

IT 2562 - Income tax : foreign tax credit system : interaction of foreign tax credit provisions with capital gains and capital losses provisions of Part IIIA

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TAXATION RULING NO. IT 2562

INCOME TAX : FOREIGN TAX CREDIT SYSTEM : INTERACTION OF
FOREIGN TAX CREDIT PROVISIONS WITH CAPITAL GAINS AND
CAPITAL LOSSES PROVISIONS OF PART IIIA

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I 1011607	FOREIGN TAX CREDITS CAPITAL GAINS AND CAPITAL LOSSES	6AB(1) and (2) 51(6), 79D, 160AE(2) and (3), 160AF, 160AFD PART IIIA

OTHER RULINGS ON TOPIC IT 2508 IT 2527

PREAMBLE This Ruling is designed to clarify in general the interaction of the foreign tax credit provisions of Division 18 of Part III of the Income Tax Assessment Act (the Assessment Act) with the capital gains and capital losses provisions of Part IIIA of that Act.

2. The matter needs to be considered against the background that -

- . Part IIIA generally applies in respect of gains and losses realised on disposals of assets acquired on or after 20 September 1985, and provides for the inclusion in the assessable income of a resident taxpayer of a year of income the amount of the "net capital gain" (determined on a worldwide basis) that accrues to the taxpayer in respect of that year.
- . Prior to the introduction of the general foreign tax credit system (FTCS), with effect from the commencement of the 1987-88 year of income, former paragraph 23(q) of the Assessment Act operated to treat as exempt from income tax (and therefore as excluded from assessable income) most categories of income, or profits or gains of a capital nature, where derived by a resident taxpayer from sources out of Australia and Papua New Guinea and where not exempt from tax in the country of derivation.
- . Since the commencement of the FTCS, an Australian resident taxpayer has generally been assessable to Australian tax on income from all sources (apart from salary or wages and other income exempted under section 23AF or 23AG), with a credit for foreign tax paid on foreign income being allowed

against the Australian tax payable in respect of that foreign income.

- . Subsection 6AB(1) effectively defines foreign income for purposes of the Assessment Act to mean income derived from sources in a foreign country or foreign countries (according to ordinary concepts of source of income), while subsection 6AB(2) provides for a reference to foreign tax to include, amongst other taxes, a tax imposed by a law of a foreign country upon profits or gains, whether of an income or capital nature.
- . Subsection 160AE(2) of Division 18 provides, in effect, for a profit of a capital nature derived by a resident taxpayer from a source in a foreign country, hereinafter referred to as a "foreign capital gain", to be treated as foreign income (within the meaning of subsection 6AB(1)) for the purposes of the foreign tax credit provisions of Division 18 providing foreign tax is payable in respect of that gain and it is a gain which is taken into account, pursuant to Part IIIA, in determining the assessable income of the taxpayer for a year of income.
- . Given the worldwide basis for determining a taxpayer's liability for tax in relation to a "net capital gain" and the basic double tax relief purpose of the FTCS, Part IIIA and the FTCS provisions interact in a way that afford the maximum benefit to a taxpayer by way of capital loss offsets against capital gains and foreign tax credit relief entitlements respectively.

RULING

3. Subsection 6AB(1) refers to income (not assessable income) and therefore does not operate to generally require references to foreign income in the Assessment Act to be read as including foreign capital gains. The purpose, therefore, of subsection 160AE(2) is to complement subsection 6AB(1), for foreign tax credit purposes, by operating where -

- (a) a resident taxpayer realises a foreign capital gain on the disposal of an asset acquired on or after 20 September 1985;
- (b) the whole or a part of that gain is included in the "net capital gain" to be included in the taxpayer's assessable income for the year of income pursuant to the provisions of Part IIIA; and
- (c) foreign tax is paid by the taxpayer in respect of the capital gain,

to deem the amount of the foreign capital gain that is so included in assessable income to be foreign income so that double taxation relief is provided with respect to the foreign tax paid on that gain by way of a foreign tax credit under

subsection 160AF(1), in place of the exemption that formerly applied under paragraph 23(q).

Determination of foreign tax credit relief in respect of foreign capital gains.

