Foreign Income and the Foreign Income Tax Offset
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CCH Learning:

Hello everybody and welcome to today's webinar, Foreign Income and the Foreign Income Tax Offset. My name is Susannah Gynther from Wolters Kluwer CCH Learning and I will be your moderator for today. A few quick pointers before we get started. In the handout section, you'll find the PowerPoint slides for today's presentation. If you're having sound problems, please check your audio settings. Try and toggle between audio and phone, and just a reminder that within 24 to 48 hours, a notification for the e-learning recording will be emailed to you. You can ask questions at any point during the presentation by sending them through the questions box. I will questions and ask at the Q&A towards the end of today's presentation.

CCH Learning also offers a subscription service which many people have termed Netflix for professionals. It provides members with access to our entire library of recordings as well as live webinars for a competitive flat fee. That's for over 500 hours of content. For CPD purposes, your viewing is logged automatically. Excuse me. Your presenter today is Mark Chapman, who is the Director of Tax Communications for H&R Block Australia. Mark has over 25 years experience as a tax professional in both the UK and Australia, specializing in tax for small businesses and individuals. He is a member of the Institute of Chartered Accountants in England and Wales, the Chartered Institute of Taxation, and is a fellow of CPA Australia. He also holds a master's of taxation law with the University of New South Wales. I will now pass you over to Mark to commence today's presentation.

Mark Chapman:

Thank you, Susannah, and good afternoon everybody, and thanks for taking the time to come along to this webinar where we're going to be looking at foreign income and the foreign income tax offset. So as Susannah just said, there will be an opportunity for questions. I'll talk for about 55 minutes. Then I'm happy to take questions for the remainder of the hour. If something occurs to you after the session has ended or indeed, if I can't answer the question for some reason, I'm happy to deal with questions out of session as well. So do please email me using my email address, which is on the final slide.

So in terms of what is on the menu for this particular session, I'll start off by talking about the different sources of foreign income and highlighting particular issues with foreign income, so pensions and annuities, business income, employment income, income from assets and investments, capital gains on overseas assets, et cetera. I'll give you a bit of a high level overview of how they are all treated. The second half of the session is specifically geared towards looking at the foreign income tax offset. So I'll do a bit of a deep dive into the foreign income tax offset. We'll talk about eligibility, how to calculate it, which foreign taxes are actually included in the calculation, when it should be claimed, and also we'll talk about the interaction between the capital gains tax discount and the foreign income tax offset.

So without further ado, if I can get my computer to work... Bear with me a bit. That's it. So let me just give you a bit of background. Obviously, as far as the foreign income tax offset is concerned, it's important that the taxpayer is actually a resident in the first place. So how do we actually decide if somebody is a resident or not? The Australian tax law treats residents and non-residents very differently. Australian residents are obviously taxed on all of their worldwide income, whereas non-residents are only taxed on Australian sourced income and as a result of that, obviously the foreign income tax offset is not particularly relevant for non-residents. The tax rates are completely different for non-residents as opposed to residents. For example, non-residents don't get the tax-free threshold, the $18,200, and in addition, non-residents pay tax at 32.5% from the first dollar of income up to $120,000. So basically non-residents, although they're only taxed on their Australian sourced income, are taxed at higher rates by and large.

Therefore, if you are a Australian resident, you do need to disclose and pay tax on all of your worldwide income, including things such as interest on overseas bank accounts, foreign pensions, rent from investment properties, disposals of foreign assets, employee share schemes, and obviously, wages and salaries. And in addition, you'll be entitled to a foreign income tax offset in respect of foreign tax which is being paid on those foreign sources. So in terms of determining whether a taxpayer actually is resident or not, there are really four tests. The other three tests I'll talk about in a few moments because they're only relevant if the primary test is failed. If the primary test, which I'm going to talk about on this slide, is passed, you don't need to consider the other three tests. So the primary test of residence, it's simply to look at where an individual resides. So that's determined by facts, by circumstance, by evidence.

So in terms of definition, there isn't one really. If we look at the dictionary definition, for example, of resides, that is, "To dwell permanently or for a considerable period of time, to have one's settled or usual abode, to live in or at a particular place." Now that's not from the tax legislation. That's simply a dictionary definition, but that's pretty much what we're seeking to establish here. We're seeking to establish where the individual actually resides. Now the ATO has given a list of factors to take into account to determine where the individual actually resides. They are set out in a fairly recent draft tax ruling, TR2022/D2. That replaced a much older tax ruling, but the factors to take into account are basically exactly the same. They're simply lifted from the earlier ruling and put into the new ruling. So you need to look, for example, at the intention and purpose of the taxpayer's state. You need to look at the taxpayer's family and business ties or his employment ties, the maintenance and location of the taxpayer's assets, the social and living arrangements the taxpayer has in Australia or in some other place. Also, their physical presence in Australia, obviously.

So we need to look at all of those factors and come up with a balanced viewpoint as to whether they indicate that the taxpayer does actually reside in Australia or not. As I said earlier, if the taxpayer passes the resides test, then they're resident and no further tests need to be considered. If the taxpayer fails the resides test, then we then need to consider the other three tests, and if any one of those tests is passed, the taxpayer is resident. So the three tests, there they are. It's probably worth pointing out that the superannuation test isn't really relevant. It only applies to typically current public servants who might be overseas for some reason, and basically, that test seeks to establish that the public servant is actually resident in Australia even though they might be overseas for potentially many years. So we won't talk about that any further. The two important ones are the domicile test and the 183 day test.

