreement (Schedule 2); and
- the Managing Agent's Agreement (Schedule 3).

24. A Name must appoint a Members' Agent through which their activities at Lloyd's are conducted. Under the Members' Agent Agreement, the Members' Agent provides services in respect of the Name's business and affairs at Lloyd's.[8] Importantly, the term business is defined at Clause 1.1 of the agreement as follows:

> means the business of underwriting and related activities carried on by the Name at Lloyd's as a member of the Contracted Syndicates.

25. The Members' Agent's agreement sets out the duties, power and remuneration of the Members' Agent and the obligations of the Name.[9] The responsibilities of a Members' Agent are to:

- advise the Name on syndicate selection;
- commit a Name to involvement in a particular syndicate or syndicates as agreed between the Members' Agent and the Name;
- enter into an Agent's Agreement with a Managing Agent of the syndicates that the Name is to participate in; and
- wind up a Name's business when the Name ceases to carry on underwriting.

---

[7] Paragraphs 2 to 5 of *Agency Agreements Byelaw No. 8 of 1988* refer.

[8] The recital to the agreement is in the following terms: The Name wishes to appoint the Agent to act as his members' agent in respect of all or part of his underwriting business and affairs at Lloyd's.

[9] The agreement may be terminated by either party in limited circumstances pursuant to Clause 11.

26. A Members' Agent also provides advice to the Name in respect of:

- syndicate performance;
- operation of trust funds and reserves;
- complying with the Lloyd's regulations;
- winding up the Members business; and
- taxation.

27. A Name's Members' Agent will enter into an Agent's Agreement with the Managing Agent of each syndicate that the Name participates in.[10] This agreement sets out the obligations between the two agents in respect of the Name's underwriting business. Business is defined in Clause 1.1 of the agreement as follows:

> in relation to a Name, means the business of underwriting and related activities carried on by the Name at Lloyd's and in respect of which the Managing Agent is appointed managing agent of the Name in accordance with clause 2 of this agreement.

28. Finally, a Managing Agent's Agreement is executed for each syndicate in which the Name participates. Under the agreement the Managing Agent is appointed to carry out the underwriting on behalf of the Name.[11] Underwriting is defined in Clause 1.1 of the agreement as follows:

> the business of underwriting and all related activities carried on by the Name and the other members of the Managed Syndicate at Lloyd's as members of the Managed Syndicate.

29. The Managing Agent's agreement sets out the duties, power and remuneration of the Managing Agent and the obligations of the Name.[12] Clause 5 of the Managing Agent's agreement requires that the Name must leave it exclusively to the Managing Agent to actually run the Name's business. The responsibilities of the Managing Agent include:

- conducting the underwriting business on behalf of the members of the syndicate as the Managing Agent in its sole discretion sees fit (subject to the requirements of Lloyd's);
- appointing and supervising the underwriting team;

---

[10] The recitals to the agreement include the following reference to the Names activities carried out by the agents: Such underwriting members wish to conduct underwriting business at Lloyd's as members of one or more syndicates in relation to which the Managing Agent is the managing agent and have authorised the Members' Agent on their behalf to enter into an agreement with the Managing Agent to govern the conduct of such underwriting business.

[11] The recital to the agreement is in the following terms: The Name wishes to appoint the Agent to act as his managing agent in respect of the underwriting business carried on by him as a member of a particular syndicate at Lloyd's.

[12] The agreement may be terminated by either party in limited circumstances pursuant to Clause 11.

- accepting risks on behalf of the members of the syndicate;
- entering into contracts of reinsurance on behalf of the members of the syndicate;
- collecting premiums on behalf of the members of the syndicate; and
- settling and paying claims on behalf of the members of the syndicate.

