PS LA 2007/7 - Making default assessments of taxable income in respect of attributable income

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This document has changed over time. This version was published on *25 September 2015*

This practice statement was originally published on 28 February 2007. Versions published from 15 November 2011 are available electronically - refer to the online version of the practice statement. Versions published prior to this date are not available electronically. If needed, these can be requested by emailing TCNLawPublishingandPolicy@ato.gov.au .

Generated on: 27 November 2026, 02:40:40 AM

Australian Government
Australian Taxation Office

PS LA 2007/7
Making default assessments of taxable income in respect of attributable income

This Law Administration Practice Statement provides guidance for ATO staff on issuing default assessments in respect of the attributable income of taxpayers.

This practice statement is an internal ATO document, and is an instruction to ATO staff.

If taxpayers rely on this practice statement, they will be protected from interest and penalties in the following way. If a statement turns out to be incorrect and taxpayers underpay their tax as a result, they will not have to pay a penalty. Nor will they have to pay interest on the underpayment provided they reasonably relied on this practice statement in good faith. However, even if they don't have to pay a penalty or interest, taxpayers will have to pay the correct amount of tax provided the time limits under the law allow it.

1. What is this practice statement about?

When a taxpayer does not lodge a return, or we are not satisfied with the return that they did lodge, we can make a default assessment under section 167 of the *Income Tax Assessment Act 1936*.[1]

This practice statement provides guidelines on issuing such a default assessment in situations where attribution regimes operate to attribute certain income to Australian residents who have interests in a foreign company or trust, or who have transferred property or services to a foreign trust.

The attribution regimes include:

- the controlled foreign company regime
- foreign investment fund regime (applicable to 2009-10 and prior years of income), and
- transferor trust regimes.

You should note though that default assessments should also be contemplated where available information suggests that the foreign source income attribution rules may not apply, that is, where the taxpayer appears to have earned income directly from a foreign source rather than through an entity.

2. When might a taxpayer be affected by attribution regimes?

A taxpayer may be affected by the attribution regimes where available information indicates the following:

- the taxpayer has transferred property (including funds) or services to an offshore entity in a nil, low or preferential tax jurisdiction
- the taxpayer is a shareholder in an offshore entity in a nil, low or preferential tax jurisdiction
- the taxpayer exercises control over an offshore entity in a nil, low or preferential tax jurisdiction
- the taxpayer has an interest in, or is entitled to acquire an interest in an offshore entity in a nil, low or preferential tax jurisdiction, or
- the taxpayer is an associate of an entity with any of the abovementioned attributes.

3. Making the default assessment

Once you have determined that a taxpayer may be affected by the attribution regimes, and the general circumstances which allow section 167 to be used, you should make a default assessment in line with the following guidelines. This should be done as soon as there is sufficient information to allow you to make a reasonable calculation of the attributable (and therefore taxable) income.

However, you should not do so if there are other considerations, such as sham transactions, which may preclude the operation of the attribution regimes.

In most circumstances, the taxpayer should be informed of your intention to make a default assessment, as well as the basis upon which it will be calculated, prior to the assessment being made.

An exception to this general rule would be where a case needs to issue urgently. As examples, this may be where there is a risk of:

- flight by the employer; or
- dilution or dissipation of assets.

4. Determining the facts

When making a default assessment, we are able to draw conclusions of fact or make subordinate calculations which allow us to determine the final taxable income.[2]

[1] All legislative references in this practice statement are to the *Income Tax Assessment Act 1936.*

[2] See *Bailey v. Federal Commissioner of Taxation* (1977) 136 CLR 214 at 217 and *Commissioner of Taxation v. Dalco* [1990] 168 CLR 614 at 630.

When considering the attribution regimes, we need to adopt a reasonable basis from available evidence and surrounding economic circumstances for determining any of the following matters.

