

TR 2007/D3 - Income tax: entitlement to foreign tax credits under Division 18 of Part III of the Income Tax Assessment Act 1936 when foreign income is included in the net income of a trust estate

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This document has been finalised by TR 2007/4.



Draft Taxation Ruling

Income tax: entitlement to foreign tax credits under Division 18 of Part III of the *Income Tax Assessment Act 1936* when foreign income is included in the net income of a trust estate

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What this Ruling is about

1. This draft Ruling addresses the following:
 - the entitlement to claim a foreign tax credit or apply an excess foreign tax credit from an earlier year under Division 18 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) for a resident beneficiary whose trust income includes foreign income; and
 - the circumstances under which the trustee of a trust estate under Division 6 of Part III of the ITAA 1936 is entitled to claim a foreign tax credit or apply an excess foreign tax credit from an earlier income year.
2. This draft Ruling does not apply to:
 - trust income which is subject to the transferor trust measures under Division 6AAA of Part III of the ITAA 1936; or
 - trust income which is subject to the Foreign Investment Fund measures under Part XI of the ITAA 1936; or
 - trust income to which sections 96B and 96C of the ITAA 1936 apply.

3. All subsequent references are to the ITAA 1936 unless otherwise stated.

Ruling

4. A resident beneficiary assessed on trust income is entitled to claim a foreign tax credit under subsection 160AF(1) in respect of foreign income included in the trust income together with their other foreign income provided foreign tax has been paid or deducted at source in respect of the foreign income.

5. Where a trustee is assessed on behalf of a resident beneficiary under section 98 (that is, a beneficiary under a legal disability or a beneficiary deemed to be presently entitled by the operation of subsection 95A(2)) on their share of the net income of the trust estate which includes foreign income, the trustee is entitled to claim a foreign tax credit under subsection 160AF(1) on account of the beneficiary provided foreign tax has been paid or deducted at source in respect of the foreign income.

6. Where a resident beneficiary to which subsection 98(1) or 98(2) applies has income from other sources, the credit given in the beneficiary's assessment under subsection 100(2) is calculated by reducing from the gross tax payable by the trustee, the beneficiary's share of the foreign tax credit entitlement.

7. Any excess foreign tax credit arising to the trustee under a section 98 assessment on behalf of a resident beneficiary is accounted for separately and is available to be carried forward and applied in the following 5 income years by the trustee on behalf of that beneficiary under section 160AFE.

Example 1

8. XYZ Trust, a resident trust estate, receives \$9,000 of foreign interest income, on which 10% withholding tax of \$1,000 has been deducted during the income year ended 30 June 2007. An Australian resident, Joe Smith, 16 years old, is the sole beneficiary who is presently entitled to 100% of the income of the trust estate, but is under a legal disability. He also receives \$1,000 in wages from a casual job.

TRUSTEE		BENEFICIARY	
The tax assessed to the trustee under subsection 98(1) would be:		Joe as the beneficiary deriving other income would be assessed as follows:	
Foreign Income	\$9,000	Trust distribution	
Foreign Tax Paid ¹	\$1,000	Foreign Income	\$9,000
Net Income (subsection 95(1))	\$10,000	Foreign Tax Paid ²	\$1,000
		Wages	\$1,000
		Taxable Income	\$11,000
Tax payable on \$10,000 × 45% = \$4,500 ³		Tax Payable on \$1,000 is nil ⁴	
Tax payable on \$10,000 × 45% = \$4,500 ⁵		Tax Payable on \$10,000 × 45% = \$4,500 ⁵	
Less		Less	
Foreign Tax Credit	\$1,000	subsection 100(2) credit	\$2,900
Low Income Tax Offset	\$600	Foreign Tax Credit	\$1,000
		Low Income Tax Offset	\$600
Tax payable	\$2,900	Tax Payable	\$Nil

9. Where the net income or any part of the net income of the trust estate in a year of income is assessed to the trustee under section 99 or section 99A, the trustee is entitled to claim a foreign tax credit under subsection 160AF(1) in respect of the foreign income included in the net income, provided foreign tax has been paid or deducted at source in respect of the foreign income.