30. Managing Agents have additional responsibilities in respect of 'binding authorities'. Insurance business is also written on behalf of the Names in the UK and in other jurisdictions under binding authorities. The binding authority specifies the terms and conditions under which the cover holder is authorised to accept risks and issue documentation on behalf of the syndicate. Essentially, the cover holder acts as the agent of the Managing Agent who in turn acts on behalf of the syndicate (and the Names). Under the binding authority, the key insurance business functions such as setting underwriting policy, corporate governance, risk and asset management, continue to be carried out by the Managing Agent in the UK. Certain back office activities, such as contract processing are also carried out in the UK. As with all the insurance underwritten, the Names are entitled to the premiums from binding authority business and bear the economic cost of any claims. From the Names perspective, there is no difference between business written under binding authorities as against that written directly by the Managing Agent. That is, both types of insurance business is aggregated to arrive at the profit or loss shown in the syndicate accounts.

31. The activities carried out by the Names in Australia will comprise some, or all of those listed below. The following activities undertaken will vary between Names dependent on their individual preferences and circumstances:

- market research including an analysis of insurance trends in the global industry;
- analysis of reports and business plans of Lloyd's syndicates to evaluate the performance of the respective syndicates;
- adopting a portfolio risk approach to investment, including establishing criteria for the allocation of capital between syndicates and other activities external to the Lloyd's market;
- allocating capital, including participation in the annual capacity auctions;
- managing investments and satisfying the Lloyd's regulatory requirements;
- selection of a Members' Agent;

- instruction to, and correspondence with the Members' Agent;
- obtaining independent advice; and
- attendance at relevant meetings, briefings and participation in the Australian Association of Lloyd's Members.

32. In other cases, Names may rely solely on the advice of their Member's Agent in selecting syndicates in which they will participate.

33. It is clear from the relevant United Kingdom (UK) legislation and the contractual arrangements between the parties that it is the Names, not the Managing Agents who are the principals in the insurance underwriting business. The Managing Agents, acting in the capacity of an agent for the Names, do not accept the ultimate business risk. Further, it is settled law that a person may be carrying on a business notwithstanding that they engage others to carry out the business on their behalf.[13]

34. A Name may choose to be in several syndicates concurrently, the only limitation imposed being the total amount of premium income the Name is eligible to receive, which in turn is based on the Name's means and the value of the Name's 'Funds at Lloyd's'. A Name's Funds at Lloyd's typically comprise a Deposit held by the Corporation of Lloyd's (the administrative arm of Lloyd's), the Special Reserve Fund and the Personal Reserve Fund. The amount of funds required from Names will vary, depending on the perceived level of risk in the business which they underwrite. This is known as 'risk based capital'.

35. In determining whether a business is being carried on the courts have held that a range of indicators will be relevant.[14] Having regard to the various indicators elaborated in Taxation Ruling TR 97/11 it is considered that the Names are carrying on a business.

36. Based on the above, it is the Commissioner's view that the Names conduct an insurance underwriting business pursuant to the *Lloyd's Act 1982* by virtue of the risks being accepted (contracts of insurance) and the agency agreements executed with the Members' and Managing Agents.

37. Income derived from the carrying on of a business is ordinary income. Subsection 6-5(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) provides that the assessable income of a resident taxpayer includes ordinary income derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

---

[13] *Ferguson v. FCT* 79 ATC 4261 and *FCT v. Lau* 84 ATC 4929.

[14] Refer Taxation Ruling TR 97/11: whilst this Ruling refers specifically to primary production the general discussion as to whether a person is carrying on a business is relevant in this context.

Whether the foreign loss quarantining provisions apply to limit the Names' allowable deductions?

38. Section 8-1 of the ITAA 1997 allows a deduction for all losses and outgoings to the extent to which they are incurred in gaining or producing assessable income, except where the outgoings are of a capital, private or domestic nature, or relate to the earning of exempt income or a provision of the ITAA 1936 or ITAA 1997 prevents the deduction.

39. Subsection 8-1(2) of the ITAA 1997 provides that some provisions of the ITAA 1936 or the ITAA 1997 prevent or limit a deduction of an otherwise deductible amount. The provisions which prevent or limit an otherwise deductible amount are listed in section 12-5 of the ITAA 1997. Relevantly, included in this list is section 79D of the ITAA 1936 which deals with a limitation on deductions relating to foreign income.

40. 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.

