TR 2009/6 - Income tax: entitlement to foreign income tax offsets under section 770-10 of the Income Tax Assessment Act 1997 where income is derived from investing in fiscally transparent foreign entities

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Taxation Ruling

Income tax: entitlement to foreign income tax offsets under section 770-10 of the *Income Tax Assessment Act 1997* where income is derived from investing in fiscally transparent foreign entities

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What this Ruling is about

1. This Ruling is concerned with the application of Division 770 of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] (foreign income tax offsets) in circumstances where an Australian resident taxpayer invests in a fiscally transparent foreign entity. In particular, this Ruling deals with:

- the entitlement of a resident taxpayer to claim a foreign income tax offset (often referred to as a 'FITO') under section 770-10 for foreign income tax imposed on the income of a fiscally transparent foreign entity in which the taxpayer holds an interest, depending on whether Division 830 applies to the foreign entity;

[1] All legislative references are to the ITAA 1997 unless otherwise indicated.

- the entitlement of a resident taxpayer to claim a foreign income tax offset for foreign income tax imposed on the notional assessable income of a controlled foreign company (CFC) where the resident taxpayer invests indirectly in the CFC through a foreign hybrid which is treated as an interest in a partnership pursuant to Division 830; and
- whether the entitlement to claim a foreign income tax offset under section 770-10 in the circumstances outlined above will be affected by the operation of Australia's tax treaties.

2. This Ruling applies to taxpayers who have an interest in a fiscally transparent foreign entity as defined at paragraphs 5 and 6 of this Ruling.

3. This Ruling does not deal with taxpayers in relation to their:

- income which is non-assessable non-exempt (NANE) income pursuant to section 23AH of the *Income Tax Assessment Act 1936* (ITAA 1936); or
- income which is NANE income pursuant to section 23AJ of the ITAA 1936.

Definitions

Australian income tax law

4. Australian income tax law means the ITAA 1936, the ITAA 1997, Schedule 1 to the *Taxation Administration Act 1953* (TAA) and Part IVC of the TAA to the extent that it relates to the aforementioned Acts.

Fiscally transparent foreign entity

5. A foreign entity is fiscally transparent if no foreign income tax is imposed on its income, either by effect of application of the laws of a foreign country or because of an election, but rather tax is imposed on such income at the level of the partner or member.

6. For the purposes of this Ruling an interest in a fiscally transparent foreign entity means:

- an interest in a foreign hybrid; or
- an interest in an entity which would be treated as a foreign hybrid but for the fact that it does not satisfy paragraph 830-10(1)(e) (if the entity is a limited partnership) or paragraph 830-15(1)(d) of the ITAA 1997 (if the entity is a company) and no election has been made to treat the interest as an interest in a foreign hybrid under subsections 830-10(2) or

830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936.

Foreign hybrid

7. A foreign hybrid is an entity that is either a foreign hybrid limited partnership or a foreign hybrid company for the purposes of Division 830.

Foreign hybrid company

8. A foreign hybrid company means a company formed in a foreign country that satisfies the requirements in subsection 830-15(1). An interest in a foreign hybrid company also includes an interest in respect of which a taxpayer has made an election under subsection 830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936.

Foreign hybrid limited partnership

9. A foreign hybrid limited partnership means a limited partnership formed in a foreign country that satisfies the requirements in subsection 830-10(1). An interest in a foreign hybrid limited partnership also includes an interest in respect of which a taxpayer has made an election under subsection 830-10(2) of the ITAA 1997 or former section 485AA of the ITAA 1936.

Foreign income tax

10. Foreign income tax means taxes imposed under a foreign law in accordance with section 770-15.

Ruling

Foreign income tax imposed on a taxpayer's share of income of a foreign hybrid

The resident taxpayer pays the foreign income tax – offset allowed

11. A resident taxpayer whose assessable income includes, under section 92 of the ITAA 1936, a share of the net income of a foreign hybrid is entitled to a foreign income tax offset under subsection 770-10(1) of the ITAA 1997 for foreign income tax the taxpayer paid under the law of a foreign country in respect of that income.

The foreign hybrid, or some other entity, pays the foreign income tax – offset allowed

12. If, rather than the resident taxpayer, the foreign hybrid or some other entity pays foreign income tax in respect of that income (being income included under section 92 of the ITAA 1936) under the law of a foreign country, the resident taxpayer is treated (under section 770-130 of the ITAA 1997) as if it had paid the foreign income tax for Australian income tax law purposes. Accordingly, the resident taxpayer is entitled to a foreign income tax offset under subsection 770-10(1) for that foreign income tax paid. (See explanation at paragraphs 65 to 76 of this Ruling.)

Foreign income tax imposed on a taxpayer's share of income of a fiscally transparent foreign entity that is not a foreign hybrid

Foreign income tax paid on dividends and distributions from the foreign entity – offset allowed

13. A resident taxpayer that has an interest in a fiscally transparent foreign entity that is not a foreign hybrid is entitled to a foreign income tax offset under subsections 770-10(1) or 770-10(2) for foreign income tax imposed on a dividend or distribution from the foreign entity. This entitlement is only to the extent that the foreign income tax is paid in respect of so much of that dividend or distribution as is either:

- included in the taxpayer's assessable income; or
- NANE income of the taxpayer under section 23AK of the ITAA 1936.

(See explanation at paragraphs 80 to 86 of this Ruling.)

14. [Omitted.]

Foreign income tax imposed on amounts included in the notional income of a CFC or a (former) Foreign Investment Fund (FIF) in which a foreign hybrid has an interest

CFCs – no offset allowed

15. A resident taxpayer may have an interest in a foreign hybrid that, in turn, has an interest in a CFC. In these cases, the resident taxpayer is not entitled to a foreign income tax offset for foreign income tax paid by the CFC in respect of amounts included in the CFC's notional assessable income.

16. This is because, under Division 830, a foreign hybrid is not a company for Australian tax purposes. Only an attributable taxpayer that is a company can satisfy paragraph 770-135(2)(a). Therefore, the resident taxpayer cannot be treated as having paid the foreign income tax. (See explanation at paragraphs 97 to 105 of this Ruling.)

17. [Omitted.]

18. [Omitted.]

