


IT 2554 - Income tax : Australia/Italy Double Taxation Agreement : Italian pensions derived by Australian residents

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TAXATION RULING NO. IT 2554

INCOME TAX : AUSTRALIA/ITALY DOUBLE TAXATION AGREEMENT :
ITALIAN PENSIONS DERIVED BY AUSTRALIAN RESIDENTS

F.O.I. EMBARGO: May be released

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| I 1011491 | DOUBLE TAXATION AGREEMENT - AUSTRALIA/ITALY | 20, 23AD, 27H, 159ZRA Income Tax (International Agreements) Act 1953 - Schedule 21 Articles 18,28 |

PREAMBLE The purpose of this Ruling is to clarify certain issues concerning the taxation treatment of certain Italian pensions received by Australian residents. This preamble outlines various matters that are relevant to the content of this Ruling, under appropriate headings.

Australia/Italy Convention

2. Article 18 of the Convention between Australia and Italy for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income ("the Convention") provides for the taxation of pensions only in the country of residence of the recipient. This means that, under the Convention, Italian pensions received by Australian residents are free of tax in Italy and taxable only in Australia.

3. The "Entry Into Force" Article (Article 29) of the Convention provides for its provisions to generally have effect in both countries in respect of income derived on or after 1 July 1976. However, pursuant to an arrangement reached between the two countries, the Australian Government announced on 25 August 1987 that Article 18 of the Convention would not be applied to Italian pensions derived by Australian residents before 1 July 1987. This means that the first time most recipients of Italian pensions are required to include this income in their assessable income, for Australian tax purposes, is in tax returns for the 1987/88 year of income. (Prior to that date, Italian pensions that were not exempt from Italian tax would have qualified for exemption from Australian tax under the former paragraph 23(q) of the Income Tax Assessment Act, (the "Act")).

Italian social insurance system

4. The Italian social insurance system is composed of various

bodies that pay retirement and other pensions. There are currently about 45 bodies administering the various forms of social insurance. The largest amongst these, both in terms of number of insured persons and pensions paid out, is the Istituto Nazionale della Previdenza Sociale (National Social Insurance Institute - "INPS"). The INPS also administers the payment of pensions on behalf of most of the major insurance funds.

5. The INPS rules stipulate that all salary received by an employee is subject to a social security contribution but imposes a ceiling on benefits. Broadly, the retirement benefit is based on the number of years of contribution and average earnings over the last five years of service. However, under Italian social security law, a guaranteed minimum level of pension is payable and, where a person's contribution-based pension is less than that minimum, a supplement up to that minimum is paid.

Undeducted purchase price

6. Section 27H of the Act operates to include in the assessable income of a taxpayer the amount of any annuity, including a superannuation pension, derived by the taxpayer during a year of income. However, in particular circumstances, some part of a pension derived by an Australian resident is excluded from the pension recipient's assessable income and therefore is not subject to Australian tax. That part of a pension which is not subject to tax is known as the 'undeducted purchase price.'

7. In order for some part of a foreign source pension to qualify for exemption from Australian tax, the following requirements must be satisfied-

- (a) the pension must have been paid from a 'foreign superannuation fund' as defined in subsection 6(1) of the Act, i.e., a provident, benefit, superannuation or retirement fund established and managed outside Australia to provide individual personal benefits, pensions or retiring allowances for non-residents of Australia; and
- (b) the pension must have been a purchased pension, i.e., contributions previously paid by the pensioner to the foreign superannuation fund must be established to be the purchase price of that pension.

8. In broad terms, the part of the undeducted purchase price which may be excluded from the pensioner's assessable income in any given year of income, ("the annual exclusion amount") is obtained by dividing the total undeducted purchase price of the pension by -

- . the term of the pension; or
- . where the pension is paid until the death of the pensioner, the remaining life expectancy of the pensioner (determined by reference to the prescribed Australian Life Tables) at the time when the pension

first commenced to be derived.

9. Where the pension is a joint life/survivorship (reversionary) pension and it first became payable on or after 1 July 1983, the life expectancy to be used is the greater of the life expectancies of the taxpayer or the other person to whom the pension will revert on the taxpayer's death (usually the spouse).

Invalid pensions

10. Under subparagraph 23AD(3)(d)(i) of the Act, an invalid pension payable under the Australian Social Security Act 1947 to a person who has not attained age pension age is exempt from Australian income tax. (A person of age pension age is a man aged 65 or more or a woman aged 60 or more.). Provision is also made under paragraphs 23AD(3)(a) and 23AD(3)(c) for certain disability or war pensions payable under the Australian Repatriation Acts and certain other disability or war pensions to be exempted from Australian tax.