So the domicile test, that's actually a concept imported from UK law. Residence is more than the place where you are physically located. It's a place where, if you like, your heart belongs, where you regard as home. So you're resident in Australia if your domicile is in Australia, unless the person's permanent place of a abode is outside Australia. Now, it's possible to have a domicile of origin, which is basically the place where you're born, or a domicile of choice, which is the place where you choose to live, or you can be domiciled by the application of law. In my case, for example, my domicile of origin is the UK. However, my domicile of choice, which has overwritten that, is Australia because this is where I've been for 15 years and I don't intend to move from here. Therefore, Australia has replaced the UK as my domicile.

And then there's the 183 day test. Simple numerical test, "Is the person physically present in Australia for more than 183 days in a year?" That doesn't need to be continuous. The person can come and go, but if they're here for more than 183 days in a year, then they will be resident unless, again, that place of abode test isn't satisfied. So it doesn't apply if the person's permanent place of abode is outside Australia. So the ATO has pulled together a table outlining some particular common situations and stating whether indeed the taxpayer will be resident or non-resident. So for example, if you've got an overseas student who's enrolled in a course of more than six months duration at an Australian institution, then they will generally speaking, be Australian resident. If you're visiting Australia, working and living in one place and have taken steps to make Australia your home, again, you would usually be Australian resident.

If you're visiting Australia and traveling and working in various places, then you would generally be foreign resident and actually you'd possibly be a working holiday maker who have a completely different set of tax rules, which we're not going to talk about today. If you're on holiday in Australia for less than six months, you would generally be a foreign resident and if you are migrating to Australia and intend to live here permanently, then generally speaking, you would be Australian resident. So what is the link between residency and the foreign income tax offset? Well, basically, unless you are resident, you can't really claim the foreign income tax offset. However, there isn't actually any reason why you can't claim the foreign income tax offset if you are non-resident. So there's no actual requirement that the individual claiming the offset must be an Australian resident and that's because of the non-discrimination rules which apply in the newer DTAs. So, in theory, a foreign resident could be entitled to a FITO for foreign income tax paid on a source basis.

That means, basically, that the foreign resident would have to be taxed on that foreign income in Australia and that, generally speaking, cannot happen. Therefore, in 99.9% of the cases, if you've got somebody who is non-resident, then the foreign income tax offset will not be relevant because they simply won't be taxed in Australia on that income. Therefore, the foreign income tax offset is by and large only going to be relevant where the taxpayer is actually resident here in Australia. So let's look at some specific types of foreign income and particularly ones which seem to cause a number of problems with the clients and also indeed with tax practitioners. Foreign pension payments. I get a lot of questions regarding foreign pension payments along the lines of, "Will this amount be assessable?" I don't understand exactly why that is the case because if it is foreign income, then it will be assessable inevitably. However, a lot of people don't seem to necessarily grasp that argument in relation to foreign pension payments. So foreign pension payments are, generally speaking, assessable in Australia because it's foreign income and an Australian resident is taxed on their entire worldwide income.

Having said that, there could well be a deduction available for the undeducted purchase price. Now that's the amount which equates to the original contributions to the pension fund out of taxed income. Now, some pensions are entitled to a standard deduction. For example, some UK pensions get that standard deduction at a rate of 8%. Those are typically UK state pensions rather than private ones and some Dutch pensions are entitled to a deduction for up to 25% of the amount which the taxpayer receives. Otherwise, it's necessary to apply to the ATO using a UPP determination form and the ATO will calculate the amount of the undeducted purchase price. Unfortunately, it is necessary to provide quite a lot of information, so they do need a note of all the contributions which have been paid into the pension fund over the years in order for them to work out the amount of the UPP. So that can be a difficult and time-consuming process, getting that information together from clients and sending it off.

So to the extent that pensions are also taxed overseas, a foreign income tax offset arises, obviously. No foreign income tax offset arises in relation to untaxed pensions overseas. So if the pension is received in Australia, it will be taxed. However, if for some reason, it wasn't taxed in the country of origin, then there'll be no foreign income tax offset in relation to that. Again, this seems to be a source of some confusion. The fact that it wasn't taxed in the country of origin doesn't mean that it won't be taxed here. There may be, for example, in the UK, there are certain tax breaks which mean that there may, in certain circumstances, be tax-free elements of pension payments within the UK. That's UK law which stipulates that. Australian law doesn't. Australian law simply regards that as a receipt of a foreign pension and seeks to assess it. So it is important to note that just because a pension was tax-free in the country of origin doesn't mean it'll be tax-free here. However, some foreign pensions are actually going to be tax-free in Australia.

Now these are often specifically made tax-free by the double tax agreement, which I'll talk about in a few moments time, such as, for example, pensions which are paid by the U.S. government. Now, that's at any level of the U.S. government, so state, federal or local. Those are always going to be tax-free here in Australia. They are taxed only in the U.S. The UK War Widow's Pension, that is going to be tax-free in Australia. New Zealand pensions, which would be exempt from tax in New Zealand, will also be exempt from tax in Australia. That's a specific New Zealand Australia measure and it doesn't apply more widely. Transfers from a foreign super fund, these are quite common. I get lots of questions from people who are transferring amounts from foreign super funds who want to understand the tax implications. The amounts will be taxable. However, the question is, "How will they be actually taxed?" Is the foreign retirement fund actually regarded as a foreign superannuation fund for Australian tax purposes? The answer to that question will dictate the way in which that receipt of foreign superannuation will be taxed.

