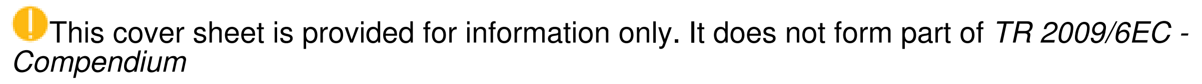
TR 2009/6EC - Compendium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Ruling Compendium – TR 2009/6

This is a compendium of responses to the issues raised by external parties to draft Taxation Ruling TR 2009/D1 – 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.

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Issue raised	Tax Office Response/Action taken
1	Where a resident taxpayer has a 10% or greater interest in a foreign investment fund (FIF) which is a fiscally transparent entity in the overseas jurisdiction but is not treated as a foreign hybrid for Australian tax purposes (because it does not satisfy the conditions to be a controlled foreign company (CFC) and no election is made under section 485AA of the *Income Tax Assessment Act 1936* (ITAA 1936)), they should be entitled to a foreign income tax offset (FITO) for foreign income tax paid by them in respect of an amount included in their assessable income under section 529 of the ITAA 1936, irrespective of whether there is a distribution (paragraphs 14 and 84 to 90 of draft ruling)..	Final Ruling references: paragraphs 87 to 95. 1.1 The extent to which an attributable taxpayer with a FIF interest is entitled to a FITO for amounts included in their assessable income under section 529 of the ITAA 1936 is governed by the rules in section 770-135 of the *Income Tax Assessment Act 1997* (ITAA 1997). This provision was part of a re-write of the foreign tax credit (FTC) rules into Division 770 of the ITAA 1997. Under the old rules, subsection 6AB(3A) of the ITAA 1936 prevented attributable taxpayers from claiming a FTC in respect of their attributable income, except as expressly provided for by the relevant tax-paid deeming rules contained in former Division 18 of the ITAA 1936. 1.2 Former subsection 6AB(3A) of the ITAA 1936 stated as follows: Except as provided by section 160AFCA, 160AFCB, 160AFCD, 160AFCE, 160AFCF, 160AFCG, 160AFCH, 160AFCJ or 160AFCK, a taxpayer is not taken to have been personally liable for, and to have paid, foreign tax in respect of: (a) an amount included in assessable income under section 102AAZD, 456, 457, 459A or 529; or (b) the section 23AI non-assessable part of an attribution account payment (within the meaning of section 160AFCD); or the section 23AK non-assessable part of a FIF attribution account payment (within the meaning of section 160AFCJ).

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1 cont.		1.3 The former FTC provisions dealing with attributable taxpayers that include attributable income in their assessable income that are referred to in former subsection 6AB(3A) of the ITAA 1936 have been re-drafted into a principles based drafting format in section 770-135 of the ITAA 1997.[1] While there is no single provision in the new law expressly replicating former subsection 6AB(3A) of the ITAA 1936, a combination of sections 770-135 and 770-10 of the ITAA 1997 gives effect to the same policy intent, that is, an attributable taxpayer cannot treat any foreign income tax as having been paid in respect of their attributable income unless they satisfy the requirements of section 770-135 of the ITAA 1997. 1.4 This is evidenced by paragraphs 1.74 to 1.82 of the Explanatory Memorandum to the Tax Laws Amendment (2007 Measures No. 4) Bill 2007 which clarifies, in relation to attributable taxpayers with FIF interests, the extent of changes to the FTC rules and detail the circumstances under which such taxpayers will be entitled to a FITO. In particular paragraphs 1.76 and 1.77 state: 1.76 In line with current foreign tax credit rules, a foreign tax offset will only be available for taxpayers that are attributed with income under section 529 of the foreign investment fund rules where the calculation method is used to determine their attributable income. 1.77 However, the foreign tax offset in these cases is limited to situations where: • the foreign company or foreign trust has paid the tax ***[Schedule 1, item 1, paragraph 770-135(3)(c)]***; • the association condition is met (in the case of a foreign company only) ***[Schedule 1, item 1, paragraph 770-135(5)(c)]***; and • the calculation method is used ***[Schedule 1, item 1, subsection 770-135(6)]***.

[1] The FTC provisions dealing with non-assessable non-exempt (NANE) income (former sections 160AFCD and 160AFCJ of the ITAA 1936) are specifically dealt with under subsection 770-10(2) of ITAA 1997.