10. Any excess foreign tax credit can be carried forward by the trustee for application by the trustee in the following 5 income years under a section 99 or 99A assessment.

¹ Subsection 6AC(1).

² Subsection 6AC(1).

³ Assessed under Division 6AA of Part III.

⁴ Assessed at general individual rates.

⁵ Assessed under Division 6AA of Part III.

TR 2007/D3**Example 2**

11. In the year ended 30 June 2006 Frederick Jones, as executor and trustee of an Australian resident deceased estate,⁶ derives foreign income of \$40,000 and pays \$9,000 foreign tax on that income. No other income is derived by the trust. No beneficiary is presently entitled to the income and the trustee is assessed under section 99 as follows:

Foreign Income	\$31,000
Foreign Tax Paid ⁷	\$9,000
Net Income (subsection 95(1))	\$40,000
Tax and Medicare Levy under s.99	\$8,460
Foreign Tax Credit	\$8,460
Tax payable	nil
Excess foreign tax credit carried forward	\$540

12. In the year ended 30 June 2007 the situation is repeated except that the rate of tax on the foreign jurisdiction changes and foreign tax paid by the trustee on foreign income of \$40,000 is \$4,200. The excess foreign tax credit from the previous year of \$540 is carried forward to the trustee in the section 99 assessment for 2007 as follows:

Foreign Income	\$35,800
Foreign Tax Paid ⁸	\$4,200
Net Income (subsection 95(1))	\$40,000
Tax and Medicare Levy under s.99	\$7,950
Foreign Tax Credit	\$4,200
Excess Foreign Tax Credit carried forward	\$540
Tax Payable	\$3,210

⁶ Resident deceased estate established in September 2005.

⁷ Subsection 6AC(1).

⁸ Subsection 6AC(1).

13. In a year of income that the trust estate makes a loss; or has zero net income, and has foreign income included in its assessable income in respect of which foreign tax has been paid or deducted at source, no entitlement to a foreign tax credit arises either for the beneficiary or for the trustee for the purposes of subsection 160AF(1) in that year of income. However, an excess foreign tax credit for the purposes of section 160AFE does arise for the trustee only, and can be carried forward for the following 5 income years for application against a future section 99 or section 99A assessment.

Example 3

14. In the year ended 30 June 2006 ABC Pty Ltd (as trustee of a resident trust estate) derives domestic rental income of \$15,000 and incurs total rental deductions of \$22,000. The trust estate also receives foreign dividend income of \$1,700 on which there has been 15% withholding tax of \$300 deducted at source. Because there is a loss, no beneficiary is presently entitled to the trust income.

15. The trustee's liability under section 99A in the year ended 30 June 2006 is calculated as follows:

Domestic Rental Income	\$15,000
Foreign Dividend Income received	\$1,700
Foreign Tax Paid ⁹	\$300
Total Assessable Income	\$17,000
Less deductions	\$22,000
Net Income (subsection 95(1))	\$5,000
Tax and Medicare Levy under section 99A	nil
Excess Foreign Tax Credit carried forward	\$300

16. In the year ended 30 June 2007 the amount of domestic rental income remains at \$15,000; however the total rental deductions are only \$8,000. The trust estate also receives foreign dividend income of \$2,550 on which there has been 15% withholding tax of \$450 deducted at source. Because the trustee accumulates the income, no beneficiary is presently entitled to the trust income.

⁹ Subsection 6AC(1).

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17. The trustee's liability under section 99A in the year ended 30 June 2007 is calculated as follows:

Domestic Rental Income	\$15,000
Foreign Dividend Income received	\$2,550
Foreign Tax Paid ¹⁰	\$450
Total Assessable Income	\$18,000
Less deductions	\$8,000
Less Trust Loss Recoupment ¹¹	\$5,000
Net Income (subsection 95(1))	\$5,000
Tax and Medicare Levy under section 99A	\$2,325
Foreign tax credit (subsection 160AF(1))	\$450
Excess Foreign tax credit carried forward	\$300
Tax Payable	\$1,575

Date of effect

18. It is proposed that when the final Ruling is issued, it will apply to years of income commencing both before and after its date of issue. 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 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

14 March 2007

¹⁰ Subsection 6AC(1).