If it isn't a foreign superannuation fund for Australian tax purposes, then the transfer will be subject to tax under section 99B. Now, the reason why that's important is that there are actually very strict rules about what constitutes a foreign superannuation fund. And it may well be that the foreign superannuation fund in question doesn't actually meet the definition of a superannuation fund. Specifically, the foreign superannuation fund must exclusively provide a narrow range of benefits including the payment of superannuation benefits upon retirement, invalidity or death of the individual. That's it. If there is capacity to withdraw amounts from the foreign retirement fund to, for example, pay for housing or education, then that means that that foreign retirement fund is not a foreign superannuation fund. So, for example, some of the popular U.S. retirement schemes such as individual retirement accounts or IRAs allow pre-retirement drawdowns for housing and school fees and therefore, they are not considered superannuation funds. So therefore, transfers to Australia from these IRAs will be taxable under section 99B and therefore, there could be some very significant tax liabilities arising within Australia in relation to those funds.

So where the scheme isn't a qualifying super fund, as I say, it'll be taxed under section 99B. Under 99B, the corpus of the trust is excluded from tax and therefore, the taxpayer is likely to be taxed on the difference between the value received and the level of contributions paid into the foreign pension over time. So this is, as we'll see on the next slide, very different to the tax treatment of the fund where the fund is actually regarded as a superannuation fund, in which case only the growth in the fund since the taxpayer became an Australian resident would be taxed. Whereas on the section 99B, that date is basically irrelevant. We need to go back for the entire duration of existence of the member's interest in the super fund and look at growth over that time. So the alternative is where the super scheme is actually a qualifying super fund and there are basically two alternative treatments in that scenario. First of all, the first one arises where foreign superannuation lump sums are transferred within six months of the individual member becoming a resident, and in that case, they are going to be tax-free.

Now, if the payment or transfer of funds occurs more than six months after becoming resident, the applicable fund earnings will be taxable. So what are the applicable fund earnings? Well, they are the excess, in Australian dollar terms, over the amount that was vested in the fund just before the individual became a resident, less additional contributions after the individual became an Australian resident and less again any other amounts transferred into the foreign fund from other foreign funds. So the effect is that the taxpayer is assessed only on the income arising in the fund during the residency period. So earnings during periods of non-residency and also contributions and transfers into the fund don't form part of the taxable amount where the lump sum benefit is paid. So this will inevitably result in tax being levied on the individual in relation to the growth, obviously, if there is any, in the foreign fund since the taxpayer's Australian residency commenced at the taxpayer's prevailing marginal tax rate. Compare that to the other situation where it's taxed on section 99B where the date of residency is irrelevant and we actually end up having to go back much further to find out the level of Australian assessable income.

Now, that's all very well, but we need to be very careful in situations like this when we're actually calculating the foreign income tax offset. So a foreign income tax offset is only available to the extent that the benefit is ultimately taxed in Australia and that will probably be different to the amount which was taxed overseas. So in terms of the amount taxed overseas, we'll be looking probably at the whole period whereas in relation to the amount which is taxed in Australia, we're only looking for the period from the date when the individual became resident. So therefore, you'd probably need to apportion foreign tax between the part of the fund that's taxable in Australia and the part that isn't. Now, we can't really talk about foreign income and not talk about double tax agreements. The important point about double tax agreements is that they largely tell us, in relation to Australian residents, whether the income will be in addition taxed in the country of origin.

So they don't tell us very much at all about the accessibility of the income in Australia because domestic law simply says that Australian residents are taxed on their entire worldwide income and DTAs don't displace that. They, by and large, simply dictate whether the income is also going to be taxed in country of residence and therefore, a foreign income tax offset may well arise. There are about 40 double tax agreements in place between various foreign jurisdictions and Australia which govern the accessibility of Australian tax residents to tax in the overseas jurisdiction. And also it is worth pointing out, there are some instances where it does talk about the accessibility of income in Australia. For example, the U.S. government pension payments which I talked about a few slides ago that are specifically made taxable only in the U.S. by the double tax agreement. However, that is very unusual.

So the DTA doesn't typically prevent the income from being taxed in Australia because domestic law simply says that it will be taxed in Australia. It generally only stipulates whether, how and occasionally, at what rate the income is going to be taxed in the overseas jurisdiction. So let's look at some of the common types of income. The first one is rental income, which basically the double tax agreement says that as well has been taxed in Australia, obviously, the rental income will also be taxed in the overseas jurisdiction in which the property is situated. In relation to dividends, dividends paid by an overseas company to an Australian resident shareholder could be subject to withholding tax in the overseas state. That's usually at a rate of 5% if the shareholder holds at least 10% of the voting power in the company or 15% in any other case. Obviously, each DTA is different and occasionally, those rates will vary but, by and large, those are in general the rates which apply.

In relation to business income, business profits of an Australian entity will also be taxed in the overseas jurisdiction where it operates through a permanent establishment situated there and the profits are attributable to that permanent establishment. In terms of interest, overseas interest is subject to a withholding tax in the overseas jurisdiction, which is usually at a rate of 10%, obviously, again, subject to the DTA. Royalties are subject to a withholding tax in the overseas jurisdiction, which is usually at a rate of 5%. In terms of employment income, then generally salaries, wages and similar remuneration derived by an Australian resident from an employment exercised overseas are taxed in the foreign state obviously as well as Australia. However, subject to certain conditions, the income is exempt from tax in the foreign state where the employment is short term. So in other words, remuneration derived by an Australian resident in respect to foreign employment is taxable only in Australia if the recipient is present in the foreign state for a period of less than 183 days in any 12 month period commencing or ending in the year of income of the foreign state.