4. It follows that such an amount of a foreign capital gain falls, together with other relevant foreign income derived by a taxpayer, to be treated as the class of income described as "other income" in subsection 160AF(7). A resident taxpayer is thus entitled to a foreign tax credit in relation to such "other income" and attributable foreign taxes, as determined on a worldwide basis, pursuant to subsection 160AF(1).

5. In broad terms, a foreign capital gain realised on disposal of an asset acquired before 20 September 1985, or such a gain realised on disposal of an asset acquired on or after that date in respect of which foreign tax is not payable, is not treated under subsection 160AE(2) as foreign income for the purposes of Division 18. Such a gain does not therefore fall to be aggregated with other relevant foreign income, and foreign capital gains that have suffered foreign tax, when determining a taxpayer's foreign tax credit entitlement (on a worldwide basis) with respect to the class of income described as "other income" in subsection 160AF(7).

6. The references to "foreign income" in Taxation Ruling No. IT 2508 - which deals generally with aggregation of the various classes of income for foreign tax credit purposes and provides for all foreign income, whether or not subject to foreign tax, to be taken into account for those purposes - needs to be read accordingly (i.e. in the light of paragraphs 4 and 5 of this Ruling.)

7. As indicated earlier, a foreign capital gain (or capital loss in respect of the disposal of an asset situated outside Australia) remains to be brought to account for assessment purposes in accordance with the provisions of Part IIIA. This means, for example, that where in a year of income a taxpayer incurs both foreign and domestic capital losses that are completely absorbed by a domestic capital gain derived in the same year of income by the taxpayer, it is only the resultant net capital gain which is included in the taxpayer's assessable income for the relevant year of income in accordance with the provisions of Part IIIA (as indicated later in this Ruling, the foreign capital loss would not be treated as subject to the foreign loss quarantining provisions of the FTCS).

8. It follows that as the amount to be included in a taxpayer's assessable income under Part IIIA is the amount of the worldwide "net capital gain" (as determined under that Part) that accrues to a taxpayer in respect of a year of income, subsection 160AE(2) has to be read as deeming to be foreign income only the whole or the part of any foreign capital gain (or gains), in respect of which foreign tax is payable, that is included in the amount of that "net capital gain" of a resident taxpayer for a year of income.

9. This amount could be greater or smaller than the amount of relevant capital gain (or gains) taken into account for purposes of imposition of the foreign tax. In any event, the foreign tax would in many cases have been imposed on a different basis than that which applies in Australia under Part IIIA with respect to capital gains. Consistent, however, with the approach reflected in paragraph 16 of Taxation Ruling No. IT 2527, the actual amount of foreign tax paid in respect of the relevant foreign capital gain (or gains) is to be taken into account when determining the taxpayer's foreign tax credit entitlement under section 160AF in respect of the deemed foreign income (i.e. the relevant foreign capital gain component of the "net capital gain" which forms part of the taxpayer's assessable income for the year of income).

10. Consistent also with subsection 160AF(3), the Australian tax payable on the amount of that deemed foreign income is calculated by multiplying that amount by the average rate of tax applicable to the taxable income of the taxpayer for the year of income. Simplified examples are given in Appendix A and Appendix B.

11. Those examples and the comments in paragraphs 9 and 10 presuppose that the deemed foreign income constitutes the whole of the class of income in relation to the taxpayer described as "other income" in subsection 160AF(7). However, as indicated earlier in this Ruling, where the taxpayer has derived other foreign income of the same class during the income year, the worldwide basis for determining foreign tax credits would require that foreign income and attributable foreign tax to be taken into account also when determining the taxpayer's foreign tax credit entitlement under section 160AF in relation to that class of income.

12. It follows also from paragraph 8 of this Ruling that situations may arise where the disposal by a resident taxpayer of an asset in a foreign country produces a capital gain which is subject to tax in that country but there is no amount of deemed foreign income pursuant to subsection 160AE(2), and thus no foreign tax credit entitlement under subsection 160AF(1) with respect to the foreign tax paid. This would be the case should the application in relation to the year of income of Part IIIA with respect to that asset disposal (and any other capital gains realised or capital losses incurred by the taxpayer) result in a "net capital loss" for that year for the purposes of that Part.