¹¹ See section 36-15 of ITAA 1997. Trust loss is available for recoupment provided the trust loss rules in Schedule 2F are satisfied.

Appendix 1 – Explanation

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

19. The taxation of income of a trust estate is determined under Division 6 of Part III.

20. Where the net income¹² of a trust estate includes foreign income¹³ in a year of income, a resident beneficiary, assessed under subsection 97(1) or section 100,¹⁴ will have foreign income included in their assessable income.

21. Subsection 160AF(1) in Division 18 of Part III provides that an Australian resident taxpayer is entitled to a credit for foreign tax paid in respect of foreign income that is included in their assessable income in a year of income.

22. To be entitled to a credit under subsection 160AF(1), an Australian resident taxpayer must have:

- included foreign income¹⁵ in their assessable income (paragraph 160AF(1)(a));
- paid foreign tax (as defined by subsection 6AB(2)) in respect of that foreign income (paragraph 160AF(1)(b)); and
- been personally liable for the foreign tax (paragraph 160AF(1)(c)).

¹² As defined in subsection 95(1).

¹³ See subsection 6AB(1).

¹⁴ A beneficiary covered by section 100 has to lodge an individual return: See TD 92/159.

¹⁵ Note amendments to subsection 160AF(1) in 2003 to allow for a credit against income, profits or gains derived from a source in an area covered by an international tax sharing treaty to the extent that the income, profit or gain is taxed in Australia. Such amounts are not considered to be foreign income.

Entitlement to a foreign tax credit for a resident beneficiary assessed under subsection 97(1) or section 100

23. Income beneficially derived by a person is deemed to be derived from the source to which the income can be directly or indirectly attributed (see subsection 6B(2A)). Subsection 6B(3) provides that a beneficiary in a trust estate who is presently entitled to income of the trust estate is deemed to have derived that amount of income for the purposes of section 6B. Tracing rules are provided in respect of dividend income (subsection 6B(1)), deemed passive income (subsection 6B(1A)) and interest income (subsection 6B(2)) for the purposes of calculating the foreign tax credit available in respect of each class of foreign income. The rules in section 6B therefore ensure that a resident beneficiary assessed under subsection 97(1) or section 100 satisfies the first test in subsection 160AF(1), where the net income of the trust estate includes foreign income.

24. The amount of foreign income included in the resident beneficiary's assessable income via section 97 and section 100 is the gross amount of the income before the payment of any foreign tax (see section 95 and section 6AC).

25. Where foreign income is derived indirectly through a trust estate and tax on that income has effectively been paid on the taxpayer's behalf, subsection 6AB(3) deems the taxpayer, for the purposes of the ITAA 1936, to have been personally liable for, and to have paid the foreign tax. The two circumstances set out in subsection 6AB(3) that are relevant for the purpose of this draft Ruling are those where foreign tax has been paid:

- by a trustee of a trust estate in which the taxpayer is a beneficiary (subparagraph 6AB(3)(a)(ii)); and
- by deduction (for example, a withholding tax) from the foreign income (subparagraph 6AB(3)(a)(iv)).

26. Subsection 6AB(4) deems a taxpayer deriving foreign income indirectly through a trust estate to have paid an amount of foreign tax equal to the difference between the net income actually derived and the gross amount to which it is attributable. This provision applies in a case where the trust estate itself did not pay the foreign tax, for example, where the resident beneficiary receives a distribution that comprises foreign income on which withholding tax was paid before the income was received by the trustee.

27. The deeming provisions in subsections 6AB(3) and 6AB(4) therefore allow a resident beneficiary assessed under subsection 97(1) or section 100 to satisfy the second and third basic tests in paragraphs 160AF(1)(b) and (c).