And in addition, the remuneration is paid by or on behalf of an employer who isn't a resident of the foreign state or is born by or deductible in determining the profits of a permanent establishment which the employer has in Australia. And in addition, remuneration isn't born by or deductible in determining the profits of a permanent establishment which the employer has in the specific foreign state. So there are quite a few hoops to jump through there for the remuneration to be only taxed in Australia. But generally speaking, employment income will be taxed in both countries. And then capital gains finally, where an overseas asset is sold is subject to the capital gains laws, if any, of the overseas country. Obviously again, with the note that it will be assessable in Australia.

So we're going to have a situation where a taxpayer typically has a particular source of income and that is going to be subject to Australian tax, but prior to that, it would probably have been subject to overseas tax as well. So the foreign income tax offset is devised to prevent the application of double taxation. So the employment income or the capital gains or the interest income or whatever has already been taxed in the UK or the U.S. or France or wherever is going to be taxed in Australia. So the foreign income tax offset basically prevents double taxation arising by relieving the Australian tax for the amount of the overseas tax. Division 770 is where the rules regarding the foreign income tax offset are located. It provides relief from double taxation. Income and gains are obviously taxed overseas and then a credit is available in the Australian tax return for the Australian dollar value of that tax which has actually been paid. So there are two criteria which a taxpayer has to satisfy in order to be able to claim a foreign income tax offset.

First of all, you need to have actually paid an amount of foreign income tax in relation to foreign income and secondly, you need to include the income or capital gain that you paid foreign income tax on in your assessable income for Australian income tax purposes. So let's just look at the first of those two criteria. The FITO can only be claimed after the amount of foreign tax is actually paid. So it can't be claimed in relation to foreign income tax that's accrued but not paid, which could happen, for example, where the foreign tax return has been submitted but the tax hasn't actually been paid yet. So if the foreign income tax is paid in a later Australian tax year, the tax taxpayer needs to go back and amend the original tax return containing that foreign income. In terms of the time limit for doing that, the normal two year period of review doesn't apply to this amendment. The taxpayer actually has four years from the date the foreign tax was paid to submit the amendment. There's a case study coming up in a few slides time which illustrates that which I'll talk through then.

And obviously, for the foreign income tax offset, then all foreign income deductions and tax payments do need to be converted to Australian dollars at the applicable rate. So the FITO is a non-refundable tax offset. It reduces the income tax payable, including Medicare levy and Medicare levy surcharge, but it can't actually create a loss. So the FITO is applied after all other non-refundable tax and non-transferable offsets and therefore, if the FITO exceeds the amount of tax which is otherwise payable by the taxpayer for the year, the excess is unfortunately lost. It can't be carried forward. It can't be transferred or whatever. It is basically lost. Let's look in a bit more detail at that criteria which says that in order to claim a foreign income tax offset, you need to have paid the amount of foreign tax. And let's look at the situation where the foreign tax has actually been paid on the taxpayer's behalf. Now, a taxpayer is deemed to have paid foreign income tax in respect of a particular amount where tax has in effect been paid by someone else on their behalf under an arrangement or under a foreign tax law.

So this particular provision is intended to apply in cases where the tax has been paid, for example, by deduction or withholding, which we'll talk about in a bit more detail for the impact on dividends, which is a common source of foreign income, on the next slide, where a trust in which the taxpayer is a beneficiary, for a partnership in which the taxpayer is a partner or where the taxpayer's spouse has actually paid the tax. For example, where the foreign country taxes husband and wife as one unit. Obviously, Australia doesn't do that and therefore, the fact that the wife has paid the tax could well be sufficient for the husband to claim a foreign income tax offset. So normally the foreign tax needs to be paid by the entity claiming the offset. However, as we just saw on the previous slide, a FITO is received in relation to foreign withholding tax. For example, on dividends or interest, et cetera. So by way of example, we've got an Australian resident who receives a dividend from an overseas company from which the company deducted the percentage in foreign tax before paying this to the Australian resident. Can a FITO offset be claimed for the withholding tax?

Well, the FITO rules say that to be able to claim a foreign income tax offset, you must have actually paid an amount of foreign income tax in relation to foreign income. But in this case, the taxpayer hasn't actually paid the tax. The company did. However, the FITO rules do actually deem this tax to have been paid on behalf of the taxpayer and therefore, a foreign income tax offset can be claimed. The mechanics of that is that the individual needs to gross up the dividend by the amount of withholding tax. The gross dividend is then included in his or her Australian tax return and a FITO can then be claimed for the withholding tax. So a practical example taken from the ATO, Emma has shares in a company resident in the United States of America. She was entitled to be paid a dividend of $400. Before she was paid the dividend, the company deducted $60 in foreign tax, sending Emma the remaining $340. So when she fills in her Australian tax return, Emma includes $400, so the gross amount of the dividend at other net foreign source income on item 20 and she can then claim a foreign income tax offset of $60 at the foreign income tax offset box.

Now, I talked briefly about the longer amendment period which exists in relation to foreign income tax offsets. Now, I just want to illustrate that by talking through a case study which has been taken from the Australian Practical Tax Examples book, it's most recent example. So it's an example which I wrote from that book. I think it illustrates the point quite well. Cameron Davis is an Australian tax resident who resides in Sydney. He owned a commercial building in Canada which he decided to sell. The contract date for the sale of the property was the 1st of June, 2019, but because of financing delays, settlement didn't take place until April, 2021. Now, under the DTA between Australia and Canada, Cameron is subject to tax in both countries in relation to any capital gain arising from the sale of the Canadian property. For Australian tax purposes, CGT event A1 happened on the 1st of June, 2019, which was the contract date for the sale of the property, and the capital gain was included in Cameron's 2018-19 Australian tax return.

