IT 2518 - Income tax : foreign tax credit system - interest derived from a transaction directly related to the active conduct of a trade or business

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TAXATION RULING NO. IT 2518

INCOME TAX : FOREIGN TAX CREDIT SYSTEM - INTEREST DERIVED FROM A TRANSACTION DIRECTLY RELATED TO THE ACTIVE CONDUCT OF A TRADE OR BUSINESS

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1011024	FOREIGN TAX CREDIT SYSTEM - INTEREST INCOME QUARANTINING	51(6) 79D 160AE(3) 160AF 160AFD(6)

PREAMBLE The purpose of this Ruling is to clarify the interpretation and practical application of paragraph 160AE(3)(d) of the Income Tax Assessment Act (the Assessment Act).

2. Subsection 160AF(7) of the Assessment Act requires a resident taxpayer's foreign tax credit entitlement under subsection 160AF(1) to be determined separately for 3 classes of foreign income - interest income as defined in subsection 160AE(3) (later referred to as "quarantined interest income"), offshore banking income as defined in subsection 160AE(4) and other income. It is relevant also that subsection 160AFD(6) of the Assessment Act operates so that the foreign loss quarantining provisions of the foreign tax credit system (FTCS), in particular subsection 51(6) and sections 79D and 160AFD, apply separately in relation to losses incurred by a taxpayer in deriving foreign income which is quarantined interest income.

3. Paragraph 160AE(3)(d) excludes from the scope of quarantined interest income, in relation to a person, "interest derived by the person from a transaction directly related to the active conduct of a trade or business" but the relevant legislative provisions do not elaborate on the meaning of that paragraph. The Explanatory Memorandum to the Bill which introduced those provisions - the Taxation Laws Amendment (Foreign Tax Credits) Bill 1986 - gave as an example of interest to which paragraph 160AE(3)(d) applies interest charged on debtors' accounts. However, enquiries received concerning its operation indicate the need for further clarification of the circumstances in which an interest earning transaction is to be construed as directly related to the active conduct of a trade or business.

RULING 4. The primary purpose of paragraph 160AE(3)(d) is to exclude from the scope of quarantined interest income for FTCS purposes foreign income in the form of interest derived from a transaction directly related to active trading or business

operations as compared, very broadly, with interest derived from a "passive" investment of funds. For the paragraph to apply, therefore, a sufficient nexus has to be established between the interest earning transaction and the carrying on by the taxpayer of a trade or business.

5. Whether that nexus exists is essentially a question to be decided on the facts of each case. However, some guidelines as to the application of the paragraph are provided by case law on the issue of whether interest and gains derived by an insurance company on the investment of insurance premiums are business income or investment income - Liverpool and London and Globe Insurance Company v. Bennett (1911) 2KB 577; (1912) 2KB 41 (CA) and 1913 AC 610 (HL); Colonial Mutual Life Assurance Society Ltd v. FC of T (1946) 73 CLR 604; Chamber of Manufactures Insurance Ltd v. FC of T 83 ATC 4773 (SC); 84 ATC 4315 (FC). See also London Australia Investment Co. Ltd v. FC of T (1977) 138 CLR 106 and Taxation Ruling No IT 2276.

6. A general statement of principle which may be drawn from those references is that the requisite nexus between an interest earning transaction and the active conduct of a trade or business will be fulfilled whenever the interest income is derived from a transaction ordinarily associated with the conduct of the taxpayer's trade or business, or is treated as part of the income arising from the business activities of the taxpayer. That nexus will also exist when the fund or asset from which the relevant interest is derived is currently employed and risked in the existing trade or business of the taxpayer. The "existing trade or business" of a taxpayer for that purpose is represented by the activities presently carried on in the ordinary course of the taxpayer's trade or business.

7. The onus of establishing the required nexus will be on the taxpayer. In this regard, taxpayers who derive foreign interest income should indicate in their returns the circumstances in which the income is derived.

Guidelines

8. The following guidelines reflect the general statement of principle referred to in paragraph 6 of this Ruling. They are provided, therefore, to assist in the interpretation and application of paragraph 160AE(3)(d) of the Assessment Act.

9. The following transactions would be considered to be directly related to the active conduct of a trade or business:

(a) the sale, exchange, or other disposition of (1) property which is purchased, manufactured, produced, constructed, grown, or extracted in the ordinary course of such trade or business or (2) an asset which is used in, or held for use in, the conduct of such trade or business;

(b) the performance in the ordinary course of such trade or business of technical, managerial, engineering,

architectural, scientific, skilled, industrial, commercial, or similar services;

(c) the performance of any activity which is an ordinary and necessary incident to the conduct of such trade or business; or

(d) the satisfaction of any requirement or condition for carrying on such trade or business.

10. An asset will be treated as used in, or held for use in, the active conduct of a trade or business if it is:

(a) held for the principal purposes of promoting the present conduct of that trade or business;

(b) acquired and held in the ordinary course of that trade or business, as, for example, in the case of an account or note receivable arising from that trade or business; or

(c) otherwise held in a direct relationship to that trade or business.

11. In determining whether an asset is held in a "direct relationship", principal consideration should be given to whether the asset is needed in that trade or business. An asset would be considered needed in a trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset would be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of that trade or business. Conversely, an asset would be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for (a) future diversification into a new trade or business, (b) expansion of the taxpayer's trade or business activities conducted outside such country or possession, (c) future plant replacement, or (d) future business contingencies.

12. By way of example of the operation of the guidelines, interest on funds derived by a taxpayer in the ordinary course of carrying on a business, such as interest on the investment of insurance premiums received by an insurance broker but not yet remitted to the insurance companies would be treated as interest to which paragraph 160AE(3)(d) applies. Similarly, in a case recently considered it was accepted that interest derived by a taxpayer from the temporary investment of fees received from the hiring out overseas of certain assets owned by other persons, prior to the remittance of those fees (less the taxpayer's commission) to the owners, would not be treated as quarantined interest income for FTCS purposes by reason of paragraph 160AE(3)(d).

13. Conversely, interest derived by a taxpayer from the investment of a fund maintained for the future replacement, construction or acquisition of depreciable or non-depreciable

capital assets should not be treated as falling within the scope of paragraph 160AE(3)(d). As the relevant trade or business of the taxpayer in that case is not the construction or acquisition of capital assets, funds committed to or held for that purpose are not currently "employed and risked" in the relevant trade or business. Generally, interest on funds deployed for extraordinary purposes will be construed as interest income rather than business income. For instance, in another case recently considered, interest derived from the investment in a foreign country of funds allocated for the construction of a factory for the future conduct of the branch operations of the taxpayer in that country was ruled to not be relieved from quarantining for FTCS purposes by paragraph 160AE(3)(d).

COMMISSIONER OF TAXATION
16 February 1989