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27 November 2019

Ms Renae Ali
Australian Taxation Office

By email: Renae.Ali@ato.gov.au

Dear Renae,

TD 2019/D10

Chartered Accountants Australia New Zealand (CA ANZ) appreciates the opportunity to provide feedback on the draft tax determination TD 2019/D10 Income tax: can capital gains be included under subparagraph 770-75(4)(a)(ii) of the *Income Tax Assessment Act 1997* when calculating the foreign income tax offset limit? (the Draft Determination).

Overall comments

CA ANZ does not support the Commissioner's preliminary view outlined in the Draft Determination. The outcome of the Australian Taxation Office (ATO)'s interpretation of existing law under the Draft Determination is not aligned with the clear overarching policy of the provision relating to relief against double taxation on amounts subject to both Australian and foreign income tax.

The limit on the amount of tax offset available is not determined solely by the Australian tax payable on amounts taxed in a foreign country. It should also clearly encompass the Australian tax payable on amounts not taxed in a foreign country if such amounts nevertheless had a foreign source.

It is contrary to this policy to suggest that foreign sourced capital gains can never be taken into account in determining this limit merely because the Capital Gains Tax (CGT) regime aggregates multiple capital gains and losses and applies concessions to determine one assessable amount being a net capital gain. It would lead to artificial differences if a taxpayer could obtain a better outcome because a foreign sourced gain is assessable as ordinary income on revenue account and therefore assessable in its own right.

Further, the Draft Determination does not provide any support for the ATO's assertion that a net capital gain inherently cannot have a source, with this point being what the ATO's conclusion ultimately turns on in the Draft Determination. We believe the context of the income tax legislation leads to a contrary conclusion on this point.

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Finally, there appears to be inconsistency between the ATO's views in the Draft Determination and the ATO's views in the recently released draft TD 2019/D7: Income tax: is the source concept in Division 6 of Part III of the *Income Tax Assessment Act 1936* relevant in determining whether a non-resident beneficiary of a resident trust (or trustee for them) is assessed on an amount of trust capital gain arising under Subdivision 115-C of the *Income Tax Assessment Act 1997*? (commentary on the application of section 99D of the *Income Tax Assessment Act 1936* (ITAA 1936).

Our detailed comments on the Draft Determination are set out in the attached.

To discuss this submission further, please contact Karen Liew at first instance on (02) 8078 5483 or by email on karen.liew@charteredaccountantsanz.com

Yours sincerely

Michael Croker
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Detailed Comments

TD 2019/D10

The Commissioner's preliminary view in the Draft Determination is that subparagraph 770-75(4)(a)(ii) of the *Income Tax Assessment Act 1997* (ITAA 1997) is not able to encompass foreign sourced capital gains in determining the foreign income tax offset (FITO) limit. This is stated to be so because the subparagraph can only take into account amounts of statutory income such that it can only cover a net capital gain rather than the underlying individual capital gains. Further, for the reason that a net capital gain cannot have a foreign source, the Commissioner concludes that capital gains will not ultimately not be able to be taken into account in calculating the FITO limit under this subparagraph.

Subsection 770-75(4) sets out the relevant assumptions in working out the amount of the FITO limit under paragraph 770-75(2)(b). Essentially this amount is the Australian income tax payable for the income year on the part of a taxpayer's taxable income that is from sources outside Australia or otherwise on which foreign income tax has been paid. This is calculated as the difference between actual income tax payable less the amount that would be payable if the taxpayer had not derived taxable income referable to such amounts.

The FITO limit is necessary to ensure that the providing relief against double taxation does not go so far as to allow foreign tax paid to reduce Australian tax payable on Australian domestic income such that the Australian tax system does not subsidise foreign tax systems where the foreign tax paid on certain amounts exceeds the Australian tax payable on those amounts.

Overarching policy

The structure of subsection 770-75(4) clearly evidences Parliament's intention to allow a taxpayer to determine the FITO limit on a global basis rather than an on item-by-item basis. A taxpayer is able to aggregate all foreign sourced amounts and all amounts on which foreign income tax has been paid. The Australian tax payable on this global amount broadly represents the FITO limit.