Controlled Foreign Companies (CFC) – Part X

- The degree of control or influence capable of being exercised by a taxpayer over a person or entity, including whether the taxpayer's circumstances meet the tests for control under:
  - strict control under paragraph 340(a)
  - assumed control under paragraph 340(b), and
  - de facto control under paragraph 340(c).
- Whether a taxpayer is an associate of a person or entity for the purposes of the section 318 associate test, including whether they have sufficient influence over that person or entity.
- Whether a taxpayer has an entitlement to acquire an interest in a CFC under the definition contained within section 322, including in situations where the taxpayer might otherwise not be an attributable taxpayer. For example, where they might have a contingent interest and the entitlement to acquire would crystallise this contingency, if exercised.
- Whether a company or a trust is an Australian 1% entity under section 317.
- The amount of an indirect control interest for the purposes of section 349.
- The amount of a direct control interest for the purposes of section 350.
- The amount of a direct attribution interest for the purposes of subsection 356(1), including determining the nature of an interest that a taxpayer may be entitled to acquire in an entity under section 322.
- Whether an indirect attribution interest exists under subsection 357(1), including determining the nature and extent of any tracing interests that may exist in entities within a chain of ownership.
- An attribution percentage for a taxpayer under section 362, based upon determining indirect and direct shareholdings, taking into account surrounding economic circumstances (including a finding of paragraph 340(c) de facto control) that indicate the likely presence of paragraph 340(a) or 340(b) control through relevant shareholdings.
- The attributable income of a CFC under Div 7 of Part X, or any element within that calculation.
- Whether the active income test is satisfied for a CFC under Division 8 of Part X, or any element relevant to that test.
- The amount of attributable income of a CFC that should form part of the taxable income of an attributable taxpayer for the purposes of section 166 as a result of section 456.

Foreign Investment Funds (FIF) – Part XI (applicable to 2009-10 and prior income years only)

- Whether a taxpayer has an interest in a foreign company for the purposes of paragraph 483(1)(a).
- Whether a taxpayer has an entitlement to acquire an interest (under section 475) in a foreign company as a FIF for the purposes of paragraph 483(1)(b), including in situations where the taxpayer might otherwise not hold such an interest. For example, where they might have a contingent interest and the entitlement to acquire would crystallise this contingency, if exercised.
- Whether a taxpayer has an interest in a foreign trust for the purposes of paragraph 483(2)(a).
- Whether a taxpayer has an entitlement to acquire an interest (under section 475) in a foreign trust as a FIF for the purposes of paragraph 483(2)(b), including in situations where the taxpayer might otherwise not hold such an interest. For example where they might have a contingent interest and the entitlement to acquire would crystallise this contingency, if exercised.
- Whether a taxpayer has an interest in a foreign life policy (FLP) for the purposes of subsection 483(3).
- Whether an interest in a FIF or FLP is held by a bare trust under which a taxpayer is absolutely entitled for the purposes of section 484.
- What should be the notional accounting period for a FIF under section 486.
- What should be the notional accounting period for a FLP under section 487.
- Whether a taxpayer is an associate of a person or entity for the purposes of the section 318 associate test, as modified by section 491, including whether they have sufficient influence over that person or entity.

- Whether there has been a disposal or acquisition of an interest in a FIF for the purposes of section 489, at the time specified in section 489 for the consideration specified in section 490.
- Whether a taxpayer qualifies for an exemption specified in Divisions 2 to 15 of Part XI in respect of their interest in certain FIFs, including calculations necessary to determine such eligibility.
- The amount of FIF income to be included in the assessable income of a taxpayer with an interest in a FIF or FLP for the purposes of Division 16 of Part XI, including any elements in calculations necessary under Division 18 of that Part.
- The amount of FIF losses applicable under Division 17, including any elements in calculations necessary.
- The amount involved in any FIF attribution account transaction for the purposes of Divisions 19 and 20.

Transferor Trusts – Division 6AAA of Part III

- Whether an entity is in position to control a trust estate for the purposes of section 102AAG.
- Whether a taxpayer has transferred property or services to a trust estate for the purposes of section 102AAJ.
- Whether a taxpayer is deemed to have transferred property or services to a trust estate for the purposes of section 102AAK, including any calculations necessary.
- The amount of interest payable on distributions from certain non-resident trust estates for the purposes of section 102AAM, including any calculations necessary.
- Whether a taxpayer is an attributable taxpayer for the purposes of section 102AAT.
- The amount of attributable income of a trust estate for the purposes of section 102AAU, including any calculations necessary.
- The amount of assessable income of a trust estate to be included in the assessable income of an attributable taxpayer under section 102AAZD, including any calculations necessary.
- Amounts relevant to the de minimis exclusion under section 102AAZE.