19. [Omitted.]

CFCs and former FIFs – distributions to a foreign hybrid

20. Paragraphs 20 to 22 of this Ruling apply to a resident taxpayer that has an interest in a foreign hybrid that, in turn, has an interest in a CFC or a former FIF.

21. If foreign income tax is imposed on distributions the CFC or former FIF makes to the foreign hybrid, then the resident taxpayer is entitled to a foreign income tax offset.

22. The offset is allowed to the extent that the foreign income tax is paid in respect of the taxpayer's share of so much of the foreign hybrid's net income as represents the distribution, where the taxpayer's share is either assessable income or NANE income under sections 23AI or 23AK of the ITAA 1936. (See explanation at paragraphs 113 to 121 of this Ruling.)

The impact of Australia's tax treaties on the availability of foreign income tax offsets

23. Paragraphs 23 to 26 of this Ruling apply in the case of foreign tax being paid in countries with which Australia has a tax treaty.

24. A difference in treatment of income as between the State of source and Australia may arise because of differences between the countries' respective domestic tax laws. For example, the foreign entity may be treated as fiscally transparent under the law of the other State but as a company taxed in its own right under Australian tax law (that is, if it is not a foreign hybrid under Division 830).

25. In these cases, provided that the other State has taxed such income in accordance with the tax treaty, as interpreted and applied by it as the State of source, such tax is foreign income tax for the purposes of section 770-15. A foreign income tax offset may therefore be available under section 770-10.

26. However, if the foreign country imposes income tax in a manner other than in accordance with the tax treaty, relief under Australian income tax law from this category of double taxation (that is under Division 770) is only available to the extent consistent with the treaty. Accordingly, relief from this particular category of double taxation may only be obtained by seeking a refund of the foreign income tax from the foreign country. (See explanation at paragraphs 122 to 128 of this Ruling.)

Limit on the amount of the offset

27. If, in the above cases, a taxpayer is entitled to a foreign income tax offset, the amount of the foreign income tax offset is subject to the foreign income tax offset limit calculated in accordance with sections 770-75 and 770-80.

Examples

Example 1 – limited liability company a foreign hybrid

28. YZ LLC (YZ), a limited liability company formed in a foreign country that meets the requirements of subsection 830-15(1), derives $100,000 income from real property investments during the 2010-11 income year and incurs expenses of $20,000 in earning that income. A.B. See (AB), an Australian resident individual, is a shareholder in YZ with a membership interest of 50%.

29. Under the laws of YZ's country of residence, YZ is taxed as a partnership and is required to withhold tax of 30% from net real property income to which foreign resident shareholders are entitled, whether or not such income is distributed. YZ withholds and remits $12,000 of foreign income tax in respect of AB's share of the net real property investment income.

30. Under Division 830, YZ is treated as a partnership for Australian income tax law purposes. Therefore, for the 2008-09 income year, AB is treated as a partner in YZ and his assessable income will include his share of the net income of YZ.

YZ LLC		**A.B. See (2010-11 income year)**	
Gross real property investment income	$100,000		
Deductible expenses	$20,000		
Net income (section 90 ITAA 1936)	$80,000	50% share of net income (section 92 ITAA 1936)	$40,000
AB See's share of net real property investment income	$40,000		
Foreign income tax withheld at 30% (0.30 x $40,000)	$12,000	Foreign income tax paid in respect of amount included in assessable income (section 770-10)	$12,000

31. AB is potentially subject to double taxation, as the amount in respect of which the foreign income tax has been paid is included in his assessable income. AB is taken to have paid that foreign income tax under section 770-130 and will be entitled to a foreign income tax offset for the 2010-11 income year for the $12,000 foreign income tax

withheld by YZ, subject to AB's foreign income tax offset limit calculated under section 770-75.[2]

Example 2 – limited liability company not a foreign hybrid

32. Assume the same facts as in Example 1, except that AB's membership interest in YZ is 10% and the remaining 90% interests are held by unrelated foreign residents. YZ therefore does not meet the requirements of paragraph 815-15(1)(d). In addition AB has not elected to treat his interest in YZ as an interest in a foreign hybrid under subsection 830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936.

33. YZ withholds and remits $2,400 of foreign income tax in respect of AB's share of the net real property investment income (30% x (10% x $80,000)).

34. YZ is treated as a company for Australian income tax law purposes. YZ does not pay any dividends to AB during the income year.

YZ LLC		**A.B. See (2010-11 income year)**	
Gross real property investment income	$100,000		
Deductible expenses	$20,000		
Net income	$80,000	Amount included in assessable income (no distribution)	$0
AB See's share of net real property investment income	$8,000		
Foreign income tax withheld at 30% (0.30 x $8,000)	$2,400	Foreign income tax paid in respect of amount included in assessable income (section 770-10)	$0

35. As YZ has not paid a dividend to AB in the 2010-11 income year, AB's assessable income for that year does not include an amount in respect of which foreign income tax has been paid. Therefore AB is not entitled to a foreign income tax offset during the 2010-11 income year.

[2] The same foreign income tax offset result would occur if, instead of the foreign income tax being withheld by YZ, the tax on the relevant income was withheld by a third party. For example, if the income derived through YZ is interest income upon which the payer (a financial institution) is obliged to withhold tax, such tax would be treated as having been paid by AB (through the operation of section 770-130) in respect of its share of the partnership net income that is included in its assessable income.

[3] Omitted.

Example 3 – distribution by limited liability company that is not a foreign hybrid

36. Assume the same facts as in Example 2. In the following year, that is the 2011-12 income year, YZ distributes AB's share of the net rental income to AB.

37. AB receives a dividend for the purposes of section 44 of the ITAA 1936. AB's assessable income for the 2011-12 income year therefore includes $8,000 (the amount of the dividend grossed up to include the foreign income tax withheld).