Therefore, it is clear that Parliament intends to provide relief from Australian tax on certain amounts where the foreign tax payable exceeds the Australian tax payable in respect of that amount if that taxpayer has other amounts of foreign source income for that year.

This policy is articulated in the Explanatory Memorandum (EM) to the *Tax Laws Amendment (2007 Measures No. 4) Bill 2007* at paragraph 1.41:

> *The inclusion of foreign source income that has not been subject to foreign income tax as the second of the income-disregarding rules is consistent with the current approach of including within the cap, for a particular class of assessable foreign income, all assessable foreign income of that class, irrespective of whether foreign tax has been paid in respect of that income. This has the effect of increasing the amount of the foreign tax offset cap. The inclusion of all foreign source income, although inconsistent with a pure double-tax-relief approach, allows the taxpayer a greater averaging capacity, in that all high foreign taxed amounts are amalgamated with low foreign taxed amounts.*

The policy was a clear choice adopted by Parliament following the Review of International Tax Arrangements conducted by the Board of Taxation. Whereas the previous foreign tax credit system only allowed foreign-taxed amounts to be calculated in the cap on credits (i.e. not amounts from foreign sources more generally), it also provided for the carry forward of foreign tax credits where they were not able to be fully utilised in the year they arose. The policy shift provided a balance by allowing assessable foreign source income to be taken into account more broadly at the expense of being able to carry-forward excess offsets. This is made clear at paragraph 1.20 of the EM:

> *In ascertaining the amount of foreign tax offset, taxpayers will no longer be required to quarantine assessable foreign income amounts into four separate classes. Rather, a taxpayer can combine all assessable foreign income amounts when working out a tax offset entitlement, allowing the taxpayer a greater averaging capacity than under the old foreign tax credit rules. This greater averaging capacity will minimise the amount of foreign income tax that goes unrelieved. Consequently, the mechanism allowing the carry-forward of excess foreign income tax will be removed.*

We note that it is clear that a foreign sourced gain on revenue account that is not otherwise subject to foreign income tax would be included under subparagraph 770-75(4)(a)(ii) to increase the FITO limit.

If a different taxpayer made a single capital gain on capital account, being an equivalent gain in amount and in the same foreign country on which no foreign income tax was payable, we would expect that the same policy outcome should occur in this second scenario. We do not see a policy distinction between the two cases.

Therefore, it would create unnecessary distortions to conclude that the taxpayer in the second scenario would not be entitled to part of a FITO for the income year merely because of the mechanism by which capital gains are included in assessable income, via the method statement in section 102-5 of the ITAA 1997.

Not only is the ATO's view in the Draft Determination inconsistent with what we believe to be the clear policy of Parliament, the ATO's view is also not a sustainable view as outlined by the reasons below.

Whether a net capital gain can have a source

The Commissioner's primary reasoning in the Draft Determination, as set out at paragraph 11, is that capital gains are not included under subparagraph 770-75(4)(b)(ii) because a net capital gain inherently does not have a source as it is an amalgamation of gains, losses and concessions:

> *11. A net capital gain does not have a source. It is a product of capital gains and capital losses made during the income year from Australian and non-Australian sources, the application of unapplied net capital losses from earlier income years and applicable discounts.*

Section 6-10 is a key structural provision of the Act that deals with the source of statutory income amounts and provides important context to assist in interpreting the Act as a whole.

Subsection 6-10(5) ensures that foreign residents only include in their assessable income statutory income from Australian sources and statutory income assessed on some other basis than having an Australian source.