5. Gathering the information to make the assessment

When gathering information to ascertain the possible application of the attribution rules, you should generally first request the information on an informal basis – either from the taxpayer themselves or relevant third parties.

However, if this is not successful, you should then consider using our formal powers, including:

- making a request under section 264A that a taxpayer produce information or documents that the Commissioner has reason to believe may be held offshore relating to that taxpayer's assessable income
- serving upon an attributable taxpayer a substantiation notice under section 453 requesting that the taxpayer provide evidence that a CFC has passed the active income test, and
- making a request from a treaty partner country for an exchange of information held by the revenue authorities in that country regarding any transactions that may relate to a taxpayer's attributable income.

6. More information

For more details about our formal information gathering powers, see Our approach to information gathering.

EXAMPLES

The following are examples of how to use section 167 in some common situations involving attributable income.

Example 1

Facsimiles and letters between two Australian resident individual taxpayers (A & B) and an offshore service provider obtained from domestic information gathering indicate that the taxpayers caused an offshore company (HavenCo) to be established in a tax haven. Banking information for the two taxpayers also indicates that they each transferred AUS$5,000,000 to a bank account in the name of the company. This evidence indicates that the offshore company operated for five years and neither A nor B reports any involvement with, or any profits received from or attributable income in respect of, the entity in their income tax returns for those years.

No further information is provided by A & B, notwithstanding ATO requests (including a section 264A notice), and no further information arises from third party enquiries.

Given the evidence relating to the establishment of the offshore company, and the transfer of funds to it, the case officer concludes that the taxpayers are affected by the CFC regime. The case officer also identifies the relevant steps in applying the attribution provisions and reaches the following conclusions in respect of those provisions:

- HavenCo is a CFC under section 340, including a finding that it is a resident of the tax haven
- A and B are each section 340(a) controllers of HavenCo and are therefore attributable taxpayers in respect of HavenCo
- A and B are shareholders in Haven Co and have an attributable interest in the company
- that all of HavenCo's income is passive and therefore attributable income of the CFC
- that the amount of attributable income should be calculated by reference to the average of the Australian bond rate of return (compounding) for each of the five years, and
- that A & B should have equal attribution percentages and therefore have 50% of the calculated attributable income of HavenCo attributed to them on the basis of the above calculations.

Accordingly, the case officer issues section 167 assessments in respect of attributable income for both taxpayers. The case officer records in the ATO management systems the basis for each of their decisions, including the steps taken to apply the particular provisions and the conclusions of fact required to support the application of those provisions.

Example 2

Emails, letters and file notes obtained from domestic information gathering indicates that the directors (C, D, E and F) of an Australian company OzCo decided to establish an offshore investment in a non-common law entity (the OzCo Anstalt) limited by shares in a tax haven to benefit OzCo's employees. Documents obtained indicate that the class of employees covered by the documents establishing the OzCo Anstalt includes the directors and their spouses, in addition to other employees. Banking information indicates that OzCo paid AUS$1,000,000 into the OzCo Anstalt each year for four years.

From available information obtained, after four years of operation, there is no evidence that OzCo Anstalt has made distributions to any of the employees, although it has made interest-free, non-recourse loans to C and her husband. Neither OzCo nor C, D, E or F reports any involvement with, or any profits received from or attributable income in respect of, the OzCo Anstalt in their tax returns for those years.

No further information is provided by OzCo or C, D, E or F notwithstanding ATO requests (including a section 264A notice), and no further information arises from third party enquiries.