YZ LLC		**AB See (2011-12 income year)**	
Net profits for distribution	$80,000		
10% of net profits distributable to AB See	$8,000	Amount included in assessable income (sections 44 ITAA 1936 and 6-10 ITAA 1997)	$8,000
*Less f*oreign income tax withheld at 30% in 2008-09 income year	$2,400		
Amount paid upon distribution	$5,600	Foreign income tax paid in respect of amount included in assessable income (section 770-10)	$2,400

38. The distribution was paid to AB during the 2011-12 income year out of income in respect of which YZ withheld foreign income tax during the 2010-11 income year. Therefore, the foreign income tax in the 2010-11 income year is taken to have been paid by AB in respect of the amount included in his assessable income in the 2011-12 income year. Accordingly, AB is entitled to claim a foreign income tax offset in that income year for the $2,400 tax withheld by YZ, subject to AB's foreign income tax offset limit for that year calculated under section 770-75.

39. [Omitted.]

40. [Omitted.]

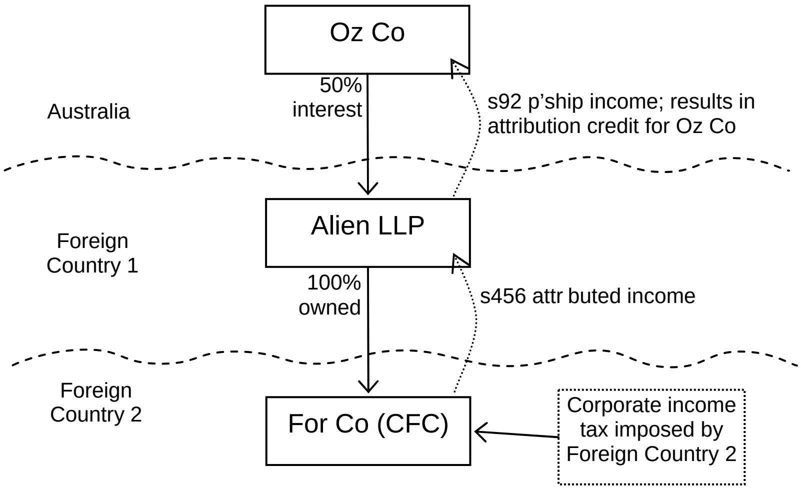
41. [Omitted.]

[4] [Omitted.]
[5] [Omitted.]

Example 5 – foreign hybrid invests in foreign company

42. Oz Co Pty Ltd, an Australian resident company, has a 50% interest in Alien LLP (Alien), a foreign hybrid limited partnership formed in Foreign Country 1. Alien in turn wholly owns For Co, a company that is resident in Foreign Country 2. For Co is a Controlled Foreign Company (CFC) for Australian tax purposes.

43. During the income year, For Co pays income tax under the laws of Foreign Country 2.

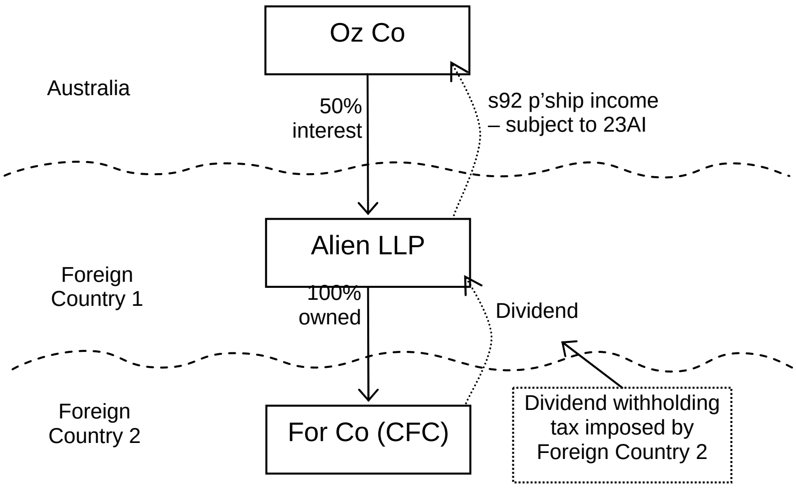


44. As Alien is treated as a partnership for Australian income tax law purposes, Oz Co's assessable income will include its share of the net income of Alien, calculated as if Alien was an Australian resident.

45. As For Co is a CFC and Alien is an attributable taxpayer by virtue of it being an Australian partnership for the purposes of Part X of the ITAA 1936, Alien's net partnership income includes attributed income under section 456 of the ITAA 1936. In calculating For Co's attributable income a notional allowable deduction is allowed for the foreign income tax paid. However, the foreign income tax paid by For Co does not count towards Oz Co's foreign income tax offset for the relevant income year, as Oz Co is not treated, pursuant to section 770-135 of the ITAA 1997, as having paid the foreign income tax for the purposes of subsection 770-10(1) of the ITAA 1997.

Example 6 – foreign hybrid receives dividend from foreign company

46. Assume the same facts as in Example 5, except that in the following income year For Co pays a dividend to Alien. Foreign Country 2 imposes withholding tax on the dividend.



47. As Alien is treated as a partnership for Australian income tax law purposes, Oz Co's assessable income would normally include its share of the net income of Alien, including the dividend payment from For Co. However, as a result of the earlier attribution of income from For Co to Alien (in Example 5) and the individual interest of Oz Co in the partnership net income of Alien, an attribution account credit exists for For Co in relation to Oz Co.

48. The share of the net income of Alien that would otherwise be included in Oz Co's assessable income will therefore be NANE income pursuant to section 23AI of the ITAA 1936 to the extent of the attribution account debit. Although Oz Co did not directly pay the foreign income tax withheld from the dividend payment made from For Co to Alien, it is taken, by virtue of section 770-130 of the ITAA 1997, to have paid the relevant tax in respect of the NANE income under section 23AI of the ITAA 1936. Oz Co will therefore be entitled to a foreign income tax offset pursuant to subsection 770-10(2) for the foreign income tax withheld from the dividend payment to the extent that the tax has been paid in respect of Oz Co's NANE income.

Example 7 – Application of a tax treaty

49. Hank LP (Hank) is a limited partnership formed in the United States. Fozzie Pty Ltd is an Australian resident company with a membership interest in Hank of 10% (with the remaining 90% interests being held by unrelated foreign residents). Hank does not meet the requirements of paragraph 830-10(1)(e) of the ITAA 1997, and Fozzie Pty Ltd has not made an election under subsection 830-10(2) of the ITAA 1997 or former section 485AA of

the ITAA 1936 to treat its interest in Hank as an interest in a foreign hybrid.