41. In this regard, 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.

42. Furthermore, the term 'assessable foreign income' is also defined in subsection 160AFD(9) as 'foreign income'[15] 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.

43. 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.

[15] Refer Taxation Ruling TR 2005/2 for a detailed discussion in respect of the term 'foreign income'.

44. Where a taxpayer has 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 subsequently recouped by reducing future assessable foreign income of the same class. The foreign loss provisions of the ITAA 1936 are commonly referred to as the 'foreign loss quarantining rules'.

45. For the purposes of section 79D there are four classes of assessable foreign income. These are:

- interest income;
- modified passive income;
- offshore banking income; and
- all other assessable foreign income.

46. The *Income Tax Assessment Amendment (Foreign Income) Act 1992* amended subsection 160AEA(1) of the ITAA 1936 by introducing paragraph (p) in order to exclude certain amounts from the definition of passive income. This relates to amounts arising from assets necessarily held by the taxpayer in connection with an insurance business actively carried on by the taxpayer. In this regard the Explanatory Memorandum accompanying this Act stated at page 205:

> Passive income is generally quarantined separately from business income. However, certain assets may be held as an essential part of the taxpayer's insurance business. Quarantining in such cases would produce inequitable results.

47. Accordingly, to the extent that the income and gains from the syndicate's activity and the income and gains from the Premiums Trust Fund have a foreign source, they will constitute one class of income (that is, all other assessable foreign income) for the purposes of the provisions relating to the quarantining of foreign losses under sections 79D and 160AFD of the ITAA 1936.

48. It should be noted that to the extent that the relevant income has an Australian source section 79D has no application. Therefore to ascertain whether deductions are limited by section 79D (as discussed above) the source of the income in question must be determined.

Whether the Names' Lloyd's income has a foreign source?

49. As the concept of 'source' is not defined in the ITAA 1936 or ITAA 1997, general source rules as elaborated in case law must be relied upon. As discussed in paragraphs 65 to 77, the judicial source rules may be modified by Australia's tax treaties incorporated as schedules to the *International Tax Agreements Act 1953* (the Agreements Act).

50. In ascertaining the source of the Names' income it is necessary to have regard to the principles developed as relevantly applicable to their specific business activities. The Courts have repeatedly held that the source of income is a 'practical hard matter of fact' which was originally stated by Isaacs J in *Nathan v. FCT* (*Nathan's case*)[16]as follows:

> The legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical hard matter of fact.

51. While universally adopting this test, the courts have also declined to substitute their own rules for the words of the statute, as stated by Lockhart J in *Spotless Services Limited & Anor v. FC of T*:[17]

> The cases demonstrate that there is no universal or absolute rule which can be applied to determine the source of income. It is a matter of judgment and relative weight in each case to determine the various factors to be taken into account in reaching the conclusion as to source of income.

52. On appeal to the Full Federal Court,[18] Beaumont J agreed with Lockhart J's views and said:

> As has been noted, Lockhart J stated, correctly in my view, that the test to be applied in determining the source of income is to 'search for the 'real source' and to judge the question in a practical way'. As his Honour went on to say (at ATC 4409-10), it is a matter of 'judgment' and 'relative weight' in each case to determine the various factors to be taken into account in reaching this conclusion. I also, with respect, agree with his Honour's statement (at ATC 4410 – cited above) as to the relative importance, for present purposes, of the place or places where the contract was made and the money lent.

53. Whilst source is a question of facts and circumstances, relevant judicial analysis is nonetheless of assistance in determining the matter. As succinctly stated by Bowen CJ in *FCT v. Efstathakis*:[19]

> the answer is not to be found in the cases, but in the weighing of the relative importance of the various factors which the cases have shown to be relevant.

---

[16] (1918) 25 CLR 183 at 189-190.
[17] 93 ATC 4397 at 4409.
[18] *Spotless Services Limited v. FC of T* 95 ATC 4775 at 4789.
[19] 79 ATC 4256 at 4259. Affirmed by Lockhart J in *Spotless Services Ltd v. FCT* 93 ATC 4397 at 4409.