Now, Cameron lodged his 2018-19 tax return in October, 2019. However, he couldn't claim any foreign income tax to offset the Australian tax liability as he hadn't yet paid any Canadian tax in relation to that capital gain. It wasn't until December, 2021 that Cameron lodged a Canadian tax return for the 2019 Canadian tax year and Cameron paid the Canadian tax on the capital gain in January, 2022. So the question is, "Is Cameron entitled to claim a foreign income tax offset in relation to the Canadian tax paid on the capital gain even though his usual two-year amendment period would've expired in November, 2021, so two months before he actually paid the tax in relation to the Canadian gain?"

Well, as of January, 2022, Cameron is entitled to claim a foreign income tax offset in relation to the Canadian tax paid on that capital gain, not withstanding that the standard amendment period of two years expired a couple of months earlier in November, 2021. So if we look at the legislation section 770-190, it gives taxpayers a special amendment period of four years after an amendment event happens. Now, relevantly to Cameron, an amendment event includes the payment of foreign tax, i.e. Canadian tax, that counts towards the FITO for the year. So the amendment period of four years overrides the standard amendment periods which exist in relation to tax returns. Now, that four year amendment period also applies where there's been an increase or decrease in the amount of foreign income tax paid. An amount of foreign tax counts towards the FITO for the year to the extent that it was paid in respect of an amount included in assessable income in that year.

So therefore, in Cameron's case, the capital gain was assessable in Australia in 2018-19 and therefore, the Canadian tax paid in respect to the gain is eligible for relief as a FITO in that same year. However, he has until January, 2026 to amend his 2018-19 tax return to claim a FITO in relation to the Canadian tax paid on the capital gain. That date, January, 2026, is four years after the date in January, 2022 when he actually paid the Canadian tax. So it is possible to greatly extend the amendment period in relation to the foreign income tax offset only. Now, another common question relates to, "Actually, what constitutes foreign taxes for the purposes of the foreign income tax offset?" Now, foreign income tax is intended to cover taxes that are substantially equivalent to Australian income tax. These particular taxes could be levied by a federal or a state authority. So, for example, some U.S. states levy their own income tax in addition to the federal income tax. In addition, taxes are covered if they're levelled at a supernational level such as the European Union. I'm not aware that the European Union does actually impose supernational taxes, but they could. If they did, they would be included within this definition.

So therefore, this definition of foreign income tax does cover a tax on income, a tax on profits or gains, whether of an income or capital nature. So capital gains tax overseas will be included or any other tax that is subject to an agreement covered by the International Tax Agreements Act of 1953. For example, a tax sparing amount such as under the Philippines DTA. So what doesn't get included in the foreign income tax offset? Well, social security contributions such as UK national insurance contributions or similar contributions across Europe, they are not included. Now, there was a case, case 8/2014 which explored this issue. It dealt with Irish pay related social insurance, which was deducted from the individual's salary. The individual attempted to claim a foreign income tax offset in relation to that amount, but the courts found that it was not an income tax. In addition, it doesn't include payroll taxes, stamp duty or land taxes, VAT, GST or similar taxes on consumption. It doesn't include inheritance taxes or annual wealth taxes. So if you can see that the taxpayer's paid any of those, they're not included in the foreign income tax offset.

So how do we actually calculate the foreign income tax offset? Well, basically there are two situations which arise. The first one is where we're claiming a foreign income tax offset of up to $1,000. In that situation, we simply record the actual amount of foreign income tax paid that counts towards the offset up to $1,000. So that's the easy situation whereby you simply put in the actual amount of foreign income tax paid and, provided it is no more than a thousand dollars, that is your foreign income tax offset. However, where the amount of the FITO is greater than $1,000, we first of all need to work out a foreign income tax offset limit, which is the maximum amount of offset that can be claimed. It could well be less than the actual amount of foreign tax paid. So where the amount of foreign income tax paid is greater than $1,000, we need to calculate the FITO offset limit, which is basically the difference between the actual tax payable in relation to all sources of income and the tax liability which would've applied if foreign income and deductions were ignored.

So there's a three step process to calculate the FITO offset limit. Step one is to simply calculate the normal tax which is payable for the period, looking at all income including the Medicare levy and Medicare levy surcharge, but excluding any tax offsets. Step two is we calculate the tax payable for the period assuming that we don't include any of that foreign assessable income for which foreign tax is paid and we don't include any deductions which relate to the derivation of that foreign income. And then for step three, we simply subtract the results from step two from the result of step one and that gives us the foreign income tax offset limit. So a quick example, we've got Marie who earned $34,000 in 2022-23 of which $12,000 is foreign income. So her deductions totalled $2,870 of which $700 relates to the foreign income. So therefore, if we're looking at her overall taxable income of $31,370, the tax payable on that will be $3,079.30, including the Medicare levy.

Now, she actually paid foreign tax of $3,400 in relation to the foreign income. So the foreign income tax offset is therefore the lower of $3,400 and the foreign income tax offset limit. So the FITO limit is simply calculated by taking out those amounts of foreign income and also the foreign deduction. So let's look at assessable income, excluding that foreign income. So that comes to $22,000. Excluding deductions which relate to foreign income, that comes to $2,100. That gives us a taxable income of $19,800. Tax on that taxable income would be $309.70. Subtract that from her actual tax on taxable income and that gives us $2,769.60. So therefore, the foreign income tax offset is the lower of $3,400 and $2,769.60. So therefore, that is the amount which we can claim as a foreign income tax offset, i.e. $2769.60. The difference between the foreign income tax that Marie has actually paid and the offset limit can't be refunded or carried forward to a future income year. In fact, it's actually wasted.