50. During the 2010-11 income year, Hank derives $1,000,000 of interest income.

51. Under United States income tax law, tax of 10% is withheld in respect of the interest income to which foreign resident partners are entitled.

52. During the same income year, Fozzie Pty Ltd receives its 10% share of the distribution from Hank, which is $100,000 less the $10,000 tax withheld, that is $90,000.

53. Hank is treated as a company for Australian income tax law purposes. Therefore, for the 2010-11 income year, pursuant to sections 94L and/or 94M of the ITAA 1936, the $100,000 distribution to Fozzie Pty Ltd will be treated as a dividend (grossed-up to include the tax withheld). Accordingly, Fozzie Pty Ltd's assessable income will include the amount distributed or credited to it as a dividend.

54. As per the circumstances of Example 3 above, Fozzie Pty Ltd will be entitled to a foreign income tax offset in the income year in which its assessable income includes the amount treated as a dividend paid by Hank. However, the availability of a foreign income tax offset may also be subject to the USA Convention. The Convention between the Government of Australia and the Government of the United States of America for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income [1983] ATS 16.

55. Article 22(2) of the USA Convention provides a general principle that where US tax has been paid in respect of US source income under the law of the US and in accordance with the USA Convention, a credit against Australian tax payable on that income will be allowed subject to the provisions and limitations of the law of Australia in force at the relevant time.

56. As Hank is treated as fiscally transparent under US tax law, the treaty benefits are applied at the level of the partner and not the limited partnership by the US for the purposes of applying the USA Convention.

57. As the income that flows through Hank to Fozzie Pty Ltd retains its character in the hands of Fozzie Pty Ltd for the purposes of US tax law, the extent to which the US exercises its source country taxing right under the Convention will be determined in accordance with Article 11 of the Convention, which deals with interest income. This is the case notwithstanding Fozzie Pty Ltd is taken to have received a dividend for the purposes of Australian income tax law.

58. As the US has taxed the income in accordance with the maximum rate allowable in respect of interest income under the Convention, Australia is obliged under the Convention to provide credit relief in respect of such tax, subject to the provisions and limitations of the law of Australia in force at the relevant time. This

relief is provided in accordance with the provisions for the granting of a foreign income tax offset.

Date of effect

59. This Ruling applies to years of income commencing on or after 1 July 2008. However, this Ruling 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
30 September 2009

Appendix 1 – 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.

Introduction

60. Division 830 was introduced to enable certain entities formed outside Australia (called foreign hybrids) that are treated as fiscally transparent for the purposes of foreign income tax (but as companies for Australian income tax law purposes) to be treated as partnerships under Australian income tax law.[6]

61. Division 830 can apply to a fiscally transparent foreign entity in one of two ways:

- automatically where all of the requirements of subsection 830-10(1) (for a foreign hybrid limited partnership) or subsection 830-15(1) (for a foreign hybrid company) are satisfied; or
- by election where the requirements of paragraphs 830-10(1)(a) to 830-10(1)(d) (for a foreign hybrid limited partnership) or paragraphs 830-15(1)(a) to 830-15(1)(c) (for a foreign hybrid company) are met, and the taxpayer makes an election under subsections 830-10(2) or 830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936.

62. The effect of an election under subsections 830-10(2), or 830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936, as applicable, is that the fiscally transparent foreign entity is a foreign hybrid only for the purpose of applying the Australian income tax law to that taxpayer's interest in the entity.[6A]

63. Where Division 830 applies in relation to a taxpayer's interest in a foreign hybrid, the Australian income tax law applies as if the

[6] In the case of a foreign hybrid company, the company is treated as a partnership for the purposes of the foreign hybrid tax provisions, which are defined in section 995-1 and essentially mean the ITAA 1997 and the ITAA 1936, except for Division 5A of Part III of the ITAA 1936, along with the other Acts administered by the Commissioner that deal with taxation administration and income tax rates.

[6A] The FIF rules were repealed with effect from the 2010-2011 income years (see *Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010*). However, taxpayers can still rely on an election for foreign hybrid treatment in respect of a former FIF interest under former section 485AA of the ITAA 1936 and can make an election under subsections 830-10(2) or 830-15(5) of the ITAA 1997, subsequent to the repeal of section 485AA. (See Sch 1, items 76, 78 and 96 to the *Tax Laws Amendment (Foreign Source Income Deferral) Act (No 1) 2010.* Also refer to paragraphs 1.34 to 1.36 of the Explanatory Memorandum accompanying the Tax Laws Amendment (Foreign Source Income Deferral) Bill (No 1) 2010).

foreign hybrid was treated as a partnership, and the taxpayer was a partner in the partnership.[7]

64. Where Division 830 does not apply, the fiscally transparent foreign entity continues to be treated as a company for the purpose of Australian income tax law.[8]

65. Subsection 770-10(1) provides that a taxpayer is entitled to a foreign income tax offset for foreign income tax paid in respect of an amount that is included in their assessable income in a year of income.[9]

66. To be entitled to an offset under subsection 770-10(1), a taxpayer must have:

- included an amount in their assessable income for that income year; and
- paid foreign income tax (as defined by subsection 770-15(1)) in respect of that amount.

67. Where foreign income tax has effectively been paid on the taxpayer's behalf, section 770-130 may treat the taxpayer, for the purposes of the ITAA 1997, as having paid the foreign income tax: for example, where foreign income tax has been withheld by the payer from a payment made to the taxpayer.

68. Section 770-130 requires that:

- the foreign income tax was paid *in respect of* an amount included in the taxpayer's ordinary or statutory income; and
- the foreign income tax has been paid under an arrangement with the taxpayer or under the law relating to the foreign income tax.

69. Both sections 770-10 and 770-130 use the phrase 'in respect of' to link the foreign income tax with an amount included in the taxpayer's ordinary or statutory income. The meaning of the phrase 'in respect of' has been considered by the Courts in a number of contexts.

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[7] There are also special rules in Subdivisions 830-C and 830-D that apply in addition to those that normally apply to partnerships.

[8] The fiscally transparent foreign entity is treated as a company because either:

- it satisfies the definition of 'company' in section 995-1; or
- it is a corporate limited partnership under Division 5A of Part III of the ITAA 1936.