54. The Full Federal Court in *Thorpe Nominees Pty Limited v. FCT*[20] (*Thorpe's case*) adopted a substance over form approach.[21] In *Thorpe's case* the court looked through a tax minimisation scheme to find that the sale of Australian land between Australian residents had an Australian source notwithstanding that some transactions relating to the sale were effected in Switzerland. Burchett J, at page 4,897 stated:

> The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income – where it came from – as a businessman would perceive it.
>
> If the matter is approached in this way in the present case, the substantial considerations point in unison to the selection, from the elements which culminated in the income being derived, of the solid facts and circumstances existing in Australia. The legal acts performed in Switzerland were ineffective in themselves to achieve anything – they were wholly dependent for their force upon Australian lands and events, and upon the persons who conceived them in Australia and also returned to consummate them here.

55. Thus, in determining the source of the income derived by the Names it is first necessary to identify the relevant factors which need to be considered. Factors previously considered as relevant by the Courts are where the payments were made, determining whether the essence of the business is making contracts, and where the parties executed the contracts.[22] It is then necessary to weigh up the factors in order to reach a conclusion.

56. In considering which factors are likely to be the most determinative in relation to this issue the Commissioner considers that relevant guidance may be obtained from *Tariff Reinsurances Limited v. Commissioner of Taxes (Victoria)*[23] (*Tariff*). In *Tariff* the High Court considered the issue of source as it related to reinsurance premiums pursuant to the Victorian State *Income Tax Act 1928*.

57. In *Tariff* a company carrying on an insurance business in Victoria reinsured a proportion of its insurance business with a UK company carrying on the business of reinsurance in London. The Victorian company was not an agent of the UK company, nor were they involved in a joint venture partnership or income sharing arrangement. The reinsurance contract was executed in London. The London company accepted a percentage of the Victorian company's insurance risk and was entitled to an equivalent proportion from the premiums received less agreed deductions based on a number of variables. Amounts were ultimately credited to the UK's company

---

[20] 88 ATC 4886.
[21] By comparison refer to the Full Federal Court's decision in *FCT v. Spotless Services Ltd* 95 ATC 4775, which ultimately, in relation to Part IVA of the ITAA 1936, went on appeal to the High Court *FCT v. Spotless Services Ltd* 96 ATC 5201.
[22] *C of T v. Meeks* (1915) 19 CLR 568, *Premier Automatic Ticket Issuers Ltd v. FCT* (1933) 50 CLR 268, *Tariff Reinsurances Limited v. Commissioner of Taxes* (Vic) (1938) 59 CLR 194, *Commissioner of Taxation v. Cam & Sons Ltd* (1936) SR (NSW) 544, *Australian Machinery and Investment Co Ltd v. Commissioner of Taxation* 8 ATD 81*, Unisys Corporation v. FCT* [2002] NSWSC 1115 at paragraph 57.
[23] (1938) 59 CLR 194.

bank account in Melbourne less its share of any losses (claims paid). The issue before the court was whether the UK company's profits from the reinsurance accepted from the Victorian company were derived in Victoria or in the UK?

58. In separate judgments the High Court held that the source of the income was in the UK where the reinsurer carried on its business. Important findings of the High Court in reaching this conclusion were that:

- the reinsurance contract was separate to the original contract of insurance and not part of a profit share or joint venture;[24]
- the Victorian company was not an agent of the reinsurer;[25]
- the contract was entered into in London as part of the reinsurer's ordinary business conducted in London;[26] and
- the reinsurer conducted no business or carried out any activity in Victoria.[27]

59. In relation to determining the nature of the business carried on, and the contracts entered into in England, Latham CJ at page 205 stated the following:

> The English company derives its profits from its own business and not from the business carried on by the Victorian company. The business which 'yields the profits' (to use the phrase *Lovell & Christmas Ltd. v. Commissioner of Taxes*) to the English company is the business of reinsurance. In order to determine whether the profits are derived in or from Victoria it is necessary to ascertain what the taxpayer does in order to obtain the profits in question (Premier Automatic Ticket Issuers Ltd. v. Federal Commissioner of Taxation, per Dixon J.). It is not relevant to consider what another person, who is not an agent in any sense of the taxpayer, does in order to obtain moneys which he uses for the purposes of making payments to the taxpayer. In this case the English company carried on no operations or transactions in Victoria at all (see Smidth & Co. Ltd. v. Greenwood). The English company made profits, but those profits were not made by reason of anything done in Victoria by the English company.