Now just bear in mind, first of all, if the Australian dollar value of the actual amount of foreign tax paid is $1,000 or less, then you can forget that calculation. You simply claim the amount of foreign tax which was paid. In all other cases, however, generally speaking, the FITO is the Australian dollar value of the actual amount of foreign tax paid. However, it can't be assumed that this is the case. It's always necessary to calculate the FITO limit just in case because it may well be that the FITO limit is actually going to be the amount which you can use. And to the extent that foreign tax paid exceeds the amount claimable as an offset, the tax benefit of the excess is unfortunately lost. It can't be carried forward to be used in determining the offset in subsequent income years nor can it be transferred. As I said earlier, it is simply lost. A numerical example of that, let's assume that foreign tax of $20,000 is paid by a taxpayer on foreign income included in the taxpayer's assessable income, but the foreign income tax offset limit is $15,000. So therefore, the taxpayer's offset is going to be $15,000. That $5,000 gap, the excess foreign tax, can't be carried forward in calculating the offset in any subsequent income year.

Now just a quick planning tip. Where it appears that part of an offset could be wasted in a particular tax year, the taxpayer could, by some means, seek to accelerate the derivation of Australian income into that year and therefore increasing his Australian tax bill. Obviously, that would have the enabling potentially the full benefit of the offset to be obtained. Now let's look at the interaction between capital gains tax and the foreign income tax offset. What the rules say is that if the taxpayer pays foreign tax on a foreign capital gain, the offset is available provided that the gain is taken into account in determining the taxpayer's net capital gain for the year. Now, in relation to individuals, obviously this can mean that FITO is only available in respect of 50% of the foreign tax paid. Because of the 50% discount, only 50% of the gain is taken into account in determining taxpayer's net capital gain for the year. Now there's an example coming up where I'll talk through that in a bit more detail and you can see the way that that actually works.

In addition, if the taxpayer has a net capital loss in Australia, the foreign tax on the capital gain obviously can't be claimed because it wasn't paid in respect of an amount included in assessable income. So let's look at the interaction between the capital gains tax discount of the foreign income tax offset by way of an example. On the 4th of January, 2000, Michael Simpson acquired an investment property in Florida, United States, for 250,000 U.S. dollars, which was 410,000 Australian dollars. On the 16th of October, 2021, Michael signed a contract to sell the property with settlement occurring on the 1st of December, 2021. The sale price was agreed to be 1 million U.S. dollars which converts to 1,430,000 Australian dollars. So Michael is advised that the profit on sale of 750,000 U.S. dollars will be subject to United States income tax or capital gains, partly at a rate of 15%, partly at a rate of 20%. On the 16th of September, 2022, Michael pays United States tax amounting to 135,000 U.S. dollars, which equates to 205,000 Australian dollars.

Now, Michael wishes to understand the Australian CGT implications of his transactions, including whether he can claim a credit for the entire amount of United States tax paid. Michael was an Australian resident for tax purposes throughout the period of ownership. He has no other CGT events in the years 2020-21 or 21-22 and no capital losses brought forward from earlier years. His other income for the year exceeds $180,000. So the disposal of the property in the United States obviously gives rise to CGT event A1. So the capital gain is simply calculated by deducting the asset's cost base in Australian dollars from the capital proceeds in Australian dollars and that therefore gives us a capital gain of 1,020,000 Australian dollars. Now where a capital gain arises from the sale of an asset owned by the taxpayer for at least 12 months, as here, the gain can be discounted by 50% where it's made by an individual. So therefore, this reduces the amount of the capital gain to $510,000. So this is the net capital gain that's going to be included in Michael's assessable income for the income year, which is 2021-22, in other words, the year that the contract of sale is signed.

Now this amount is going to be subject to income tax at Michael's marginal tax rate, which is 45% plus 2% Medicare levy. Therefore, his total income tax liability in relation to the transaction will be $239,700. In order to avoid double taxation, Michael will be entitled to a foreign income tax offset in relation to the United States tax paid, which will reduce his tax liability, which we've just calculated. So the question is, "Can he claim a foreign income tax offset in relation to the entire amount of U.S. tax paid or does he need to discount that by 50%?" Now, if a taxpayer pays foreign tax on a foreign capital gain, the offset obviously will be available, provided that the gain is taken into account in determining the taxpayer's net capital gain for the year. There was a tax case about four years ago, Burton v FC of T, in which the taxpayer derived capital gains from investments made in the United States. Those gains were subject to tax in the U.S. Burton paid the applicable United States tax and the gains were also taxable in Australia as capital gains but were subject to a 50% discount as the investments have been held for more than a year.

The taxpayer claimed a foreign income tax offset for the full amount of the tax paid in the United States, but the commissioner argued that since only 50% of the capital gain was included in the taxpayers assessable income, only 50% of the amount of the United States tax paid should count towards the FITO. Now the court agreed with the commissioner's view. He did so on the grounds that the amount that's included in assessable income is the net capital gain, so the capital gain after the discount has been applied, not the gain before the discount. As the taxpayer was only entitled to a FITO for the United States tax paid in respect of the amount included in his assessable income, that is the net capital gain, he was only entitled to a FITO of 50% of the United States tax paid. So basically, because of the operation of the 50% discount, Australia didn't tax all of the gain. It taxed 50% of it. That was the income in respect to which Australian tax was payable.