[9] A foreign income tax offset is also available under subsection 770-10(2) for foreign income tax paid in respect of an amount that is a taxpayer's NANE income under sections 23AI or 23AK of the ITAA 1936.

70. It is well settled by the Courts that the phrase 'in respect of' denotes a relationship or connection between two things: *State Government Insurance Office (Qld) v. Rees & Anor (Liquidators of KD Morris & Sons Pty Ltd)* (1979) 144 CLR 549. The Courts have also considered that the meaning of the phrase, although wide, must be determined by the context within which the words are used: *State Government Insurance Office (Qld) v. Rees & Anor* at CLR 553-554 and 560-561, *Technical Products Pty Ltd v. State Government Insurance Office (Qld)* (1989) 167 CLR 45 at 47, 51 and 54, *Construction Industry Long Service Leave Board v. Irving* (1997) 74 FCR 587 at 595 and *Commissioner of Taxation v. Scully* (2000) 201 CLR 148 at 171; 2000 ATC 4111 at 4121; (2000) 43 ATR 718 at 729.

71. Applying the principles expressed in these cases, the phrase 'in respect of' should be construed within the context of Division 770, the intent of which can be found in the Object contained in section 770-5 and at paragraph 1.30 of the Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007 (the 2007 EM), which provides:

> 1.30 Pursuant to Australia's tax laws, resident taxpayers may be assessed on both their foreign and domestic sourced income. To prevent the double taxation of worldwide income that has been taxed in another country, resident taxpayers will be entitled to a non-refundable tax offset for foreign income tax paid on an amount included in their assessable income (a 'double-taxed amount') ***[Schedule 1, item 1, subsections 770-5(1) and (2)]***. This tax offset will extend to foreign residents where certain requirements are satisfied.

72. Within this context, it can be said that the phrase 'in respect of' is intended to draw a nexus between foreign income tax paid and an amount included in a taxpayer's assessable income, where the imposition of such foreign income tax would, apart from the application of Division 770, result in the taxpayer being exposed to double taxation in respect of that income.

Foreign income tax imposed on taxpayer's share of income of a fiscally transparent foreign entity

73. The key feature of a fiscally transparent foreign entity is that foreign income tax is not imposed on the income of that entity but rather on the partners or members. Such foreign income tax may be imposed by differing means, including directly on the partners by assessment, or indirectly by a payer withholding from the partner's share of the income of the fiscally transparent foreign entity. An Australian resident taxpayer with an interest in such an entity will therefore be exposed to foreign income tax in respect of their investment in the foreign entity.

74. The availability and timing of foreign income tax offsets depends on the treatment of the taxpayer's interest in the fiscally transparent foreign entity for Australian tax law purposes.

Fiscally transparent foreign entity treated as a foreign hybrid

75. Where a resident taxpayer has an interest in a fiscally transparent foreign entity, foreign income tax is imposed at the level of the partner or member under the law of the foreign country. Where that foreign entity qualifies as a foreign hybrid, it is treated as a partnership for the purposes of Australian income tax law. A resident taxpayer with an interest in a foreign hybrid is therefore treated as a partner in a partnership under Australian income tax law and is subject to tax in relation to their share of the net income of the foreign hybrid, thereby ensuring alignment of tax treatment of the relevant income under the laws of both countries.

76. In these situations, as both the foreign and Australian income tax are levied at the level of the partner or member, the core rules in Division 770 and, in particular, subsection 770-10(1) should apply in a straightforward manner to work out the foreign income tax paid (or taken to be paid) in respect of the amount included in the taxpayer's assessable income.

Fiscally transparent foreign entity not treated as a foreign hybrid (as it is not a CFC)

77. Where a fiscally transparent foreign entity is not treated as a foreign hybrid because it does not satisfy the CFC requirement[10] at paragraph 830-10(1)(e) (if the entity is a corporate limited partnership) or paragraph 830-15(1)(d) of the ITAA 1997 (if the entity is a company) and the taxpayer does not make an election under subsections 830-10(2) or 830-15(5) of the ITAA 1997 or former section 485AA of the ITAA 1936, the foreign income tax offset implications for the resident taxpayer with an interest in such an entity are less straightforward.

78. As the fiscally transparent foreign entity is treated as a company for Australian tax purposes, any distribution the taxpayer receives (or is taken to receive under sections 94L or 94M of the ITAA 1936) from it is characterised as a dividend.

79. In these circumstances, it is necessary to consider whether, for the purposes of subsection 770-10(1), the foreign income tax imposed on the taxpayer's share of the net income of the fiscally transparent foreign entity has been paid *in respect of* an amount included in the taxpayer's assessable income.

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[10] This requirement is explained at paragraphs 9.28 (for limited partnerships) and 9.30 (for companies) respectively of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003 (the 2003 EM).

[11] [Omitted.]

Taxpayer's assessable income includes dividend or deemed dividend payment

80. Where the taxpayer receives a distribution from the fiscally transparent foreign entity and foreign income tax has been imposed on the taxpayer's share of the profits, there will be a relevant connection between the foreign income tax paid and the distributed amount (characterised as a dividend and included in the taxpayer's assessable income under Australian tax law).

81. That connection exists because the foreign income tax is levied at the level of the partner or member on their share of the entity's net income, rather than on the profits of the fiscally transparent foreign entity. Accordingly, to the extent that a distribution made to the resident taxpayer is included in their assessable income as a dividend, it is considered that the relevant portion of foreign income tax is paid (or taken to have been paid) by the taxpayer *in respect of* the distributed amount: see discussion at paragraphs 70 and 71 of this Ruling.

82. Where the taxpayer does not pay the foreign income tax directly but rather an obligation is imposed on the fiscally transparent entity or another entity to withhold foreign income tax on the taxpayer's share of the net income of the fiscally transparent entity, it is accepted that such tax is paid in a representative capacity for the taxpayer. As such, the taxpayer is taken to have paid the relevant foreign income tax for the purposes of determining their entitlement to the foreign income tax offset under Division 770: see discussion in relation to section 770-130 at paragraphs 67 and 68 of this Ruling and paragraph 1.99 of the 2007 EM.