Given the evidence relating to the establishment of the OzCo Anstalt, and the transactions with it, the case officer concludes that the taxpayers are affected by the CFC regime. The case officer also identifies the relevant steps in applying the attribution provisions and reaches the following conclusions in respect of those provisions (notwithstanding any other decisions about the deductibility of the payments made by OzCo to the OzCo Anstalt):

- that the OzCo Anstalt is a CFC under section 340, including a finding that it is a resident of the tax haven
- C, D, E and F are section 340(a) controllers, and therefore attributable taxpayers, in respect of the OzCo Anstalt
- that the amounts 'loaned' to C and her husband are distribution benefits paid to an associate of the CFC under section 47A and properly income of C and her husband
- that all of the amounts received from OzCo are tainted services income of the OzCo Anstalt and therefore attributable income of the CFC
- OzCo Anstalt's ongoing income from the investment of its received fees is passive and therefore attributable income of the CFC
- that the amount of passive income should be calculated by reference to the average of the Australian bond rate of return (compounding) for each of the four years, less the amount assessable to C under section 47A, and

- aside from the amount assessable to C under section 47A, that C, D, E and F should have equal attribution percentages and therefore have 25% of the attributable income of OzCo Anstalt attributed to them on the basis of the above calculations.

Accordingly, the case officer issues section 167 assessments in respect of attributable income for each of C, D, E and F and in respect of deemed dividends received by C and her husband. The case officer records in the ATO management systems the basis for each of their decisions, including the steps taken to apply the particular provisions and the conclusions of fact required to support the application of those provisions.

Example 3

Company formation documents obtained from another country under one of Australia's tax treaties indicates that G, an Australian resident individual taxpayer, is a guarantee member of an international business company (IBCo) located in a tax haven. IBCo has two shares (held by H & I respectively), each with a face value of AUS$1.00. Evidence obtained from domestic information gathering indicates that G caused AUS$1,000,000 in intellectual property to be transferred to IBCo for nil consideration. IBCo then uses this property for the following six years in transactions with third parties. G does not report either the initial transfer, or any capital gains applicable to it, in her return for that year. G also does not report any interest in, or any profits received from or attributable income in respect of, IBCo's activities in the following six years.

Limited and conflicting information is provided by G following multiple ATO requests (including a section 264A notice), and no further information arises from third party enquiries.

Given the evidence relating to the establishment of the offshore company, and the transfer of the intellectual property to it, the case officer concludes that the taxpayers are affected by the CFC regime. The case officer also identifies the relevant steps in applying the attribution provisions and reaches the following conclusions in respect of those provisions:

- IBCo is a CFC under section 340, including a finding that it is a resident of the tax haven
- G is a section 340(a) controller, and therefore an attributable taxpayer, in respect of IBCo
- G, as a guarantee member, is a shareholder in IBCo and has an attribution interest in the company
- G is assessable on the calculated difference between the market value of the intellectual property and its cost base as a capital gain at the time of the transfer
- that the income earned by IBCo from the use of the intellectual property is passive income and therefore attributable income of the CFC
- that the value of the income earned by IBCo will be calculated by reference to the average of Australian Bureau of Statistics figures for the return on investment from intellectual property of the relevant type over the six years
- that G's attribution interest in IBCo is 100%, notwithstanding the inconsequential interests notionally held by H and I
- that G's attribution percentage in respect of the attributable income of IBCo is therefore 100%, and
- that all of the attributable income of IBCo should be assessed to G on the basis of the above calculations.

Accordingly, the case officer issues section 167 assessments in respect of attributable income for G. The case officer records in the ATO management systems the basis for their decision, including the steps taken to apply the particular provisions and the conclusions of fact required to support the application of those provisions.

Example 4

Letters, facsimiles and witness statements obtained from domestic information gathering indicates that JCo, an Australian resident company controlled by J, established an international company (IntlCo) located in a tax haven. This evidence indicates that IntlCo has a single share with a face value of AUS$1.00, held by K who works for a tax planning and asset protection services entity in the tax haven. This evidence also indicates that JCo conducted a series of transactions to allegedly obtain goods from IntlCo over a period of four years and income tax returns indicate that JCo claimed deductions for those costs in its tax return for each year. From those returns, JCo does not report any interest in, or any profits received from or attributable in respect of, IntlCo's activities in the four years. In addition, the evidence indicates that J obtained an interest-free loan from IntlCo in the second, third and fourth years for 85% of the amount charged by IntlCo. In addition, in his income tax returns, J does not report any interest in, or any profits received from or attributable in respect of, IntlCo's activities in any of the four years.

Limited information is provided by JCo and J, notwithstanding multiple ATO requests (including a section 264A notice to each taxpayer), and no further information arises from third party enquiries.