Therefore, only half of the United States tax paid could be said to be in respect of the income which was taxed here in Australia. So if we apply those principles to Michael's case, he can't claim a FITO in respect of the entire amount of the United States tax paid, so the entire $205,000. Recognizing that only half of the gain is included in Michael's assessable income, he's entitled to claim a FITO of $102,500. So therefore, that will reduce his Australian income tax liability to $137,200. Now, that's the end of the formal presentation. I actually make it about two minutes past 2:00, so we've slightly overrun. However, I'm happy to take questions for a few minutes. If I don't have the chance to deal with the question or if you come up with anything subsequently, do please feel free to email me. My details are on the slide there, but for now, I'll just hand you back very quickly to Susannah to tell you what's coming up and then we'll do the Q&A.

CCH Learning:

Thank you very much for that, Mark. Lots of information in that webinar today. We will be spending the next few minutes taking questions, so please just a reminder to please type them into the questions pane. To give you some time to type those up, I will let you know about some of our upcoming webinars. So next week, we're looking at employees v contractors. We're also going to be discussing navigation conflict in the workplace and also accounts receivable and cash flow modelling. We'll also be looking at any work related expenses hotspots. The week after, it's nearly financial year end, so we'll be looking at SMSFs and getting ready for the annual audit and we'll also be looking at asset reduction strategies for pension and aged care.

If you're interested in any of those, please head to our website at wolterskluwer.cchlearning.com.au and please have a look at those webinars. So let's have a little look at some questions. So I have a question from Mary. Their client receives rental income from overseas. The tax year of the foreign country ends on 31 December. Can the income be declared in his Australian tax return on the basis of the year ended 31 December rather than having to split it over two income years to enable it to cover the period ended 30 June?

Mark Chapman:

Possibly. Possibly, yes. If we look at IT 2498, paragraph 39, it does actually say that individual taxpayers who are required to prepare foreign source income accounts on a basis other than a year ending 30th of June and who can demonstrate difficulties in dissecting the income or expenses for the purposes of returning on a strict Australian income year basis in relation to a year of income may be permitted to return the foreign source income in his or her Australian return for that year of income on the relevant foreign income year basis. So therefore, if it isn't possible or practical to report on the basis of 30th June and obviously provided the taxpayer can prove that that is the case, so it needs substantiation, it is actually possible to report income and expenses for the year ended 31st of December instead.

CCH Learning:

Thank you for that, Mark. So I hope that helps you there, Mary. I had a question from Wilson. Wilson was asking... I think you may have answered this. Oh, no. That's all right. He does say he thinks his question just got answered. I apologize for that. I have a question here from Brian. Brian is asking, "How is accrued bonus taxed? Will the taxpayer have to pay tax on cash basis on receipt of the entire amount, including the bonus accrued prior to becoming an Australian resident or only on the amount accrued for the period worked after becoming an Australian resident?"

Mark Chapman:

So if you're an Australian resident, you're only taxed in relation to income which arises during that period of residency. So if somebody receives a bonus from overseas and part of it relates to the period before they became Australian resident, then that won't be taxed in Australia. The complication is in substantiating that, so proving that the amount of bonus is partially related to the period before you were resident. If you've got a paper trail that proves that, you're fine. You won't be taxed in relation to that earlier period when you weren't resident. However, if you can't actually prove it, so if you simply get a lump sum and you go to the ATO and you say, "Well, actually, part of that relates to a period before I was resident," if you can't prove that, then you will be taxed on the entire amount. So it comes down to a question of substantiation. It is very worthwhile getting your employer to provide substantiation of the periods that that bonus relates to and also to prove the date at which you actually came to Australia. Otherwise, it will all be taxed here in Australia.

CCH Learning:

Thank you for that, Mark. So I hope that helps you there, Brian. I also have a question from Sarah. Sarah was asking, "I have a client who is an Australian resident. A relation died. Under the will, my client is the beneficiary. The deceased had a bank account overseas and these accounts have earned interest. My client has paid tax overseas on that interest income. He now wishes to transfer the money from the deceased estate to his Australian bank account. Is the interest income from overseas included in my client's Australian assessable income? And is the capital amount from the deceased estate included in the Australian assessable income?"

Mark Chapman:

In relation to the interest? The answer is, "Yes." So the interest income from overseas is included in the client's assessable income. So the client is assessed obviously on his entire worldwide income and that includes interest received. So they'll receive a foreign income tax offset for any foreign tax which has been paid in relation to that. However, in relation to the capital, no, the client isn't required to include the capital amount transferred in his assessable income. The distribution of the money from a bank account is regarded as distribution of corpus or a capital amount. So a distribution of corpus from a deceased estate to a beneficiary isn't considered to be ordinary income and therefore it isn't assessable on the section 65 of the tax act. Obviously there are no capital gains tax consequences in relation to a distribution or an entitlement of the corpus of a deceased estate. So, no, the short answer is, "No. The amount of capital isn't going to be taxable, but the interest income will be."

CCH Learning:

Thank you for that, Mark. So there you go, Sarah. A bit of a win and maybe a bit of a not of a win, but thank you for that. So I also have a question from Jason. Jason has a question. Sorry, I'm just making sure I can see the whole of his question. "So if the taxpayer is working overseas for a few years and then comes back to Australia, so say five years later..." Sorry, I'm just trying to read the question. So his question is, "Would the cost of living and travel and accommodation in the overseas country be excluded or used as a deduction against the gross earned income? So the foreign income. That is, do we tax only the savings or do we follow the same rules as per within AU, Australia?"