83. This result is consistent with the legislative intent expressed in the 2007 EM which outlines the necessary link between foreign income tax paid by someone else and amounts included in a taxpayer's assessable income, particularly in the situation where a taxpayer has not elected foreign hybrid treatment. Paragraph 1.103 of the 2007 EM states:

> Even where the Australian resident has not elected for the US limited liability company to be a foreign hybrid, the Australian resident will be entitled to a tax offset for the US withholding tax imposed on the distribution of the profits of the limited liability company. The tax offset will be in respect of the gross amount (pre-US tax) paid to the Australian resident. This is irrespective of the fact that the amount is regarded as a 'dividend' under Australian tax law and a 'distribution of partnership profits' under US law.

84. The use of the phrase 'in respect of an amount (a taxed amount) *that is all or part of an amount included* in your ordinary income or statutory income…' (emphasis added) in subsection 770-10(1) indicates that an apportionment should be made of the amount of foreign income tax paid to reflect the amount actually included in the taxpayer's assessable income.[12] Accordingly, where the taxpayer receives a dividend, or a distribution deemed to be a dividend under sections 94L or 94M of the ITAA 1936 from the fiscally transparent foreign entity, but the dividend does not represent all of the partner's share of the income of the foreign entity in respect of which foreign income tax has been paid, the taxpayer will only be entitled to a foreign income tax offset to the extent that the foreign income tax has been paid *in respect of* that dividend income.

85. If in an income year the taxpayer is not taken, for the purposes of Australian income tax, to have received a dividend from the fiscally transparent foreign entity, the taxpayer's assessable income will not include any dividend income from the entity. Subsection 770-10(1) requires an amount to be included in the taxpayer's assessable income and that foreign income tax has been paid in respect of that income. Although foreign income tax may have been paid in a particular income year, if the income in respect of which that tax is paid is not included in the taxpayer's assessable income then the taxpayer is not entitled to claim a foreign income tax offset in that income year. By corollary, the taxpayer will be entitled to a foreign income tax offset in the year of income in which the taxpayer's assessable income includes the amount in respect of which foreign income tax has been paid, even though the foreign income tax may have been paid in an earlier income year.[13] Thus, where a taxpayer receives a dividend from a fiscally transparent foreign entity (that is not a foreign hybrid) which is included in their assessable income in a later year to the year of income during which the foreign income tax was paid on the amount, the entitlement to a foreign income tax offset will arise in the later year.

86. Where, under the law of the foreign country, tax is imposed on a withholding basis on the amount of the distribution or deemed distribution, the amount included in the taxpayer's assessable income will be grossed up by the amount of any foreign income tax withheld by the payer. This is because, as noted in the 2007 EM, the foreign income tax constitutes income according to ordinary concepts pursuant to general tax law principles.[14] Further, this income is derived in the relevant year of income by the taxpayer when it is applied or dealt with on the taxpayer's behalf: see subsection 6-5(4).

[12] Support for an apportionment approach is also found in paragraph 1.107 of the 2007 EM.
[13] See Note 1 to subsection 770-10(1).
[14] See paragraphs 1.95 -1.96 of the 2007 EM.

Taxpayer receives a distribution which is non assessable non exempt income under section 23AK of the ITAA 1936

87. A distribution to a taxpayer whose interest in a foreign entity was assessed in accordance with the former FIF provisions will still be NANE income under section 23AK of the ITAA 1936 to the extent that the distribution gives rise to a post FIF abolition debit.

88. [Omitted.]

89. [Omitted.]

90. [Omitted.]

91. [Omitted.]

92. [Omitted.]

93. [Omitted.]

94. [Omitted.]

95. [Omitted.]

96. Where section 23AK of the ITAA 1936 applies, subsection 770-10(2) of the ITAA 1997 allows for a foreign income tax offset to be claimed where the taxpayer has paid foreign income tax *in respect of* that income.[19] Accordingly, where a distribution is made by the foreign entity out of previously attributed profits to the attributable taxpayer that is NANE income under section 23AK of the ITAA 1936, and such amount has been taxed on a withholding basis in the hands of the foreign entity, the attributable taxpayer will be entitled to an offset for the foreign income tax paid to the extent that it is paid *in respect of* the section 23AK income. Note that the 'tax-paid deeming' rules in section 770-130 also apply where the taxpayer derives ordinary or statutory income that is NANE income (see subsection 770-130(1)).

Foreign income tax imposed on amounts included in the notional income of a CFC in which the foreign hybrid has an interest

97. As a foreign hybrid is treated as a partnership for Australian income tax law purposes its net income, pursuant to section 90 of the ITAA 1936, is its assessable income less allowable deductions, calculated as if the foreign hybrid were a resident taxpayer.

98. Where that foreign hybrid (in which an Australian resident is a partner) holds an interest in a CFC, the definitions of 'Australian

[15] [Omitted.]
[16] [Omitted.]
[17] [Omitted.]
[18] [Omitted.]
[19] Further, the foreign income tax offset limit is increased under section 770-80 by any amounts of foreign income tax that count towards the taxpayer's tax offset for the year because of subsection 770-10(2).

entity', 'Australian partnership' and 'attributable taxpayer' in sections 336, 337 and 361 of the ITAA 1936 respectively, enable section 456 and section 457 of the ITAA 1936 to apply to include an amount of attributable income in the net income of the foreign hybrid for the purposes of Division 5 of Part III of the ITAA 1936.

99. [Omitted.]

100. Accordingly, a foreign hybrid can have an interest in a CFC, and have attributed CFC income included in its net income.

101. A foreign income tax offset may be available for foreign income tax, income tax or withholding tax paid by a CFC in which an entity has an interest, where the requirements of section 770-135 are met. The entity is taken to have paid the foreign income tax (as calculated under subsection 770-135(7)) only if:

- an amount is included in the entity's assessable income as described in subsection 770-135(2); and
- the conditions in subsections 770-135(3) and 770-135(5) are satisfied.

102. Subsection 770-135(2) states:

> An amount is included in an entity's assessable income as described in this subsection if the entity is a company and the amount is included under:
>
> (a) section 456 (a ***section 456 case***) of the 1936 Act in relation to a *CFC and a statutory accounting period; or
>
> (b) section 457 (a ***section 457 case***) of that Act in relation to a CFC.