13. Further examples relating to the operation of the provisions of Part IIIA and Division 18 are at Appendix C and Appendix D.

Ordering of offset of capital losses against capital gains when determining a "net capital gain".

14. As already indicated, the FTCS provisions do not override the operational effect of the provisions of Part IIIA of the Assessment Act, the broad scheme of which is that worldwide capital gains that accrue to a resident taxpayer during a year

of income and worldwide capital losses that are incurred during the year for the purposes of that Part are "netted" to arrive at the amount of the "net capital gain" or "net capital loss" of the taxpayer for the year. It follows that a foreign capital gain or foreign capital loss for purposes of Part IIIA is not taken into account for purposes of the foreign loss quarantining provisions of former subsection 51(6), section 79D or section 160AFD of the Assessment Act; those provisions are concerned only with losses arising by reason of an excess of allowable deductions over assessable income derived from a "foreign source", within the special meaning of that expression in subsection 160AFD(7), and the offsetting of such losses against income derived in a subsequent year of income from such a "foreign source" from a business or other income-producing activity.

15. Accordingly, where a resident taxpayer disposes of an asset situated outside Australia and incurs in a year of income a foreign capital loss for purposes of Part IIIA, that amount is available under that Part, together with any domestic capital loss, for offset against any worldwide capital gains derived by the taxpayer in that year when determining the "net capital gain" of the taxpayer for the year. If no such capital gains have been derived, or a "net capital loss" otherwise results, the amount of that loss for the year (determined on a worldwide basis) is available to be carried forward to the next succeeding year of income for the purpose of calculating the taxpayer's "net capital gain" or "net capital loss" for that year.

16. Given that situation, it would be appropriate for priority to be given, when determining the "net capital gain" to be included in a taxpayer's assessable income (or the "net capital loss" of the taxpayer) for a year of income under Part IIIA, to ensuring maximum foreign tax credit relief is available to the taxpayer.

17. Accordingly, any foreign and/or Australian "sourced" capital losses (of the same year of income or available for carry forward from previous years pursuant to Part IIIA) are to be offset against the sum of Australian "sourced" capital gains and foreign capital gains in respect of which no foreign tax is paid, with only the excess (if any) being offset against foreign capital gains subject to foreign tax. This approach will afford maximum foreign tax credit relief with respect to the latter gains - see example at Appendix E. It is noted that this approach is broadly consistent with the design under the FTCS of the domestic carry forward loss election provisions of subsections 80(2B) and (2C) of the Assessment Act.

COMMISSIONER OF TAXATION
14 December 1989

APPENDIX APPENDIX

Appendix A

EXAMPLE - Resident individual taxpayer

FOREIGN COUNTRY X ASSESSMENT

	Purchase price of foreign asset X	\$20,000
	Sale price of foreign asset X	\$30,000
	Gain on sale of foreign asset X	\$10,000
LESS	Deductions allowable under foreign law	\$ 2,000
	Net foreign gain	\$ 8,000
	Foreign tax paid (20%)	\$ 1,600

AUSTRALIAN ASSESSMENT

INCOME	DOMESTIC	FOREIGN	TOTAL
Professional fees	\$17,000		\$17,000
 CAPITAL GAINS			
Gain on sale of domestic asset Y (1)	\$6,000		
Gain on sale of foreign asset X (2)		\$7,000	
"Net capital gain"			\$13,000
Gross assessable income			\$30,000
Less			
Deductions allowable in respect of professional services			\$2,000
Taxable income (3)			\$28,000
Australian tax payable (4)			\$4,809
	(5)		
LESS			
Foreign tax credit (FTC) entitlement (6)			\$1,190
Net Australian tax payable			\$3,619

NOTES

- (1) The gain realised on the sale of the domestic asset is calculated in accordance with Part IIIA.
- (2) The gain realised on the sale of the foreign asset is also calculated for Australian tax assessment purposes in

accordance with Part IIIA, and this amount is less than the gain of \$10,000 taken into account in country X.