60. Further at page 206:

> In this case the contract for reinsurance was made in England, and that fact is an important element in the determination of the question which arises. Further, the profits were derived from that contract and were not derived from the insurance operations of the Victorian company in Victoria.

[24] Latham CJ at 203, 207; and Dixon J at 215.
[25] Latham CJ at 207; and Dixon J at 215.
[26] Latham CJ at 205-206; Rich J at 209; Starke J at 211; Dixon J at 217; and McTiernan J at 218.
[27] Latham CJ at 207; Starke J at 211-212; and McTiernan J at 218.

61. Starke J considered that the substance and essence of the operations were a key factor and held at page 211:

> Every detail of the transaction must be considered: no one fact is conclusive. In my opinion in this case the real connection of the business operations is with England. It is where the substance and essence of the operations were transacted.

62. It is notable that in *Tariff* the reinsurer was not carrying on its business through agents. The Names, however, are required as an integral component of the Lloyd's structure to carry on their business through agents in the UK.

63. In this regard, the following factors have been considered in determining the source of the Names' income:

- It is the insurance activities carried on in the UK which 'yields the profits' of the Names.
- The relevant contracts at issue are those in relation to the insurance underwriting and whilst not decisive, these contracts are negotiated on behalf of the syndicates by the underwriters engaged by the Managing Agents and are concluded at Lloyd's premises in London.
- The Managing Agent receives and invests premiums, and settles claims in the UK where the insurance business takes place on behalf of the Names.
- The payment to the Names of their share of syndicate profit is merely akin to a banking transaction and in accordance with *Tariff* is not a significant factor.
- Whilst the Names may make decisions regarding whether or not to participate in respective syndicates in Australia, and may also maintain capital in Australia in respect of the insurance risks taken, this does not result in the income having a source in Australia. The Names may undertake some preparatory activities in Australia (refer paragraph 31) but the key business activities which give rise to the income are undertaken by their agents in the UK.

64. To summarise, in relation to the insurance business written directly by Managing Agents[28] the key factors take place in the UK including the making of the contracts which in the Commissioner's view is the essence of the business. Therefore, it follows that the Names' Lloyd's income has a foreign source under domestic law.

[28] Names may also have a relatively minor amount of income from insurance contracts written under binding authorities in Australia. In respect of the source of this income refer to paragraphs 76 and 77.

The application of the Australia – United Kingdom Double Taxation Convention in relation to source

65. Subsection 4(1) of the Agreements Act provides that, subject to subsection 4(2) of the Agreements Act, the ITAA 1936 and the ITAA 1997 are incorporated and should be read as one with the Agreements Act. Further, subject to limited exceptions, the provisions of the Agreements Act have effect notwithstanding anything inconsistent with the provisions of the ITAA 1936 or the ITAA 1997 (see subsection 4(2)). This means that in the case of an inconsistency between a provision in a tax treaty and a provision in either the ITAA 1936 or the ITAA 1997, the tax treaty prevails where the exceptions do not apply.

66. If the source of income is determined by a specific treaty provision, then that provision displaces the domestic law (even if in a particular case it happens to end up with the same result on the facts). If a tax treaty does not provide a source rule that applies to the situation in question, source continues to be determined under domestic law.

67. Australia's current tax treaty with the UK which entered into force on 17 December 2003 is in Schedule 1 of the Agreements Act.[29] For ease of reference the current treaty will be referred to as 'the current UK treaty'. The previous treaty will be referred to as 'the former UK treaty'.