Given the evidence relating to the establishment of the offshore company, and the nature of the transactions between it and JCo, the case officer concludes that the taxpayers are affected by the CFC regime. The case officer also identifies the relevant steps in applying the attribution provisions and reaches the following conclusions in respect of those provisions (ignoring the potential application of Division 13 or Division 815, as applicable, in respect of transfer pricing and any questions in relation to the deductibility of the expenses under section 8-1 of the *Income Tax Assessment Act 1997*):

- IntlCo is a CFC under section 340, including a finding of fact that IntlCo is a resident of the tax haven
- that K is a nominee of JCo in respect of the single share in Intl Co making JCo a section 340(a) controller based upon an entitlement to acquire that share, and therefore an attributable taxpayer, in respect of IntlCo
- that the amounts 'loaned' to J are distribution benefits paid to an associate of the CFC under section 47A and properly income of J
- that the income earned by IntlCo from the provision of the goods is tainted as the goods were not substantially altered or transformed by IntlCo and therefore is attributable income of the CFC
- that JCo's attribution interest in IntlCo is 100%, notwithstanding the nominee shareholding notionally held by K and I
- that JCo's attribution percentage in respect of the attributable income of IntlCo is therefore 100%, and
- that all of the attributable income of IntlCo should be assessed to JCo on the basis of the above calculations.

Accordingly, the case officer issues section 167 assessments in respect of attributable income for JCo and deemed dividends for J. The case officer records in the ATO management systems the basis for each of their decisions, including the steps taken to apply the particular provisions and the conclusions of fact required to support the application of those provisions.

Example 5

Third party documentary evidence (loan application documents and emails) obtained from domestic information gathering indicates that L, an Australian resident individual for all relevant years, caused the creation of a discretionary foreign trust HavenTrust, with its sole trustee being MCo, resident in a tax haven. In addition, this evidence indicates that members of L's family who are Australian residents are listed as potential beneficiaries. Banking and AUSTRAC information indicates that over a period of six years L made, or caused to be made, a series of transactions with HavenTrust that include direct or indirect transfers of funds valued at AUS$1,000,000 (Year 1). In addition, a media article from a reputable financial publication about tax haven investment trusts lists the assets of HavenTrust as being the equivalent of AUS$10,000,000 in Year 1. Income tax returns indicate that L does not report these transfers, or any profits received from or attributable income in respect of, HavenTrust's activities in the six years. Enquiries have identified no other taxpayer who may have been an attributable taxpayer in respect of HavenTrust and there are no indications from the available evidence of any actual distributions to L's family during those years.

Limited information is provided by L notwithstanding multiple ATO requests (including a section 264A notice), and no further information arises from third party enquiries (including an Exchange of Information with a treaty partner involved in an audit of MCo's activities as a promoter of tax avoidance schemes).

Given the evidence relating to the establishment of the offshore company, and the transfer of funds to it, the case officer concludes that the taxpayers are affected by the Transferor Trust regime. The case officer also identifies the relevant steps in applying the attribution provisions and reaches the following conclusions in respect of those provisions:

- HavenTrust is a discretionary trust, with a finding of fact that its sole trustee (MCo) is resident in an unlisted country (the tax haven)
- L is an attributable taxpayer in respect of HavenTrust based upon the direct and indirect transfers of funds
- based upon the evidence, L could obtain information necessary to calculate the attributable income of HavenTrust, despite the lack of response to ATO enquiries, meaning that section 102AAZD(4) will not apply
- based upon the reported assets of HavenTrust, the notional attributable income will be calculated on the value of AUS$10,000,000 in Year 1, compounding through years 2 to 6, calculated by reference to the average of Australian Bureau of Statistics figures for the net return on investment from foreign investments over the six years
- that L has not provided complete information in approved form regarding other persons who made transfers of property or services to HavenTrust, so that section 102AAZD(3) will not apply

- that L's attribution percentage in respect of the attributable income of HavenTrust will therefore be 100%, and
- that all of the attributable income of HavenTrust should be assessed to L, on the basis of the above calculations.

Accordingly, the case officer issues section 167 assessments in respect of attributable income for L. The case officer records in the ATO management systems the basis for their decision, including the steps taken to apply the particular provisions and the conclusions of fact required to support the application of those provisions.

Date issued 28 February 2007

Date of effect 28 February 2007