- (3) The "net capital gain" for Australian tax purposes is included in the taxpayer's assessable income by virtue of sections 160ZC and 160Z0.
- (4) The Australian tax payable is calculated (at 1989-90 rates) using the formula $A + B$ where

$$A = \text{tax at ordinary resident rates on} \\ \$15,000 \text{ (the reduced taxable income)} \qquad \qquad \$2,079$$

$$\text{and } B = 5 \times [(\text{tax at ordinary resident rates} \\ \text{on a taxable income of } \$15,000 \\ + 20\% \text{ of } \$13,000) - A]$$

$$= 5 \times [(\text{tax at ordinary resident rates on} \\ \$17,600) - A]$$

$$= 5 \times [\$2,625 - \$2,079]$$

$$= 5 \times [546] \qquad \qquad \qquad \$2,730$$

Australian tax payable \$4,809

- (5) The Medicare levy has not been taken into account for the purposes of this example.

- (6) The FTC entitlement is the lesser of the foreign tax paid (\$1,600) and the Australian tax payable in respect of the foreign capital gain included in assessable net capital gain (\$7,000 x 0.17 [average rate of Australian tax payable] = \$1,190).

Appendix B

EXAMPLE - Resident company taxpayer

FOREIGN COUNTRY X ASSESSMENT

Purchase price of foreign asset X	\$25,000
Sale price of foreign asset X	\$45,000
Gain on sale of foreign asset X	\$20,000
LESS Deductions allowable under country X's law	\$ 3,000
Net foreign gain on foreign asset X	\$17,000
Foreign tax paid (30%)	\$ 5,100

FOREIGN COUNTRY Y (NIL ASSESSMENT)

Purchase price of foreign asset Y	\$15,000
Sale price of foreign asset Y	\$20,000

Gain on sale of foreign asset Y \$ 5,000
0

Foreign country Y does not impose tax on capital gains made on disposals of assets.

AUSTRALIAN ASSESSMENT

INCOME	DOMESTIC	FOREIGN	TOTAL
Product sales	\$40,000		\$40,000
CAPITAL GAINS			
Gain on disposal of domestic asset (1)	\$10,000		
Gain on disposal of :			
. foreign asset X (2)		\$14,000	
. foreign asset Y (2)		\$ 4,000	
"Net capital gain"			\$28,000
Gross assessable income			\$68,000
LESS			
Deductions allowable in respect of product sales			\$20,000
Taxable income			\$48,000
Australian tax 39%			\$18,720
LESS			
FTC entitlement (3)			\$ 5,100
Net Australian tax payable			\$13,620

NOTES

- (1) The gain realised on the sale of the domestic asset is calculated in accordance with Part IIIA.
- (2) The gains realised on the sale of foreign assets X and Y calculated for Australian tax assessment purposes in accordance with Part IIIA, are less than the gains of \$20,000 and \$5,000 taken into account in countries X and Y respectively.
- (3) The FTC entitlement is the lesser of the foreign tax paid (\$5,100) and the Australian tax payable in respect of the foreign capital gain calculated in accordance with Part IIIA made on the disposal of foreign asset X and included in assessable income ($\$14,000 \times 0.39 = \$5,460$). Note that because no foreign tax is payable in foreign country Y with respect to the gain on sale of foreign asset Y, that gain is not deemed by subsection 160AE(2) to be foreign income for

purposes of Division 18 and does not therefore enter into the FTC entitlement calculation.

Appendix C

EXAMPLE

A resident company taxpayer in a year of income derives a foreign capital gain that is subject to foreign tax, a foreign capital loss, "interest income" as defined in subsection 160AE(3) and contract fees from its Australian operations.