Income splitting

11. Clarification has also been sought as to the appropriate income tax treatment in circumstances where a pensioner receives an Italian pension based on a combined rate. Requests have been received that this type of pension be allowed to be split between the husband and wife for Australian tax purposes.

12. The splitting of pension income was considered by Taxation Board of Review No. 2 in Case Q3, 83 ATC 7. In that case, the Board examined the situation of a taxpayer who received a pension from a State superannuation fund which basically consisted of two components -

- (a) an amount payable in respect of the taxpayer (spouse of the deceased contributor); and
- (b) an amount payable in respect of the taxpayer's children (dependants).

In particular, the Board considered whether the component of the pension received by the taxpayer in respect of her dependants was only in the capacity of a trustee.

13. To ascertain whether the taxpayer received the total pension in her own right, or part of it in her own right and the balance in the capacity of a trustee, the Board had regard to the relevant provisions of the legislation under which the superannuation fund operated. In this particular case, the Board held that the total amount of the pension was received by the taxpayer in her own right and thus she was not entitled to split the pension between herself and her dependants for Australian taxation purposes.

Currency translation

14. Section 20 of the Act requires all income and expenses to be

expressed in Australian currency for the purposes of the Act. The practical application of the provisions of that section is clarified in Taxation Ruling No. IT 2498. In particular, paragraphs 6, 7 and 26 to 28 of that ruling deal specifically with pension income.

RULING Basis of calculation of amount of pension to be included in assessable income

15. Under the Australian taxation system, tax is generally calculated on the amount of income derived by an individual taxpayer for the twelve month period 1 July to 30 June (known as the 'year of income'). Thus, in ascertaining the amount of an Italian pension to be included in a pensioner's income tax return as assessable income, regard must be had to the fact that certificates of pensions are generally provided by Italian organisations on a calendar year basis. In other words, it would not generally be appropriate for a taxpayer receiving an Italian pension to simply include in an income tax return the total amount shown on a certificate of pension. Instead, the amount included should be the sum of the amounts derived during the relevant year of income, namely during the period July to June, expressed in Australian currency.

16. For Australian taxation purposes, pension income is derived when it is received. Where pension income is paid or credited into the pensioner's bank account in Australia, it will be taken to have been received on the day on which it is paid or credited to that account. In a case where a bank draft is sent direct to the pensioner, the amount of pension specified in the draft would be derived on the date that the draft is received, notwithstanding that the draft may be presented for payment at some subsequent date. Italian pensions paid to an Australian resident, but not remitted to Australia, must also be included in the pensioner's Australian income tax return of the relevant year of income. Where, for example, a pension is paid into an Italian bank account, it is derived by the pensioner on the date that the pension is credited to that account.

Undeducted purchase price

17. It is accepted that the INPS is a foreign superannuation fund for the purposes of establishing whether the undeducted purchase price of certain Italian pensions should be excluded from a pension recipient's assessable income.

18. If the second requirement set out in paragraph 7 of this Ruling is satisfied, that is, if the pension is a purchased pension, as would generally be the case with contributions made by pensioners to the INPS, the pensioner's contributions may be taken into account to determine the undeducted purchase price. Furthermore, the pensioner's contributions may be included in the undeducted purchase price whether or not tax deductions were allowed for those contributions in Italy. Contributions made to a superannuation fund, including the INPS, by an employer of the pensioner do not qualify as part of the undeducted purchase price.

19. In certain circumstances, Australian residents have remitted funds to the INPS to 'make-up' contributions to secure a level of Italian pension to which they would not have otherwise been entitled. These voluntary contributions would also form part of the undeducted purchase price of the Italian pension except to the extent that the taxpayer was previously entitled to tax relief under Australian taxation law in the form of -

- (a) for pensions that commenced to be paid before 1 July 1983 - so much of the contribution which qualified for a deduction or rebate;
- (b) for pensions that commenced to be paid on or after 1 July 1983 - so much of the contribution which qualified for a deduction.

20. It is appreciated that some Italian pension recipients who have retired to Australia may have difficulty in establishing with complete accuracy the total amount of the contributions which they made in Italy in past years and which constitute the "undeducted purchase price" of their pension. As a practical means of assisting pensioners who find themselves in this situation, it has been decided that an estimate of their contribution, if certified by the foreign superannuation fund as being reasonably based, would be accepted as establishing the undeducted purchase price of the pension.

21. In recognition of the difficulties for pensioners in obtaining information relating to their contributions to the INPS, it has been decided to accept the portion of the pension identified by the INPS as being derived from the contributions made by the pensioner (reduced by 10% to reflect the interest element in that component of the pension) as the annual exclusion amount, that is as the amount which may be excluded from the pensioner's assessable income in any given year of income. This method may be adopted for the income year ended 30 June 1988 and future income years until a more precise value of the contributions can be obtained from the INPS.