Mark Chapman:

So are we assuming that this individual was still Australian resident even though he was overseas?

CCH Learning:

I think that's the concept, yes.

Mark Chapman:

Yeah, because if the individual wasn't Australian resident, then he wouldn't have to pay tax here in relation to that income. So if he was Australian resident, the amount of income would be assessable and he would be able to claim whatever deductions against that that the tax law tells him that he can claim. So if, under Australian tax law, he was entitled to a deduction for the accommodation, travel, et cetera, then he could claim. I don't know whether that's the case or not or whether these were simply private and domestic expenses, but you need to look at it within the light of the normal rules regarding Australian deductions. So if they arose as a result of earning his assessable income, they would be deductible.

CCH Learning:

Okay. He just had an additional question of, "Do we use the currency average rate as per the ATO publication to convert the earning to Australian dollars in the relevant tax year and ignore the actual exchange rate and its timing? That is, the taxpayer sent money back once every two years."

Mark Chapman:

The amounts are going to be taxed or deducted, in the case of expenses, at the date the amount was actually incurred. So therefore, if he worked for a particular period and got paid for that period, the amount which is subject to tax, it will be worked out using the exchange rate at the date that he was actually paid. Now, if he was paid into a foreign bank account and he didn't transfer that across to Australia until two years later, that doesn't matter. So you forget that. The fact remains that on a certain date, he was paid an amount from his employer and therefore, that is going to be subject to tax. So you need to convert it at that date.

CCH Learning:

Thank you for that, Mark. So I hope that helps you there, Jason. I also just had another question from Jason actually. He was just asking, "In regards to the USA, et cetera, and alike where it is tax-free in Australia," I'm assuming he means to talk about income, "are we saying we exclude them from the tax return or do we put them in the return?"

Mark Chapman:

Sorry, are we talking about pension payments, because cause aren't taxed in Australia. If somebody receives, for example, a U.S. government pension, that is made specifically non-taxable by the operation of the U.S. double tax agreement. So it is taxed only in Australia. That's only taxed in the U.S. It isn't taxed in Australia and therefore, it doesn't need to be included on the tax return. So if you've got an item of income such as that which is excluded from tax by the operation of the double tax agreement, then it simply doesn't need to be reported anywhere. However, I should emphasize I'm not aware that there are many items of income like that. The U.S. government pensions is about the only one that I can think of.

CCH Learning:

All right, thank you for that, Mark. I also have a question just asking in regards to a New Zealand citizen living in Australia, "Are there special rules with that?" I suppose it depends if they're a resident of Australia.

Mark Chapman:

Yes, it does, but there are. So Somebody who's a New Zealand citizen who comes here gets what's called a special category visa. Now that is regarded as a temporary visa in Australian terms and therefore, the New Zealander isn't subject to Australian tax in relation to any foreign income. Not just New Zealand income, any income from outside Australia. So foreign rental income, foreign bank accounts, foreign jobs, foreign capital gains, whatever, it's all tax-free. Having said that, they do need to be regarded as temporary residents, so if the New Zealand citizen comes to Australia and takes permanent residency or becomes an Australian citizen, then they become subject to worldwide tax. And in addition, if a New Zealand citizen comes here and gets an Australian spouse, for example, then they lose that temporary resident status. So you probably do need to do a bit of digging in relation to that, the specific circumstances of that New Zealand taxpayer. But prima facie, they are only taxed on their Australian sourced income.

CCH Learning:

All right. Thank you very much for that. I've got one more question if we have time.

Mark Chapman:

Yes. We'll squeeze it in.

CCH Learning:

Okay. It's again when relating to an Australian citizen who's receiving income from, say, a New Zealand company or trust, and then they invest in shares in Australian companies and they receive dividends. Can those citizens claim any imputation credits attached to those dividends if a clear report can be given with those figures from the New Zealand trust?

Mark Chapman:

So what's the situation again? Just run that by me again.

CCH Learning:

So it's an Australian citizen who's receiving foreign income from a New Zealand company slash trust. Now that New Zealand company does invest in shares in Australia and receives dividends on behalf of their clients. So can the Australian citizen claim any imputation credit attached to those dividends if a clear report can be given with those figures from the New Zealand trust?

Mark Chapman:

So the individual has received New Zealand income paid by a New Zealand company.

CCH Learning:

I think so.

Mark Chapman:

Well, New Zealand has its own imputation system, so the Australians certainly can't claim Australian imputation credits. However, they can now opt to receive the benefit of those New Zealand tax credits. I'm not sure what the precise conditions are for doing that, but maybe if your correspondent can just drop me an email, it may be possible for them to claim New Zealand imputation credits in relation to those dividends.

CCH Learning:

All right. Well thank you for that, Mark. So there you go. So Jason, if you want a little bit more information, please get in touch with Mark. His email address is there on the screen for the moment. Well that does bring us to the end of our questions for today. So in terms of next steps, I would like to remind you all to please take a moment to provide your feedback when exiting. We've asked you a couple of questions about today's webinar, so it's really important for us to hear your opinions. It's also a reminder that within 24 to 48 hours, you will be enrolled into the e-learning recording, which can be watched multiple times and have access to the PowerPoint transcript, any other supporting documentation, and of course, your CPD certificate. I would very much like to thank Mark for the session today, and to you, the audience, for joining us. We hope to see you back online for another CCH learning webinar very soon. Please enjoy the rest of your day. Thank you very much.