68. This Ruling does not deal with the issue of whether the Names have a permanent establishment in the UK. Notwithstanding, the UK asserts a source country taxing right to tax the Names' Lloyd's income on the basis that the Names have a permanent establishment in the UK.[30]

69. The former UK treaty provided a specific source rule that was relevant where an Australian resident had a permanent establishment (as defined in the treaty) in the UK and derived industrial or commercial profits attributable to that permanent establishment. Relevantly, Article 5(3) concluded as follows:

> and the profits so attributed shall be deemed to be income derived from sources in that other territory.

70. For the reasons given in Taxation Ruling TR 2001/11,[31] the term 'profits' in the business profits article is to be interpreted to extend to the calculation of losses resulting in Article 5(3) being relevant for determining source in this context. Therefore if an Australian resident Name had a permanent establishment in the UK under the former UK treaty, any assessable income of the Name attributable to that permanent establishment would have been sourced in the UK for the purposes of the application of section 79D of the ITAA 1936. Conversely, if an Australian resident Name did not have a permanent establishment in the UK under the former

---

[29] Received Royal Assent 5 December 2003: it replaced Schedule 1 – UK Agreement (as amended by Schedule 1A – the United Kingdom Protocol).
[30] As a consequence of this position, a foreign tax credit for UK tax paid by the Names against their Australian tax payable has not been denied.
[31] TR 2001/11 paragraphs 3.46-3.52 refer.

UK treaty, the source rule in Article 5(3) was not operative and consequently the judicial source rules applied in accordance with domestic law.

71. However the current UK treaty contains sources rules only at Articles 21 and 22. Article 21 applies to confer a source in Australia where income is derived by a UK resident which may be taxed under the treaty in Australia. The source rule in Article 22(3) relevantly applies for paragraphs (1) and (2) of Article 22 which operate to eliminate double taxation by means of the foreign tax credit system.

72. The *Taxation Laws Amendment (Foreign Tax Credits) Act 1986* inserted a replacement for the then existing double taxation relief arrangements with a general foreign tax credit system, including the foreign loss quarantining rules. The foreign loss quarantining rules are an integral part and a major design feature of the foreign tax credit system.[32] In this regard, the explanatory memorandum that accompanied *Taxation Laws Amendment (Foreign Tax Credits) Act 1986* states:

> The major design features of the proposed foreign tax credit system are discussed briefly below. ….
>
> **Foreign losses**
>
> Where a taxpayer has incurred a loss from a foreign source it will be carried forward for a maximum period of 7 years and set off against any future income from the same foreign source. Only the resulting net amount of that income will be taken into account as assessable income for Australian tax purposes in the later year (page 11).

73. The foreign loss quarantining rules are not only a major design feature of the foreign tax credit system but also directly impact upon the amount of credit which may be available to a taxpayer. Therefore the foreign loss quarantining rules cannot be separated from the provisions that actually provide the credit.

74. Further, the Explanatory Memorandum[33] to the current treaty states at paragraph 1.237:

> This provision is variously included in Article 21 (*Source of income*) or Article 22 (*Elimination of double taxation*) of Australia's tax treaties and has the operative effect of ensuring that where an item of income or gain is taxable in both countries, double taxation relief will be given by the recipient's country of residence in accordance with paragraphs 1 and 2 of this Article. In this way, income or gains derived by a resident of Australia, which is taxable by the United Kingdom under this treaty, will be treated as being foreign income for the purposes of the ITAA 1936 and the ITAA 1997, including the foreign tax credit provisions of the ITAA 1936. (emphasis added)

---

[32] See also the Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990 page 15, and RL Hamilton, RL Deutsch & JC Raneri, *Australian International Taxation*, Butterworths, Loose Leaf edition Oct. 2002, para. 3-290 that describe the foreign loss quarantining provisions as a feature or a significant feature of the foreign tax credits system.

[33] Explanatory Memorandum accompanying the International Tax Agreement Amendment Bill 2003.