28. Accordingly, a resident beneficiary assessed under subsection 97(1) or section 100¹⁶ on trust income that includes foreign income is entitled to a credit of:

- the amount of foreign tax; or
- the amount of Australian tax payable in respect of that income, profit or gain,

whichever is the lesser amount in respect of each class of foreign income.¹⁷

29. To support a claim for a relevant foreign tax credit, the details of foreign tax paid shown in trust distribution advices provided by a trustee of a trust to beneficiaries will normally suffice as sufficient evidence.¹⁸

30. Any excess foreign tax credit in a year of income can be carried forward by the resident beneficiary for application in any of the following 5 income years in which foreign income is derived either directly or indirectly through any trust estate.

When can a trustee claim a foreign tax credit?

31. Division 6 of Part III adopts the scheme of assessing the beneficiary who is entitled to the income from the trust estate, except in special situations. Excepting in these situations provided for in the ITAA 1936, a trustee is not liable as trustee to pay income tax upon the income of the trust estate.¹⁹

32. The trustee is assessed and is liable to tax where:

- the beneficiary is presently entitled to a share of the income of the trust estate but is under a legal disability (subsection 98(1)) or the beneficiary is deemed to be presently entitled by the operation of subsection 95A(2) (subsection 98(2)); or
- there is trust income to which no one is presently entitled (sections 99 or 99A).

¹⁶ See paragraph 34 of this Ruling.

¹⁷ See subsection 160AF(7). In the 2005 Federal Budget, the government announced it would abolish the foreign loss and foreign tax credit quarantining rules. See Treasurer's Press Release No. 044/2005.

¹⁸ See Taxation Ruling IT 2527.

¹⁹ See section 96.

Trustee assessed under section 98

33. A trustee assessed on behalf of a beneficiary under section 98 is entitled to claim a foreign tax credit under subsection 160AF(1) in respect of the foreign income included in the beneficiary's share of the net income, provided foreign tax has been paid or deducted at source. The trustee, as the legal owner of the trust property and in carrying out the affairs of the trust estate²⁰ is personally liable for the foreign tax paid or is deemed to be personally liable under subparagraph 6AB(3)(a)(iv).

34. Section 100 provides that where a beneficiary who is under a legal disability or is deemed presently entitled to any trust income under subsection 95A(2) is either:

- a beneficiary of more than one trust estate; or
- derives income from other sources,

the beneficiary is to include the net income of all the trust estates referable to the period they are a resident. Accordingly, the foreign income included in their trust income is aggregated with their (other) foreign income in the individual tax return for the purpose of determining the entitlement for a foreign tax credit under subsection 160AF(1) (see paragraphs 13 to 21 of this Ruling).

35. The tax payable by the trustee under section 98 on account of the beneficiary's share of the net income is determined after ascertaining the foreign tax credit entitlement under subsection 160AF(1) in respect of the foreign income included. This amount constitutes the credit that the beneficiary receives under subsection 100(2) for the Australian tax paid or payable by the trustee on behalf of the beneficiary. As Example 1 above shows, the benefit of the foreign tax credit is not actually allowed twice.

36. Any excess foreign tax credit arising under a section 98 assessment on behalf of a resident beneficiary is accounted for separately by the trustee and is available to be applied by the trustee for that beneficiary in the following 5 income years in accordance with section 160AFE.

Trustee assessed under sections 99 or 99A

37. Where the net income (or any part of the net income) of the trust estate in a year of income is income to which section 99 or section 99A applies and foreign income is included in the net income of the trust estate, the trustee qualifies as an Australian resident taxpayer who has satisfied the 3 basic tests in subsection 160AF(1).²¹

38. The amount of foreign income included in the net income of the trust estate assessed to the trustee in such situations is inclusive of the amount of foreign tax paid in accordance with section 6AC.

²⁰ *DFC of T v. Balnaves* (1998) 98 ATC 5123; 40 ATR 431.

²¹ See paragraphs 24 and 26 of this Ruling.

39. Any excess foreign tax credit arising in a year of income as a result of section 99 or section 99A applying to the net income (or any part of the net income) of the trust estate can be carried forward under section 160AFE for the following five income years. Any excess foreign tax credit can be applied under subsection 160AFE(2) to increase the current foreign tax amount in an income year where foreign income is included in the net income (or any part of the net income) of the trust estate to which section 99 or section 99A applies.