The Explanatory Memorandum to the *Income Tax Assessment Bill 1996* (the first instalment of the Tax Law Improvement Project) states in relation to section 6-10:

Residence and source

> *The existing law is applied so that both ordinary income and statutory income are only assessable income if they have a sufficient link to Australia. The rules are:*
>
> > *• for a resident of Australia, all ordinary and statutory income is assessable (including amounts from sources outside Australia), unless it is exempt; and*
> > *• for a non-resident, all ordinary and statutory income from Australian sources is assessable, unless it is exempt.*
>
> *This is less clearly expressed in the terms of the existing Act. Most ordinary and statutory income from foreign sources is not assessable to foreign residents. However, there are limited cases where an amount is assessed on a specifically expressed basis (eg. the capital gains and losses provisions bring to account gains and losses on the disposal of a 'taxable Australian asset' rather than on Australian-sourced capital gains and losses).*

The comment above highlights the CGT provisions as being one of the limited cases where paragraph 6-10(5)(b) applies to assess foreign residents on statutory income on some basis other than having an Australian source. This EM commentary does not suggest that a net capital gain can have no source at all or cannot have an Australian source. Rather, it notes that the "sufficient link" to Australia that makes a net capital gain assessable is the concept of 'taxable Australian Asset' (now taxable Australian property).

For net capital gains, because its constituent capital gains and losses have specific rules that cover the link to Australia there is the relevant "other basis" such that a foreign resident taxpayer does not need to determine the source or sources of the net capital gain.

There is a view that paragraph 6-10(5)(b) is needed not because a net capital gain would otherwise never be included in the assessable income of a foreign resident because it cannot have an Australian source, but rather because (as stated in the EM) Australian source is not the correct basis to assess non-residents on this type of statutory income.

The disposal of taxable Australian property may, on a given set of facts, have a foreign source. For example, a foreign resident sells shares in a foreign company to another foreign resident where the shares are only deemed taxable Australian property because of a previous CGT event I1 (individual or company stops being an Australian resident). Such a capital gain would clearly be foreign sourced. If it were the only capital gain for the income year, the net capital gain may also be considered to be wholly foreign sourced. However, paragraph 6-10(5)(b) works to protect the tax base by bringing this capital gain to tax even if though it is not made from sources in Australia.

This is different to a view that paragraph 6-10(5)(b) is needed because the source of a net capital gain is inherently indeterminable.

ATO view should be consistent with the reading of subsection 6-10(4)

The view that a net capital gain can have a source is supported by paragraph 6-10(4) which assesses Australian residents on "statutory income from all sources, whether in or out of Australia". Arguably, if a net capital gain does not or cannot have a source in or out of Australia (as per the ATO's view in the Draft Determination), residents would never include a net capital gain in their assessable income as one of the requirements for statutory income to be assessable to residents is that it is from a source. The conclusion that a net capital gain can have a source therefore provides for a more coherent reading of section 6-10 which is a key structural provision.

Note that paragraph 6-10(5)(b) is phrased as “some basis other than having an Australian source” rather than “some basis other than having a source”. This is consistent with the view that a net capital gain can have a source, but that the legislature intended to bring this to account for non-residents on some other basis than whether it is Australian or foreign sourced. In our opinion, this is a more appropriate view than paragraph 6-10(5)(b) being necessary to bring to tax items of statutory income that cannot possibly have a source.

Even though section 102-5 states that “your assessable income includes your net capital gain (if any) for the income year”, it cannot be the case that the basis for inclusion for foreign residents is the method statement in that provision. As the EM referenced above makes clear, the relevant basis is the sufficient link to Australia.

Another example, if (hypothetically) Division 855 of the ITAA 1997 was repealed, there is no reason to suggest that foreign residents could not be assessed on capital gains. It is likely that the source of the net capital gain would need to then be determined according to general principles of source as there would be no other basis that covers the sufficient link with Australia. This would lead to the ultimate conclusion that a net capital gain has multiple sources.

Judicial authority regarding source

That amounts can have dual or multiple sources (or being partly sourced in Australia and partly sourced outside of Australia) is consistent with the authority in *Australian Machinery and Investment Company Limited v DFCT* (1944) 7 ATD 415 where the gain on the sale of certain shares (assessable on revenue account) was held to be sourced in both Australian and the UK with a relevant apportionment being required to determine an amount of exempt income under former paragraph 23(q) of the *Income Tax Assessment Act 1936*.