75. Therefore despite the absence of the direct reference in the current treaty to domestic law, the policy intent remains unchanged from the former treaty and that the words used are intended to be interpreted in that context. Accordingly any assessable income of a Name, attributable to their permanent establishment, will have a source in the UK for the purposes of the application of section 79D of the ITAA 1936 pursuant to both the former and current UK tax treaties.[34]

76. The question has been raised as to whether insurance written under binding authorities (refer paragraph 30) could have a source other than in the UK? From a domestic tax perspective, the question could only be relevant in respect of insurance accepted in Australia under a binding authority. That is, for insurance accepted under binding authorities in other countries, if the source of the income was not in the UK, it would continue to have a foreign source for Australian tax purposes. Nevertheless, in practice the question will not arise because the income would be attributable to a Name's permanent establishment in the UK and therefore be deemed to have a source in the UK pursuant to the operation of both the former and current UK tax treaties.

77. As discussed at paragraphs 49 to 64, the Commissioner has concluded that the Names' Lloyd's income written directly by Managing Agents has a foreign source under the judicial rules for domestic law purposes. Furthermore pursuant to the UK tax treaties, a Name's Lloyd's income that is attributable to a permanent establishment in the UK would be deemed to have a source in the UK. It follows that the foreign loss quarantining rules will apply in respect of any Lloyd's losses incurred by the Names (as explained in paragraphs 38 to 48).

The application of the Foreign Tax Credit System

78. Section 160AF of the ITAA 1936 provides a credit for foreign tax[35] paid that a taxpayer was personally liable for in respect of foreign income, or certain profits or gains which are included in the taxpayer's assessable income to the extent to which those profits or gains are taxed in Australia. The taxpayer will generally be entitled to a credit which is the lesser of the amount of foreign tax paid or the Australian tax payable in respect of that income, profit or gain.

79. A Name's Lloyd's income will constitute foreign income as a consequence of the above conclusion as to the source of the income (refer paragraphs 65 to 77) in conjunction with the application of subsection 6AB(1) of the ITAA 1936 (refer paragraph 42).

---

[34] There is an alternative view that the foreign loss quarantining rules do not form part of the foreign tax credit system. It follows under the alternative view, that the current UK treaty would not deem income, which has a source in Australia under the Australian judicial rules and in respect of which the UK has a taxing right, to have a UK source and hence a foreign source for the purposes of section 79D.

[35] Foreign tax is defined in section 6AB(2) of the ITAA 1936.

80. It is necessary to separate the foreign income into the following classes for the purpose of calculating foreign tax credits:

- passive income;
- offshore banking income;
- an assessable amount pursuant to section 27CAA of the ITAA 1936; and
- other income.

81. To the extent an Australian resident Name derives assessable income from carrying on business at the Lloyd's insurance market, it will fall within the class of 'other income'. Such income is excluded from passive income pursuant to paragraph 160AEA(1)(p) as discussed at paragraphs 45 to 47.

82. Section 160AFE of ITAA 1936 allows excess foreign tax credits, not claimed in a particular year, to be carried forward for a maximum period of five years.

Detailed contents list

83. Below is a detailed contents list for this Taxation Ruling:

	Paragraph
What this Ruling is about	**1**
Class of person/arrangement	3
Date of effect	**4**
Previous Rulings	**5**
Background	**7**
Glossary of terms used in this Ruling	8
Ruling	**9**
Losses are subject to foreign loss quarantining rules	9
Foreign tax credits	11
Explanation	**12**
The nature of the Names' business	13
Whether the foreign loss quarantining provisions apply to limit the Names' allowable deductions?	38
Whether the Names' Lloyd's income has a foreign source?	49
The application of the Australia – United Kingdom Double Taxation Convention in relation to source	65
The application of the Foreign Tax Credit System	78
Detailed contents list	**83**

Commissioner of Taxation
2 November 2005

Previous draft:
TR 2005/D10

Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 97/11; TR 97/16; TR 2001/11; TR 2005/2

Previous Rulings/Determinations:
IT 2610; IT 2638; TR 93/5; TR 93/41; TR 94/31

Subject references:
- foreign income
- foreign losses
- foreign tax credits
- quarantining of foreign losses