FOREIGN COUNTRY E ASSESSMENT

Purchase price of foreign asset E	\$20,000
Sale price of foreign asset E	\$90,000
Gain on sale of foreign asset E	\$70,000
LESS	
Deductions allowable under Country E's laws	\$ 5,000
Net foreign gain on foreign asset E	\$65,000
Foreign capital gains tax paid (20%)	\$13,000
Interest income	\$10,000
Foreign income tax paid (10%)	\$ 1,000

FOREIGN COUNTRY F ASSESSMENT

Purchase price of foreign asset F	\$80,000
Sale price of foreign asset F	\$40,000
Net loss on sale of foreign asset F	(\$40,000)

AUSTRALIAN ASSESSMENT

INCOME	DOMESTIC	FOREIGN	TOTAL
Contract fees	\$100,000		\$100,000
Net Capital gain (1)		\$ 25,000	
Interest income		\$ 10,000	\$ 35,000
Gross assessable income			\$135,000
LESS			
Deductions allowable in respect of contract fees			\$ 35,000
Taxable income			\$100,000

Australian tax (39%)	\$ 39,000
Less FTC (2)	\$ 10,750
Net Australian tax payable	\$ 18,250

NOTES

- (1) The net capital gain to be included in assessable income is calculated in accordance with the provisions of Part IIIA. (For ease of illustration in this example, the foreign capital gain and loss have been treated as being the same amounts for those purposes as the net amounts taken into account in the foreign countries). Accordingly, the capital gain made on the disposal of foreign asset E (\$65,000) is reduced by the capital loss incurred on the disposal of foreign asset F (\$40,000) resulting in a net capital gain of \$25,000 being included in assessable income. The amount of this net capital gain relates solely to the foreign capital gain in respect of which foreign tax has been paid. The whole amount of the net capital gain qualifies, therefore, to be treated as foreign income for foreign tax credit purposes pursuant to subsection 160AE(2).
- (2) Pursuant to subsection 160AF(7), the amount of the net capital gain (deemed by subsection 160AE(2) to be foreign income) and the amount of the interest income are treated as separate classes of foreign income for the purposes of determining the taxpayer's foreign tax credit entitlement under subsection 160AF(1). Accordingly, a separate foreign tax credit is applicable in relation to each of those classes of foreign income.

The FTC entitlement in relation to each class of foreign income is the lesser of the sum of the Australian tax payable on the amount included in assessable income and the foreign tax paid, viz:

.	Net capital gain	
-	Australian tax payable (25,000 x 0.39)	\$9,750
-	Foreign tax paid	\$13,000
	FTC =	\$9,750
.	Interest income	
-	Australian tax payable (10,000 x .39)	\$3,900
-	Foreign tax paid	\$1,000
	FTC =	\$1,000

Accordingly, the total FTC allowable is
\$9,750 + \$1000 = \$10,750

Appendix D

EXAMPLE

A resident company taxpayer in a year of income disposes of a foreign asset resulting in the realisation of a foreign capital gain that is subject to foreign tax. However, for Australian assessment purposes the disposal of the foreign asset results in a capital loss. No other foreign sourced income is derived but the taxpayer also derives a domestic sourced capital gain from the disposal of an Australian asset. The taxpayer also derives management fees from its Australian operations.

FOREIGN COUNTRY D ASSESSMENT

Purchase price of foreign asset D	\$15,000
Sale price of foreign asset D	\$20,000
Gain on sale of foreign asset D	\$ 5,000
LESS	
Deductions allowable under country D's laws	\$ 2,000
Net foreign gain on foreign asset D	\$ 3,000
Foreign tax paid (30%)	\$ 900

AUSTRALIAN ASSESSMENT

INCOME	DOMESTIC	FOREIGN	TOTAL
Management fees	\$20,000		\$20,000
CAPITAL GAINS			
Gain on disposal of domestic asset (1)	\$10,000		
Loss on disposal of foreign asset D (2)		(\$1,000)	
"Net capital gain"			\$ 9,000
Gross assessable income			\$29,000
LESS			
Deductions allowable in respect of management fees			\$ 5,000
Taxable income			\$24,000
Australian tax payable (39%) (3)			\$ 9,360

NOTES

- (1) The gain realised on the sale of the domestic asset is calculated in accordance with Part IIIA.
- (2) The loss incurred on the sale of foreign asset D is calculated for Australian tax assessment purposes in accordance with Part IIIA. In this example, even though a gain was realised on the disposal of foreign asset D under foreign country D's laws, for Australian assessment purposes

the disposal resulted in a capital loss due to the effects of indexation of the cost base of the asset and the allowance under Australia's law of a different quantum of incidental expenses deductions relating to its disposal.