Relevantly, Rich J stated that:

> *Having thus equipped itself with a large stock in trade of shares, it entered the English market, and began its operations there by selling the shares at prices which included shares in certain English companies. In determining the source of any income which may have resulted from the sales, it must be remembered that “source” in this sense is not a legal concept but something which a practical man would regard as a source. Legal concepts may enter into the question, but the ascertainment of source is “a practical hard matter of fact” …* ***I feel no doubt that if a person, trading in wares which are locally situated in one country, makes a profit by selling them in another country, the source of his profit is in part the wares and in part the contracts of sale, and the locality of the source is in part the locus of the wares and in part the locus of the contracts.***
>
> *(emphasis added)*

The profit on a disposal of shares is also a net concept and the product of various other amounts such as the proceeds of sale, cost of purchase and other expenses. In this regard it may be analogous to a net capital gain which is a product of many such gains. Nevertheless, it is not precluded from having a source or multiple sources.

There is no clear reason why it is not possible to disaggregate a net capital gain into Australian source and foreign source components. In many cases this would be a very easy task. For example, the total net capital gain would comprise of a number of small capital gains, whereby each of those gains would have a relevant source, being either Australian or foreign. This would be consistent with the example in section 770-75 which disaggregates the net capital gain into its constituent capital gains, although it is acknowledged that this example appears to relate to paragraph 770-75(4)(a)(i) amounts where foreign tax has been paid on the capital gain.

Even if one was to accept a view that subparagraph 770-75(4)(a)(ii) does not allow for apportionment, we highlight that if a net capital gain is entirely comprised of foreign sourced capital gains one must conclude that the entire net capital gain is from a source other than an Australian source. If apportionment is not allowed, net capital gains should still satisfy subparagraph 770-75(4)(b)(ii) where they are entirely comprised of foreign sourced capital gains.

Inconsistency with draft TD 2019/D7's views on section 99D

The view that a net capital gain can have multiple sources is consistent with the Commissioner's own recent draft TD 2019/D7 which states at paragraph 21:

> *21. It is noted that the source concept is relevant to the application of section 99D of the ITAA 1936, which in some cases can provide a non-resident beneficiary with a refund of tax paid by the trustee under section 99A of the ITAA 1936 on income from non-Australian sources.* ***Section 99D could potentially apply to all or part of a capital gain that is asserted to have a foreign source****. Importantly, any entitlement under subsection 99D(1) is subject to the discretion of the Commissioner under subsection 99D(2) to refuse a refund where there was a purpose of enabling the beneficiary to obtain the refund of tax. The Commissioner would carefully consider the requirements of subsection 99D(1) and the operation of subsection 99D(2) in a case where a non-resident beneficiary seeks a refund under section 99D in respect of a distribution which the beneficiary asserts is attributable to a capital gain.*
>
> *(emphasis added)*

Section 99D applies to allow a refund of tax paid by a trustee on amounts of net income (including a net capital gain). Where a foreign beneficiary is distributed an amount that is attributable to sources outside of Australia that is taken into account in the net income of the trust, they may be entitled to that refund. For this view to be correct, a net capital gain that is included in net income of a trust estate would have to be able to have a source (either outside of Australia or not).

It is submitted that the views in TD 2019/D7 and the Draft Determination are inconsistent in this regard.

Conclusion

Based on the above, we submit that the Draft Determination should allow for a net capital gain to be broken down into its component capital gains and that paragraph 770-75(4)(b)(ii) should be taken to be satisfied to the extent of the portion relating to foreign sourced capital gains. We believe that this view provides the correct policy outcome and is consistent with the treatment of a "net profit" brought to account on revenue account on the sale of the same asset. In our opinion, the ATO's current view is likely to create a distortion which would lead to taxpayers seeking to argue that such gains are on revenue account rather than being on capital account in order to satisfy the requirements of the provision. This would likely result in unnecessary disputes and complexity, which is not otherwise warranted.