103. A taxpayer that has an interest in a foreign hybrid that holds a CFC interest will not satisfy subsection 770-135(2) because the taxpayer's assessable income does not include an amount under sections 456 or 457 of the ITAA 1936. In these circumstances it is the foreign hybrid, not the partner, that is the relevant attributable taxpayer. The taxpayer's assessable income will include their share of the net income of the foreign hybrid under section 92 of the ITAA 1936.

104. Further, the taxpayer could not meet the association condition in subsection 770-135(5) in relation to the CFC. The association condition requires the taxpayer to have an 'attribution percentage' of 10% or more in relation to the CFC and, because the taxpayer's interest is held indirectly via the foreign hybrid, the taxpayer will not have an attribution percentage in the CFC..[20]

105. As noted at paragraph 86 of this Ruling, the net income of a foreign hybrid (for the purposes of Division 5 of Part III of the ITAA 1936) may include an amount under sections 456 or 457 of the ITAA 1936 in respect of an interest the foreign hybrid has in a CFC.

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[20] The taxpayer's attribution percentage in relation to a CFC is determined under section 362 of the ITAA 1936.

However, as subsection 770-135(2) is only satisfied where the attributable taxpayer is a company, a foreign hybrid (which is treated as a partnership) will not be taken to have paid foreign income tax which has been paid by a CFC in which it holds an interest. Accordingly, a resident taxpayer that has an interest in such a foreign hybrid is not entitled to claim a foreign income tax offset for foreign income tax, income tax or withholding tax paid by a CFC in respect of an amount included in the CFC's notional assessable income.

106. [Omitted.]

107. [Omitted.]

108. [Omitted.]

109. [Omitted.]

110. [Omitted.]

111. [Omitted.]

112. [Omitted.]

Tax imposed on distributions made by a CFC to a foreign hybrid

113. Where a taxpayer holds an interest in a foreign hybrid which in turn holds an interest in a CFC, and the CFC makes a distribution or dividend payment to the foreign hybrid, the taxpayer may be entitled to a foreign income tax offset for any withholding tax imposed at source on the distribution.

114. As discussed at paragraph 67 of this Ruling, where the taxpayer's assessable income includes a share of the net income of a foreign hybrid which includes a distribution paid to the foreign hybrid upon which foreign income tax has been withheld at source, section 770-130 will treat the taxpayer as if it had paid foreign income tax in respect of an amount included in the taxpayer's assessable income, and thereby entitle the taxpayer to a foreign income tax offset under subsection 770-10(1).

115. However, where a CFC makes a distribution to the foreign hybrid in circumstances where an amount has previously been included in the net income of the foreign hybrid under sections 456 or 457 of the ITAA 1936, the amount will be treated as NANE income of the taxpayer under section 23AI of the ITAA 1936, to the extent of the amount previously attributed. This is achieved through Division 4 of Part X of the ITAA 1936 which concerns attribution accounts.

116. The attribution account rules in Division 4 of Part X of the ITAA 1936 apply where an interest in a CFC is held by a partnership to ensure that a resident taxpayer with an interest in the partnership will obtain the benefit of section 23AI of the ITAA 1936. This is achieved through a combination of provisions that ensure that attribution credits and debits (which arise when income is attributed

[21] [Omitted.]

and when it is distributed respectively) arise for the resident taxpayer, rather than for the partnership that is the attributable taxpayer under Part X of the ITAA 1936.

117. Similar rules in former Division 19 of Part XI of the ITAA 1936 applied to interests in FIFs so that later distributions can be treated as NANE income under section 23AK of the ITAA 1936.

118. Accordingly, where a foreign hybrid includes an amount in its assessable income under sections 456 or 457 of the ITAA 1936, an attribution credit arises for the resident taxpayer who holds an interest in the foreign hybrid: see subsection 371(6) of the ITAA 1936.[22] As a consequence, when a subsequent distribution is paid to the foreign hybrid by the CFC, the taxpayer's share of that distribution that would be included in the taxpayer's assessable income under section 92 of the ITAA 1936 is NANE income of the taxpayer under section 23AI of the ITAA 1936: see paragraphs 23AI(1)(d), 365(1)(b), and 371(1)(d) and section 372 of the ITAA 1936.[23]

119. As the 'tax-paid deeming' rules in section 770-130 also apply where the taxpayer (that is the resident partner in the foreign hybrid) derives ordinary or statutory income that is NANE income (see subsection 770-130(1)), the taxpayer will be treated as having paid the foreign income tax imposed on the distribution to the extent that it give rise to such NANE income in the hands of the taxpayer.

120. In these circumstances, subsection 770-10(2) enables the taxpayer to claim a foreign income tax offset for foreign income tax taken to have been paid in respect of the taxpayer's section 23AI of the ITAA 1936 amount, which arises from distributions made by a CFC to a foreign hybrid in which the taxpayer holds an interest.

121. The same outcome arises for an interest held in a former FIF via an interposed foreign hybrid in respect of any income to which section 23AK of the ITAA 1936 applies.

The impact of Australia's tax treaties on the availability of foreign income tax offsets

122. The availability of a foreign income tax offset may be affected by the application of Australia's tax treaties. Subsection 4(1) of the *International Tax Agreements Act 1953* (the Agreements Act) provides that the ITAA 1936 and the ITAA 1997 must be read as one with the Agreements Act.

123. The elimination of double taxation articles of Australia's tax treaties generally provide that where tax has been imposed by a foreign country in respect of income from sources in that country and

[22] The same result is effected under section 23AK of the ITAA 1936 for a taxpayer who holds an interest in a foreign hybrid that included an amount in its assessable income under former section 529 of the ITAA 1936 prior to the repeal of the FIF provisions: see former subsection 605(8) of the ITAA 1936.
[23] For an interest in a FIF, see subparagraph 23AK(1)(a)(i), paragraph 23AK(9)(b), former paragraphs 603(1)(c) and 605(1)(d) of the ITAA 1936.

in accordance with the particular tax treaty, a credit against tax payable in Australia on that income will be allowed under the law of Australia.