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1936 6AB
- ITAA 1936 6AB(1)
- ITAA 1936 6AB(2)
- ITAA 1936 27CAA
- ITAA 1936 51(6)
- ITAA 1936 79D
- ITAA 1936 Pt III Div 18
- ITAA 1936 160AEA(1)
- ITAA 1936 160AEA(1)(p)
- ITAA 1936 160AF
- ITAA 1936 160AFD
- ITAA 1936 160AFD(9)
- ITAA 1936 160AFE
- ITAA 1936 Pt IVA
- ITAA 1997 6-5(2)
- ITAA 1997 8-1
- ITAA 1997 8-1(2)
- ITAA 1997 12-5
- Income Tax Assessment Amendment (Foreign Income) Act 1992
- International Tax Agreements Act 1953
- International Tax Agreements Act 1953 4(1)
- International Tax Agreements Act 1953 4(2)
- International Tax Agreements Act 1953 Sch 1
- International Tax Agreements Act 1953 Sch 1A
- Taxation Laws Amendment (Foreign Tax Credits) Act 1986
- Income Tax Act 1928 (Vic)
- Lloyd's Acts 1871-1982 (UK)
- Lloyd's Act 1982 (UK) 6
- Lloyd's Act 1982 (UK) 6(1)
- Lloyd's Act 1982 (UK) 8
- Lloyd's Act 1982 (UK) 12
- Lloyd's Act 1982 (UK) Sch 2
- Financial Services and Markets Act 2000 (UK)

Case references:
- Australian Machinery and Investment Co Ltd v. Commissioner of Taxation 8 ATD 81; 180 CLR 9
- C of T v. Meeks (1915) 19 CLR 568; 21 ALR 244
- Commissioner of Taxation v. Cam & Sons Ltd (1936) SR (NSW) 544; (1936) 4 ATD 32
- Commonwealth Bank of Australia v. White [1999] 2 VR 681; [1999] VSC 262
- FCT v. Efstathakis 79 ATC 4256; 9 ATR 867
- FCT v. Lau 84 ATC 4929; 16 ATR 55
- FCT v. Spotless Services Ltd 95 ATC 4775; 32 ATR 309
- FCT v. Spotless Services Ltd 96 ATC 5201; 34 ATR 183; 186 CLR 404
- Ferguson v. FCT 79 ATC 4261; 9 ATR 873; 37 FLR 310
- Nathan v. FCT (1918) 25 CLR 183
- P & B (Run-Off) Ltd v. Woolley [2002] All ER (D) 89 (Feb); [2002] EWCA Civ 65; [2002] 1 All ER (comm.) 577
- Premier Automatic Ticket Issuers Ltd v. FCT (1933) 50 CLR 268
- Spotless Services Ltd v. FCT 93 ATC 4397; 25 ATR 344
- Spotless Services Limited v. FC of T 95 ATC 4775; 32 ATR 309

- Tariff Reinsurances Limited v. Commissioner of Taxes (Vic) (1938) 59 CLR 194
- Thorpe Nominees Pty Limited v. FCT 88 ATC 4886; 19 ATR 1834
- Unisys Corporation v. FCT [2002] NSWSC 1115; 2002 ATC 5146; 51 ATR 386
- Williams v. The Society of Lloyd's [1994] 1 VR 274

Other references:

- Agency Agreement Byelaw No. 8 of 1988, 7 December 1988
- Australian International Taxation, Butterworths, Loose Leaf edition Oct 2002
- Budget Paper No. 2 Part 1: Revenue Measures Treasury
- Explanatory Memorandum to the Income Tax Assessment Amendment (Foreign Income) Bill 1992
- Explanatory Memorandum to the International Tax Agreement Amendment Bill 2003
- Explanatory Memorandum to the Taxation Laws Amendment (Foreign Income) Bill 1990
- Lloyd's Review 2004
- Lloyd's <http://www.Lloyds.com>
- Treasurer's Press Release of 10 May 2005, No. 44

ATO references

NO:	2004/10226
ISSN:	1039-0731
ATOlaw topic:	Income Tax ~~ Tax offsets, credits and benefits ~~ foreign tax credits Income Tax ~~ Assessable income ~~ business and professional income - foreign sourced