Currency Translation

22. The question has also been raised as to the appropriate currency exchange rate to be used for converting Italian lire into Australian dollars. In accordance with the currency translation rules contained in section 20 of the Act and clarified in Taxation Ruling No. IT 2498, pensions received in foreign currency should, strictly, be translated to Australian currency on the following basis -

- (a) where pensions are remitted to Australia - at the exchange rate applicable when each instalment of pension is received;
- (b) where pensions are not remitted to Australia - at the exchange rate applicable at the end of the year of income.

However, in recognition of the difficulties that a strict application of the law may cause some pensioners, translation of remitted pensions on the basis of the average annual exchange rate for the relevant year of income will be accepted.

23. Where the pension amount is translated to Australian dollars at the average annual exchange rate or at the exchange rate applicable at the end of the year of income -

- (a) the annual exclusion amount of the undeducted purchase price should be calculated in Italian lire in accordance with paragraphs 8 & 9 of this ruling;
- (b) the gross amount of the pension (in Italian lire) should be reduced by the annual exclusion amount; and
- (c) the net amount should be translated to Australian dollars at the average annual exchange rate or the end of year exchange rate, as the case may be.

If the Italian pension is translated to Australian dollars when each instalment of pension is derived, or if the annual exclusion amount is calculated on the basis of paragraph 21 of this Ruling, it may also be translated at the average annual exchange rate for the relevant year.

24. The basis of calculation of the Australian dollar amount of Italian pension included in a taxpayer's assessable income should be detailed in an attachment to the return of income.

Invalid pensions

25. Italian invalid (disability) pensions paid to Australian residents by the INPS and other Italian organisations are not payable under the Australian Social Security Act, and therefore do not qualify for exemption from Australian income tax under subparagraph 23AD(3)(d)(i) of the Act. Disability and war pensions paid from Italy likewise do not qualify for the exemption from Australian tax applicable under paragraph 23AD(3)(a) to certain disability and war pensions payable under the Australian Repatriation Acts. However the position of such Italian disability and war pensions is under further examination as part of a general review of the scope of the pensions covered by paragraph 23AD(3)(c) of the Act. The outcome of that review may be expected to be the subject of a later ruling.

Income splitting

26. It is understood that an Italian pension received by an Australian resident at the combined 'husband and wife' rate is received by that resident in his or her own right. Accordingly, where a person is eligible to receive an Italian pension which includes an additional amount payable in respect of a dependant, the amount of pension income based on the combined rate does not qualify to be split between the pension recipient and the spouse or other dependants.

Italian tax

27. Article 28 of the Convention provides for a refund of taxes withheld at source by either Australia or Italy if the right to collect those taxes is affected by the provisions of the Convention. This means that an Australian resident may be entitled to a refund from the Italian revenue authorities of any Italian tax that has been deducted from an Italian pension (derived on or after 1 July 1987) contrary to the provisions of Article 18 of the Convention.

28. In order to obtain a refund and, where necessary, stop further tax being deducted by the Italian authorities, the pensioner is required to complete certain forms. Forms for this purpose are available from the Italian Embassy and Consulates in Australia.

29. The completed forms are to be sent to an Australian Taxation Office which will endorse on the papers that the applicant is an Australian resident. When the endorsed forms are returned to the applicant by the Tax Office, they should then be sent to the Italian organisation which pays the pension.

30. In the event that a refund of tax is not obtained, a credit in respect of the tax paid would not be available in Australia under the foreign tax credit system as the Italian tax would have been imposed in contravention of the Convention.

Arrears of pensions paid in a lump sum

31. Section 159ZRA, which was recently introduced into the Act by Taxation Laws Amendment Act (No. 5) 1988, allows a rebate of tax to people who on or after 1 July 1986 receive a lump sum payment in arrears of certain income. The rebate provided is available in respect of lump sum payments of superannuation and social welfare pensions, annuities, and supplements to pensions and annuities, including those paid by foreign governments.

32. For Australian Taxation purposes, pension income is treated as derived when it is received. As Italian pensions derived by Australian residents after 1 July 1987 will be subject to Australian tax, any arrears of Italian pension received after that date will also be subject to Australian tax. Generally, people who receive a taxable lump sum payment of several years of Italian pension entitlements will be entitled to the rebate in the tax assessment for the income year in which they receive the lump sum. Only that part of the lump sum representing income that accrued in income years earlier than the income year of receipt qualifies for the rebate.

33. Taxpayers are entitled to the rebate if the part of the lump sum that relates to income that accrued in earlier years is at least 10% of the 'taxable income' for the year in which the lump sum was received. The 'taxable income' that is taken into account in determining eligibility for the rebate is the actual taxable income as shown on the tax return, less the arrears part of the lump sum, any capital gains, abnormal income and certain

payments received on termination of employment included in the actual taxable income.