124. This includes situations where there is a difference in treatment of income derived from sources in the other country and Australia that arise because the foreign entity is treated as fiscally transparent under the law of the other State but as a company for Australian tax law purposes.[24] This type of conflict which arises because of domestic law differences between the two countries to a tax treaty is commonly referred to as a Conflict of Qualification.

125. The Commissioner's view expressed at paragraph 104 of Taxation Ruling TR 2001/13 is that the OECD Model Tax Convention and Commentary may be considered in interpreting tax treaties. The 2010 OECD Commentary on Articles 23A and 23B at paragraphs 32.1 to 32.7 discusses the concept of a Conflict of Qualification, concluding that where the difference in treatment is solely referable to differences in the respective domestic laws of the State of source and State of residence of the taxpayer, it is considered that the State of source has taxed the income in accordance with the Convention and accordingly the State of residence is obliged to provide relief in accordance with the relevant article of the Model Convention.[25]

126. Therefore, to the extent that the foreign country taxes income in accordance with the Convention, as interpreted by it as the State of source and gives rise to a Conflict of Qualification referable solely to differences in domestic tax laws, such tax will constitute foreign income tax within the meaning of section 770-15 and relief in the form of a foreign income tax offset may therefore be available in accordance with, and to the extent allowed, under section 770-10.

127. Conversely, where a resident taxpayer derives income that has borne foreign income tax in circumstances where the foreign country imposes the tax other than in accordance with a tax treaty with Australia, relief from double taxation is to be obtained by seeking a refund of the foreign income tax (or similar relief) from the foreign country that imposed it.[26]

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[24] In the context of this Ruling, an example of where this could occur is where a taxpayer has an interest in a fiscally transparent foreign entity but has not made an election under former section 485AA of the ITAA 1936 in relation to that interest.

[25] In relation to the OECD Model Convention article 23 concerns the 'Methods for elimination of double taxation'.

[26] In limited circumstances the contracting states may have different views as to the interpretation of a treaty Article, which may give rise to unrelieved double taxation. When this occurs, the various treaties provide for a Mutual Agreement Procedure (MAP) in an endeavour to relieve the double taxation. Part 4 of Taxation Ruling TR 2000/16 provides details of MAPs applicable in a transfer pricing context. The Tax Office website (ato.gov.au) also contains the 'Mutual Agreement Procedures Operational Guidance for Member Countries of the Pacific Association of Tax Administrators (PATA)' to assist taxpayers. This document is not a Tax Office publication. It was prepared by the members of PATA, an inter-country affiliation between Australia, USA, Canada and Japan.

128. In these circumstances a foreign income tax offset under Division 770 is not available because the relevant foreign income tax, imposed other than in accordance with the tax treaty, is not considered to be 'foreign income tax' within the meaning of section 770-15. This is supported by the Note to section 770-15 which states:

> Foreign income tax includes only that which has been correctly imposed in accordance with the relevant foreign law, or, where the foreign jurisdiction has a tax treaty with Australia (having the force of law under the *International Tax Agreements Act 1953*), has been correctly imposed in accordance with that treaty.

Application of former Division 18 of Part III

129. The explanation at paragraphs 60 to 128 of this Ruling deals with the application of the foreign income tax offset rules in Division 770 to circumstances involving the imposition of foreign income tax on income derived from investing in foreign hybrid entities. These rules have effect for income years commencing on or after 1 July 2008.

130. For income years commencing before 1 July 2008, generally equivalent relief from double taxation was achieved under the foreign tax credit rules in former Division 18 of Part III of the ITAA 1936.

131. To the extent that the rules in Division 770 effectively replicate the rules in former Division 18 of Part III of the ITAA 1936 then where, in the circumstances set out in this explanation, a taxpayer is entitled to a foreign income tax offset, it would normally be expected that the same set of circumstances arising in an income year commencing prior to 1 July 2008 would also lead to the taxpayer being entitled to a foreign tax credit under former Division 18 of Part III of the ITAA 1936.

Appendix 2 – Detailed contents list

132. The following is a detailed contents list for this Ruling:

References

Previous draft:

TR 2009/D1

Related Rulings/Determinations:

TR 2000/16; TR 2001/13;
TR 2006/10; TD 2006/52

Subject references:

- controlled foreign companies
- foreign hybrid company
- foreign hybrid limited partnership
- foreign hybrids
- foreign income
- foreign income tax offsets
- foreign investment funds

Legislative references:

- ITAA 1936
- ITAA 1936 23AH
- ITAA 1936 23AI
- ITAA 1936 23AI(1)(d)
- ITAA 1936 23AJ
- ITAA 1936 23AK
- ITAA 1936 23AK(1)(a)(i)
- ITAA 1936 44
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- ITAA 1936 92
- ITAA 1936 94L
- ITAA 1936 94M
- ITAA 1936 336
- ITAA 1936 337
- ITAA 1936 361
- ITAA 1936 362
- ITAA 1936 365(1)(b)
- ITAA 1936 371(1)(d)
- ITAA 1936 371(6)
- ITAA 1936 372
- ITAA 1936 456
- ITAA 1936 457
- ITAA 1936 485AA
- ITAA 1936 603(1)(a)
- ITAA 1936 603(1)(c)
- ITAA 1936 605(1)(d)
- ITAA 1936 606
- ITAA 1936 Pt III Div 5
- ITAA 1936 Pt III Div 5A
- ITAA 1936 Pt III Div 18
- ITAA 1936 Pt X
- ITAA 1936 Pt X Div 4
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- Tax Laws Amendment (Foreign Source Income Deferral) Act (No. 1) 2010

Case references:

- Construction Industry Long Service Leave Board v. Irving (1997) 74 FCR 587

- Commissioner of Taxation v. Scully [2000] HCA 6; (2000) 201 CLR 148; 2000 ATC 4111; (2000) 43 ATR 718
- State Government Insurance Office (Qld) v. Rees & Anor (Liquidators of KD Morris & Sons Pty Ltd) (1979) 144 CLR 549
- Technical Products Pty Ltd v. State Government Insurance Office (Qld) (1989) 167 CLR 45

Other references:

- The Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 7) 2003
- The Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007
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- USA Convention [1983] ATS 16, Article 11
- USA Convention [1983] ATS 16, Article 22(2)

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