Worked example

Foreign income tax offsets – transitional rules

Description

This example provides guidance on the operation of the transitional rules for the foreign income tax offset provisions that came into effect for the income year starting on and after 1 July 2008. This example shows how:

1. excess foreign tax credits are converted to pre-commencement excess foreign income tax
2. pre-commencement excess foreign income tax is transferred from the joining entity to the head company, and
3. pre-commencement excess foreign income tax is utilised to increase the foreign income tax offset.

Commentary

The foreign income tax offset rules replace the foreign tax credit rules from the first income year starting on or after 1 July 2008. When the foreign income tax offset rules take effect, the head company of a consolidated or MEC group will convert any existing excess foreign tax credits from the previous five income years to pre-commencement excess foreign income tax.

Transitional rules for consolidated and MEC groups allow the joining entity to transfer to the head company excess foreign tax credits that have been converted to pre-commencement excess foreign income tax. These transitional rules reflect the previous foreign tax credit rules on the transfer of excess foreign tax credits to the head company at the joining time.

The pre-commencement excess foreign income tax transferred from the joining entity is pooled with any other pre-commencement excess foreign income tax of the head company and any other subsidiary members. There is no longer any requirement to categorise or quarantine foreign income tax into various classes of income. However, it is necessary to track the year in which the excess foreign tax credits arose due to the five year limit on utilisation.

Pre-commencement excess foreign income tax can be used to increase the foreign income tax offset if there is a foreign income tax shortfall, subject to the five year time limit. A foreign income tax shortfall occurs where the foreign income tax paid is less than the foreign income tax offset limit as calculated under section 770-75 of the ITAA 1997.

Where an entity joins a consolidated or MEC group part way through an income year, the head company cannot apply the pre-commencement excess foreign tax transferred from the joining entity until the following income year.

Example

Facts

On 30 June 2005, HCo becomes the head company of a consolidated group with one subsidiary member, ACo. On 30 June 2006, BCo is acquired by HCo and becomes a subsidiary member of the consolidated group for six months until HCo disposes of all its interests in BCo on 31 December 2006, at which time BCo leaves the group.

At 30 June 2008, HCo has the following excess foreign tax credits available (including amounts transferred to the group when BCo joins on 30 June 2006).

Table 1: Pooled excess foreign tax credit balances of HCo (available at 30 June 2008)

		Excess foreign tax credits arising in …					
		03-04	**04-05**	**05-06**	**06-07**	**07-08**	**Total**
Passive income	HCo	$53			$200		
	ACo	$19	$88			$100	
	BCo	$57	$48	$33			
	Total	**$129**	**$136**	**$33**	**$200**	**$100**	**$598**
Other income	HCo					$150	
	ACo		$101			$70	
	BCo		$50	$97			
	Total		**$151**	**$97**		**$220**	**$468**

On 1 January 2009, HCo acquires all the membership interests in CCo (which has the same income year as HCo). CCo had converted its excess foreign tax credits to pre-commencement excess foreign income tax when the foreign income tax offset rules commenced on 1 July 2008. The pre-commencement excess foreign income tax of CCo immediately before the joining time is as follows:

Table 2: Pre-commencement excess foreign income tax of CCo at 31 December 2008

	Pre-commencement excess foreign income tax arising in...				
	03-04	**04-05**	**05-06**	**06-07**	**07-08**
As at 31 Dec. 2008	$350	$500	–	$600	$400

CCo pays foreign income tax of $2,500 on income derived in its non-membership period from 1 July 2008 to 31 December 2008.

For the 2008-09 income year, HCo pays $4,000 in foreign income tax on amounts included in its assessable income.

For the 2009-10 income year, HCo pays foreign income tax of $7,000 on amounts included in its assessable income.

Calculation

2008-09 income year

From 1 July 2008, the foreign income tax offset rules apply to HCo, which converts its excess foreign tax credits to pre-commencement excess foreign income tax.