Issue No.	Issue raised	Tax Office Response/Action taken
1 cont.		1.5 Section 770-135 of the ITAA 1997 contains detailed rules about the circumstances in which an attributable taxpayer with a FIF or CFC interest that includes an amount in their assessable income under either section 529 or 456 of the ITAA 1936 is treated as having paid foreign income tax. 1.6 Under subsection 770-135(3) of the ITAA 1997, it is a relevant condition that the foreign income tax be paid by the FIF or the CFC. In this instance, as the FIF is a fiscally transparent entity under the laws of the foreign country it pays no tax. Rather, tax is imposed at the level of the member in respect of their share of the net income of the fiscally transparent foreign entity. As this pre-condition is not met, there is no foreign income tax that can be treated as having been paid by the attributable taxpayer that can count towards that taxpayer's tax offset in respect of their attributable income. Accordingly, section 770-135 of the ITAA 1997 cannot apply to treat the attributable taxpayer in this instance as having paid any foreign income tax in respect of their section 529 of the ITAA 1936 income. 1.7 In this instance, while it is accepted that the foreign income tax in question is paid by the attributable taxpayer (not the FIF), as section 770-135 of the ITAA 1997 is the exclusive code for treating foreign income tax as having been paid in respect of an attributable taxpayer that derives attributable income, the core rules in subsection 770-10(1) of the ITAA 1997 cannot be satisfied unless the requirements of the first-mentioned provision are met. 1.8 The suggested view, that subsection 770-10(1) of the ITAA 1997 should be interpreted in a manner to cover the situation where an attributable taxpayer is directly liable for foreign tax and derives attributable income, if adopted, would enable such attributable taxpayers to bypass the specific eligibility rules set out in section 770-135 of the ITAA 1997 and obtain access to a foreign income tax offset in circumstances that were expressly not provided for by that provision.

Issue No.	Issue raised	Tax Office Response/Action taken
1 cont.		1.9 More specifically, it would mean that an individual attributable taxpayer (instead of a company) with a foreign company FIF interest that is assessed under section 529 of the ITAA 1936 could obtain a tax offset. This is contrary to the policy intent of section 770-135 of the ITAA 1997 which is to expressly limit the foreign tax paid deeming rules to corporate attributable taxpayers with foreign company FIF or CFC interests. 1.10 In addition, it would enable the attributable taxpayer with a FIF interest to claim an offset, irrespective of which method of FIF taxation was chosen. Again, section 770-135 of the ITAA 1997 (and its predecessor provisions under the former law) expressly limits the ability of attributable taxpayers with FIF interests to deem foreign income tax to have been paid by them where their attributable income is worked out under the calculation method. 1.11 Finally, the minimum attribution requirement of 10% for attributable taxpayers with foreign company FIF interests would not apply. Thus, an attributable taxpayer that is liable to foreign tax with an attribution percentage of less than 10 per cent would be able to access a tax offset that is expressly denied under section 770-135 of the ITAA 1997. It is considered that this outcome (of bypassing section 770-135 for an attributable taxpayer with attributable income) is inconsistent with policy intent. Accordingly, the interpretation adopted in the draft ruling is retained. 1.12 It is also noted that the mismatch between the derivation of attributable income and the eligibility for a tax offset which crystallises upon the inclusion of the distribution that is either taxed as a dividend under section 44 of the ITAA 1936 or treated as non-assessable non-exempt income under section 23AK of the ITAAA 1936, arises because of a choice made by the taxpayer not to elect foreign hybrid treatment in respect of their interest in the fiscally transparent foreign entity.

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Issue No.	Issue raised	Tax Office Response/Action taken
1 cont.		1.13 The foreign hybrid rules were introduced to overcome the misalignment of treatment of an entity under the laws of a foreign country compared to Australia by treating the foreign entity not as a corporate, but as a partnership for Australian tax purposes. It is noted that section 485AA of the ITAA 1936 was included in the legislation specifically to enable Australian resident taxpayers with an interest in a FIF, which is not otherwise an interest in a foreign hybrid, to treat that interest as an interest in a foreign hybrid to enable them to avoid the possible mismatches. By not electing into the regime in this instance, attributable taxpayers would be aware that they are subjecting themselves to the same outcomes that previously existed, including the inability to access a foreign income tax offset for foreign tax paid by them in respect of their FIF interest at the attribution stage. 1.14 Accordingly, the interpretative view expressed in the draft ruling is maintained in the final Ruling, however further clarification of the Tax Office reasons has been provided in the explanation section of the final Ruling, taking into account the above material.
2	Where a resident company holds an interest in a foreign hybrid that in turn holds an interest in a CFC or foreign company FIF, the resident company should be entitled to a FITO for tax paid by the CFC or FIF (paragraphs 15 to 19 and 91 to 106 of the draft ruling).	Final Ruling references: paragraphs 96 to 112. 2.1 Where a resident company indirectly holds a CFC or foreign company FIF interest via a foreign hybrid, the effect of the foreign hybrid rules is to treat the foreign hybrid as a partnership for Australian tax purposes.