- (3) In this example, the taxpayer is not entitled to any foreign tax credit relief in relation to the foreign tax paid with respect to the foreign gain realised on the disposal of asset D because, for Australian assessment purposes, the disposal of foreign asset D resulted in the realisation of a capital loss. Accordingly, no part of the foreign capital gain in respect of which foreign tax has been paid was included in the net capital gain which formed part of the assessable income. It therefore follows that subsection 160AE(2) is not called into operation.

Appendix E

EXAMPLE - Resident company taxpayer

The taxpayer realises the following capital gains and losses during the income year:

FOREIGN COUNTRY D ASSESSMENT

Purchase price of foreign asset D	\$ 50,000
Sale price of foreign asset D	\$200,000
Gain on sale of foreign asset D	\$150,000
LESS	
Deductions allowable under country D's laws	\$ 20,000
Net foreign gain on foreign asset D	\$130,000
Foreign tax payable (30%)	\$ 39,000

FOREIGN COUNTRY E (NIL ASSESSMENT)

Purchase price of foreign asset E	\$ 50,000
Sale price of foreign asset E	\$ 65,000
Gain on sale of foreign asset E	\$ 15,000

Foreign country E does not impose tax on capital gains made on disposals of assets.

FOREIGN COUNTRY F

Purchase price of foreign asset F	\$ 90,000
Sale price of foreign asset F	\$ 50,000
Loss on sale of foreign asset F	\$(40,000)

AUSTRALIA

Indexed cost base of asset G	\$ 90,000
Sale price of asset G	\$150,000
Gain on sale of asset G	\$ 60,000 *
Reduced cost base of asset H	\$ 65,000
Sale price of asset H	\$ 25,000
Loss on sale of asset H	\$ (40,000) *

* No expenses were incurred in relation to the holding or disposal of the assets.

AUSTRALIAN ASSESSMENT

INCOME	DOMESTIC	FOREIGN	TOTAL
Machinery sales	\$ 60,000		\$ 60,000
"Net capital gain"(1)		\$125,000	\$125,000
Gross assessable income			\$185,000
LESS			
Deductions allowable in respect of machinery sales			\$ 20,000
Taxable income			\$165,000
Australian tax 39%			\$ 64,350
LESS			
FTC entitlement (2)			\$ 39,000
Net Australian tax payable			\$ 25,350

NOTES

(1) The "Net capital gain" is calculated as follows:

Gain on sale of foreign asset D (in respect of which foreign tax has been paid)	\$130,000
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LESS/ADD

Gain on sale of foreign asset E (in respect of which no foreign tax has been paid)	\$ 15,000	
Gain on sale of Australian asset G	\$ 60,000	\$ 75,000

Loss on sale of foreign asset F	\$ 40,000		
Loss on sale of Australian asset H	\$ 40,000	(\$80,000)	(\$ 5,000)
Net Capital Gain			\$125,000

The net capital gain has been calculated so as to ensure maximum allowable foreign tax credit relief to the taxpayer. This is achieved by adding the domestic sourced capital loss and the foreign sourced capital loss together and deducting this amount from firstly, the sum of the domestic sourced capital gain and the foreign sourced capital gain in respect of which NO foreign tax has been paid and secondly, as this results in a capital loss, from the foreign sourced capital gain in respect of which foreign tax has been paid.

Foreign source capital gains and capital losses for Australian assessment purposes are calculated in accordance with Part IIIA. However, for ease of illustration, in this example the foreign capital gains and losses have been treated as being the same for those purposes as the amounts taken into account in the foreign countries.

(2) In this example the amount of the "net capital gain" included in the taxpayer's assessable income relates solely to the foreign capital gain in respect of which foreign tax has been paid. The whole amount qualifies, therefore, to be treated as foreign income for foreign tax credit purposes pursuant to subsection 160AE(2).

Accordingly, the taxpayer is entitled to a credit for the lesser of the foreign tax paid (\$39,000) and the Australian tax payable in respect of the foreign capital gain that is included in assessable income ($\$125,000 \times 0.39 = \$48,750$).

□