Table 3: Pre-commencement excess foreign income tax of HCo at 1 July 2008

	Pre-commencement excess foreign income tax arising in ...				
	03-04	04-05	05-06	06-07	07-08
Pool	$129	$287	$130	$200	$320

CCo joins the group on 1 January 2009. In the non-membership period from 1 July 2008 to 31 December 2008, CCo pays foreign income tax of $2,500 on an amount included in its assessable income in this period.

CCo is eligible for a foreign income tax offset for the foreign income tax it has paid subject to the foreign income tax offset limit. CCo can calculate the foreign income tax offset limit as the lesser of the foreign income tax paid or the Australian tax payable on the double-taxed amounts, or choose to use the $1,000 de minimis cap. CCo calculates its foreign tax offset limit as $2,200.

CCo is able to offset $2,200 of the foreign income tax it has paid to reduce tax payable for the non-membership period. The foreign income tax of $300 not utilised cannot be transferred to HCo, as it relates to income included in CCo's assessable income and it is not pre-commencement excess foreign tax.

CCo transfers its pre-commencement excess foreign income tax to HCo at the joining time to be pooled with HCo's pre-commencement excess foreign income tax, as follows:

Table 4: Pre-commencement excess foreign income tax of HCo at 1 Jan 2009

	Pre-commencement excess foreign income tax arising in ...				
	03-04	04-05	05-06	06-07	07-08
Previous pool	$129	$287	$130	$200	$320
Transferred from CCo	$350	$500	–	$600	$400

For the 2008-09 income year, HCo calculates its foreign tax offset limit at $4,250. As HCo paid foreign income tax of $4,000, there is a foreign income tax shortfall because the tax offset amount is less than the foreign tax offset limit.

HCo can utilise its pre-commencement excess foreign income tax to increase the tax offset amount. It uses a first-in, first-out basis for utilising pre-commencement excess foreign income tax from the pool. HCo increases the foreign income tax offset amount by $250 by using pooled pre-commencement excess foreign income tax amounts (reducing the 2003-04 amount by $129 and 2004-05 by $121).

HCo cannot use any excess foreign income tax transferred by CCo because CCo had not joined the consolidated group before the start of HCo's 2008-09 income year. The first income year in which HCo can use the transferred excess foreign income tax from CCo is 2009-10.

Table 5: Pre-commencement excess foreign income tax of HCo at 30 June 2009

	Pre-commencement excess foreign income tax arising in ...				
	03-04	04-05	05-06	06-07	07-08
Previous pool	$129	$287	$130	$200	$320
Transferred from CCo	$350	$500	–	$600	$400
Utilised 30 June 2009	($129)	($121)			
Balance	$350	$666	$130	$800	$720

2009-10 income year

For the 2009-10 income year, HCo calculates its foreign income tax offset limit as $8,500. Having paid foreign income tax of $7,000, HCo is left with a foreign income tax shortfall of $1,500. HCo can utilise its pre-commencement excess foreign income tax and add $1,500 to the tax offset for the income year.

The five year time limit prevents HCo from using pre-commencement excess foreign income tax from the 2003-04 income year because these amounts arose outside the five years preceding 2009-10. The pre-commencement excess foreign income tax from the 2004-05 and following income years is available for HCo to use. HCo uses a first-in, first out basis for utilising the pre-commencement excess foreign income tax from the pool.

The balance of the pool after utilising pre-commencement excess foreign income tax is calculated as follows:

Table 6: Pre-commencement excess foreign income tax available for HCo at 30 June 2010

	Pre-commencement excess foreign income tax arising in ...				
	04-05	05-06	06-07	07-08	Total
Pool	$666	$130	$800	$720	$2,316
Utilised 30 June 2010	($666)	($130)	($704)		($1500)
Balance			$96	$720	$816

References

Income Tax Assessment Act 1997, Subdivision 717-A and Division 770, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Income Tax (Transitional Provisions) Act 1997, Subdivisions 770-D and 770-E, as amended by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*

Explanatory Memorandum to Tax Laws Amendment (2007 Measures No. 4) Bill 2007, Chapter 1

Revision history

Section C6-2-120 first published 30 June 2009.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).