Issue No.	Issue raised	Tax Office Response/Action taken
2 cont.		2.2 The foreign hybrid, in turn, is treated as an Australian partnership for the purposes of the CFC rules because it has at least one resident partner, namely the resident company. As the foreign hybrid is an Australian partnership, it is the attributable taxpayer with the effect that the relevant attributable income under section 456 of the ITAA 1936 is included as assessable income in the partnership net income as defined at section 90 of the ITAA 1936. Similarly, the FIF rules apply to include the FIF attributed income in the assessable income of the partnership under section 529 of the ITAA 1936. Accordingly, under both the CFC and FIF rules, it is the partnership that is treated as the attributable taxpayer, not the partner in a partnership. 2.3 In turn, the partner (in this instance the resident company) includes in their assessable income the relevant share of the partnership net income under section 92 of the ITAA 1936. As the relevant assessable income provision is section 92 of the ITAA 1936, the resident company does not satisfy the requirements of subsection 770-135(2) of the ITAA 1997 as no amount is included in their assessable income under either sections 456 or 529 of the ITAA 1936. As this is a core requirement of the tax-paid deeming rules the provision cannot apply to the resident company that is a partner in the foreign hybrid that in turn holds the CFC or foreign company FIF interest. This outcome is consistent with the policy intent of the provision which is that the tax-paid deeming rules only apply to attributable taxpayers.

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2 cont.		2.4 As the foreign hybrid (partnership) is the attributable taxpayer that includes an amount in its assessable income under sections 456 or 529 of the ITAA 1936, the conditions for the application of section 770-135 of the ITAA 1997 are applied to it. One of the conditions, set out in paragraph 770-135(2)(b) of the ITAA 1997, is that the attributable taxpayer with a CFC or foreign company FIF interest must be a company. Therefore, as the foreign hybrid is treated as a partnership and not as a company, the tax-paid deeming rules in section 770-135 of the ITAA 1997 also cannot apply to it (paragraph 770-135(2)(a) of the ITAA 1997). 2.5 It has been contended that this result is contrary to the policy intent of the foreign hybrid rules which was to broadly allow Australians to invest in foreign hybrids with certainty by removing uncertainties arising from misalignment of treatment, that is, as a company for Australian tax purposes and as a partnership under the foreign tax law. This policy intent is given legislative effect by re-aligning the Australian tax treatment of a fiscally transparent foreign entity to that of the foreign country by treating the entity as a partnership. Hence, the Australian tax law consequences would flow from the treatment of the foreign hybrid as a partnership under Australian tax law. One relevant consequence is that the FITO result of denying the resident company that invests in CFCs or FIFs indirectly via an Australian partnership applies equally to all partnerships and not just foreign hybrids. This result applies to foreign investment structures of this type under both the earlier FTC and new FITO rules.

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2 cont.		2.6 It has also been suggested that one way to overcome the purported unintended policy result is to interpret the FITO rules such that: (i) income retains its character as it passes through foreign hybrids; (ii) the Australian taxpayer is treated as having ‘paid’ the foreign income tax by virtue of the fact that the foreign hybrid (in which it is treated as a partnership) is the attributable taxpayer in relation to the CFC; and (iii) the relevant interest requirements in subsection 770-135(5) of the ITAA 1997 are satisfied having regard to the foreign hybrid’s attribution interest in the underlying entity. 2.7 In relation to subparagraph 2.6(i) of this compendium, and as noted earlier, the scheme of the ITAA 1936 in relation to partnerships is to ascertain the net income of a partnership under section 90 of the ITAA 1936 by hypothesising it to be a resident taxpayer (subject to certain modification rules) and to assess the partners on their share of that partnership net income under section 92 of the ITAA 1936. In accordance with this fundamental principle there is no scope to adopt a view for these purposes that a partner includes amounts in their assessable income (representing their share of the net income of a partnership) under the particular provisions relevant to the components of the partnership’s net income rather than the amount ascertained in accordance with section 92. 2.8 In relation to subparagraph 2.6(ii) of this compendium, as the resident company (that is a partner in the foreign hybrid, which in turn holds the relevant CFC or FIF interest) is not the attributable taxpayer, nor is it assessed under sections 456 or 529 of the ITAA 1936 in respect of such interests it holds, the tax paid deeming rules in section 770-135 of the ITAA 1997 cannot apply to it.