Where the resident trust estate derives foreign income, but returns a loss in a year of income

40. In a year of income that the trust estate has foreign income included in its assessable income, but returns a loss, any foreign tax paid in respect of foreign income does not give rise to a foreign tax credit in that year of income in the hands of either:

- the beneficiary as there is no income distribution by the trust estate; or
- the trustee of the trust estate.

41. In a loss year, the requirements of subsection 160AF(1) are therefore not satisfied either by the beneficiary or by the trustee. Any foreign tax paid by the trustee or deducted at source cannot be applied as a credit against Australian tax payable by a beneficiary who has (other) foreign income in their hands in the income year that the trust estate returns a loss.

42. However, any foreign tax paid or deducted at source does give rise to an excess foreign tax credit that is available to be carried forward by the trustee only under section 160AFE.

43. Such an excess foreign tax credit can be applied in any of the following five income years in which the trustee is assessed on foreign income included in the net income or any part of the net income of the trust estate under section 99 or section 99A.

44. It is considered that the requirements of subsection 160AF(1) are satisfied only by the trustee because of the inclusion of foreign income in calculating the loss of the trust estate for the earlier income year. As the amount of foreign income included in calculating the loss of the trust estate is the gross amount before the payment of any foreign tax, relief from (future) double taxation is afforded by the trustee carrying forward an excess foreign tax credit. The availability of an excess foreign tax credit to be carried forward by the trustee under these circumstances is aligned with its ability to carry forward foreign losses for offset against future foreign assessable income (of the same class) under section 160AFD for the purposes of the net income calculation under subsection 95(1).

45. Such an excess foreign tax credit is not available to a beneficiary of the trust estate as, in relation to a loss year, there is no trust distribution.

Appendix 2 – Your comments

46. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

Due date: 27 April 2007

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Appendix 3 – Detailed contents list

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

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

IT 2527; TD 92/159; TR 2006/10

Subject references:

- beneficiary
- deemed liability
- excess foreign tax credit
- foreign income
- foreign tax
- foreign tax credit
- grossing up
- presently entitled
- trust estate
- trust income
- trust loss
- trustee

Legislative references:

- ITAA 1936 6AB(2)
- ITAA 1936 6AB(3)
- ITAA 1936 6AB(3)(a)(ii)
- ITAA 1936 6AB(3)(a)(iv)
- ITAA 1936 6AB(4)
- ITAA 1936 6AC
- ITAA 1936 6AC(1)
- ITAA 1936 6B
- ITAA 1936 6B(1)
- ITAA 1936 6B(1A)
- ITAA 1936 6B(2)
- ITAA 1936 6B(2A)
- ITAA 1936 6B(3)
- ITAA 1936 Pt III Div 6
- ITAA 1936 95

- ITAA 1936 95(1)
- ITAA 1936 95A(2)
- ITAA 1936 96
- ITAA 1936 96B
- ITAA 1936 96C
- ITAA 1936 97(1)
- ITAA 1936 98
- ITAA 1936 98(1)
- ITAA 1936 98(2)
- ITAA 1936 99
- ITAA 1936 99A
- ITAA 1936 100
- ITAA 1936 100(2)
- ITAA 1936 Pt III Div 6AA
- ITAA 1936 Pt III Div 6AAA
- ITAA 1936 Pt III Div 18
- ITAA 1936 160AF(1)
- ITAA 1936 160AF(1)(a)
- ITAA 1936 160AF(1)(b)
- ITAA 1936 160AF(1)(c)
- ITAA 1936 160AF(7)
- ITAA 1936 160AFD
- ITAA 1936 160AFE
- ITAA 1936 160AFE(2)
- ITAA 1936 Pt XI
- ITAA 1936 Sch 2F

Case references:

- DFC of T v. Balnaves (1998)
98 ATC 5123; 40 ATR 431

Other references:

- Treasurer's Press Release
No. 044/2005 - International
Tax Reform

ATO references

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ATOlaw topic: Income Tax ~~ Tax offsets, credits and benefits ~~ foreign
tax credits
Income Tax ~~ Entity specific matters ~~ trusts
Income Tax ~~ Assessable income ~~ trust income -
beneficiaries