34. The relevant Branch of the Taxation Office will determine whether a person is entitled to a rebate and the amount of entitlement on the basis of the income of the two most recent earlier years in which the pension arrears accrued. If income accrued in only one earlier year, that year only will be taken into account. Therefore, taxpayers who have not lodged a return of income for either or both earlier years (for example, taxpayers whose income was below the tax free threshold) should either lodge returns or, if that is not possible, provide full details of the income for those earlier years in a schedule to the tax return for the year of income in which the lump sum is received.

35. Taxpayers claiming the rebate must provide a statement from the authority paying the lump sum, for example, the INPS or other relevant Italian pension fund, showing the allocation of the arrears part of the lump sum to the years of income over which the arrears accrued. Where the statements of the Italian pension fund are provided on a calendar year or on a quarterly basis and an arrears payment is made in respect of a period bridging two years of income, for example 1 April to 31 August, that payment will be apportioned between the two years on an average monthly basis (ie in the above example, payment x 3/5 will be included in the income for year 1 and payment x 2/5 will be included in the income for year 2).

36. The example contained in the Attachment to this Ruling illustrates the method of calculating the rebate where the pension arrears are only referable to a period up to two years prior to the year of receipt. An example of the calculation of the rebate where the pension arrears are referable to a period of more than two years prior to the year of receipt may be found in the Explanatory Memorandum to Taxation Laws Amendment Act (No.5) 1988.

Provisional Tax

37. Australian residents who receive Italian pensions are not liable for Australian provisional tax on that pension, or any Australian pension or on any salary and wages. They may, however, be liable for Australian provisional tax on other income such as investment or rental income if the amount is more than \$1000 per year.

Tax instalment deductions

38. Under certain conditions, Australian social security pensioners can ask the Department of Social Security to make tax instalment deductions from their Australian pensions so that they can avoid an end of year tax debt. Italian pensioners, who also receive an Australian social security pension, may wish to ask the Department of Social Security to deduct tax from their Australian pension at a level that reflects the fact that the pensioner also receives an Italian pension.

Social Security income test

39. Branch Offices should be aware that they may receive enquiries from Italian pensioners who are confused as to the operation of the Department of Social Security income test for pensioners. The problem arises because such pensioners, whose Australian pension is reduced by reference to the amount of Italian pension received, may consider that the reduction of the Australian pension has had the effect of discharging their tax obligations. It needs to be explained in that respect, of course, that the operation of that income test is for social security pension purposes only and does not affect the determination of a pensioner's income tax position.

COMMISSIONER OF TAXATION
10 August 1989

TABLE

ATTACHMENT

ARREARS OF PENSIONS PAID IN A LUMP SUM

Pension arrears of \$4000 were received in a lump sum during the year ended 30 June 1989. Relevant details are:

| | | | |
|-----------------|------|--------|-----------------------------------|
| | | \$ | |
| Taxable income: | 1989 | 25,000 | (includes \$4000 pension arrears) |
| | 1988 | 17,000 | |
| | 1987 | 15,000 | |

The lump sum consisted of pension that accrued as follows:

| | | |
|--|------|-------|
| | 1988 | 2,500 |
| | 1987 | 1,500 |
| | | 4,000 |

(1) Calculation of tax on arrears:

| | | |
|-------------------------|---|-------|
| Year ended 30 June 1989 | | \$ |
| | Tax on \$25,000 | 6,001 |
| (less) | Tax on \$21,000 (viz \$25,000 less 4,000) | 4,401 |
| | TAX ON ARREARS | 1,600 |

(2) Calculation of notional tax for recent accrual years

| | | |
|-----------------|--|-------|
| 1987 | | |
| Rebated tax on: | | |
| | Increased income (\$15,000 + 1,500 = \$16,500) | |
| | (tax at 1987 tax rates) | 3,032 |
| (less) | Actual income (in this example actual income = taxable, i.e. \$15,000) | 2,590 |
| | NOTIONAL TAX ON ARREARS | 442 |

1988

Rebated tax on:

| | |
|--|-------|
| Increased income ($\$17,000 + 2,500 = \$19,500$) | |
| (tax at 1988 tax rates) | 3,801 |
| (less) Actual income (in this example actual income = taxable income i.e., $\$17,000$) | 3,076 |
| NOTIONAL TAX ON ARREARS | 725 |

(3) Rebate allowable:

| | | |
|--|-------|-------|
| TAX ON ARREARS | 1,600 | |
| (less) NOTIONAL TAX AMOUNT ($\$442 + \725) | | 1,167 |
| REBATE ALLOWABLE | 433 | |