Issue No.	Issue raised	Tax Office Response/Action taken
2 cont.		2.9 In relation to subparagraph 2.6(iii) of this compendium, it is not possible to apply an attribution percentage test to the interest held by the resident company in the underlying CFC or FIF via the foreign hybrid. The concept of an attribution interest only applies to entities that are attributable taxpayers. As the attributable taxpayer in this instance is the foreign hybrid and not the resident company that is a partner in the foreign hybrid, the association condition in subsection 770-135(5) of the ITAA 1997 cannot be met. 2.10 Accordingly, the final Ruling position on this issue has not been altered.
3	That it is incorrect to deny a foreign income tax offset merely because the other country has not imposed tax in accordance with the treaty (according to Australia's interpretation of the treaty). In such a situation, the issue should be whether the foreign country provides a refund for the tax inappropriately imposed. That is, the tax offset should only be denied to the extent that the foreign country provides a refund of the foreign income tax paid in accordance with section 770-140 of the ITAA 1997 (paragraph 121 of the draft ruling).	Final Ruling reference: paragraph 127. 3.1 One of the key requirements in Australia's tax treaties is that relief from double taxation applies only to the extent that the foreign tax paid has been imposed in accordance with the treaty. 3.2 Where Australia considers that the other country has not imposed tax in accordance with the treaty it is not obliged to provide a FITO for such tax paid. 3.3 This approach is complemented by Division 770 of the ITAA 1997. In particular, the note to section 770-15 of the ITAA 1997 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. 3.4 Accordingly, any foreign income tax imposed other than in accordance with the relevant treaty (as interpreted by Australia) is not considered to be 'foreign income tax' within the meaning of section 770-15 of the ITAA 1997.

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3 cont.		3.5 This approach is also consistent with the context in which the Mutual Agreement Procedure (MAP) operates within our treaties. The MAP provisions exist to endeavour to resolve cases where *inter alia* it is considered that tax has been imposed in one of the Contracting States not in accordance with the treaty and a footnote has been added to paragraph 127 of the final Ruling with further information on MAPs. 3.6 The ruling has been amended to make specific reference to the Note in section 770-15 of the ITAA 1997 but otherwise has not been amended on this issue.
4	Paragraph 72 refers to a fiscally transparent entity being treated as a partnership for both the purposes of Australian income tax law and the law of the foreign country- this may not be the case (for example, US LLCs can also be treated as disregarded entities for US tax purposes).	See amended paragraphs 75 and 76 of the final Ruling: these paragraphs clarify that the effect of the law of the foreign country is to tax the fiscally transparent foreign entity (including a disregarded entity) at the level of the partner or member rather than to accord partnership treatment to such entity.
5	It would be helpful if an example was included (similar to Example 3 which assumes the FIF is exempt - refer footnote 2) for a taxable FIF such that the example would show the outcome (that is, FITOs available) where the distribution is NANE income under section 23AK of the ITAA 1936.	Example 4 (at paragraphs 39 to 41) has been added to the final Ruling to cover this situation.

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6	It would be helpful if an example was included whereby the foreign tax is withheld by a third party (for example, interest payable by a borrower to the foreign entity and the borrower has an obligation to withhold tax from the interest – this would presumably arise under the foreign laws due to the entity being fiscally transparent under the tax laws in the foreign country) – if the foreign entity is a foreign hybrid then it should be straightforward that the Australian taxpayer (with an interest in the foreign hybrid) will be entitled to a foreign income tax offset under subsection 770-10(1) of the ITAA 1997.	Footnote added to Example 1 to explain that a FITO would still apply to the resident partner in a foreign hybrid if, instead of the partnership being required to withhold tax in respect of the share of the partnership profits to which the resident partner is entitled, the foreign income tax was paid by a third party on a withholding basis.
7	It would be helpful to include a reference to TD 2006/52 (in the context of a FIF interest where a section 485AA of the ITAA 1936 election has not been made), particularly as some of the examples include situations where the Australian taxpayer holds a 10% interest in the FIF (refer Example 3 in particular).	A reference to TD 2006/52 has been made by way of a footnote to new Example 4 of the final Ruling.