Foreign Income and the Foreign Income Tax Offset

Mark Chapman

Thursday 27 April 2023

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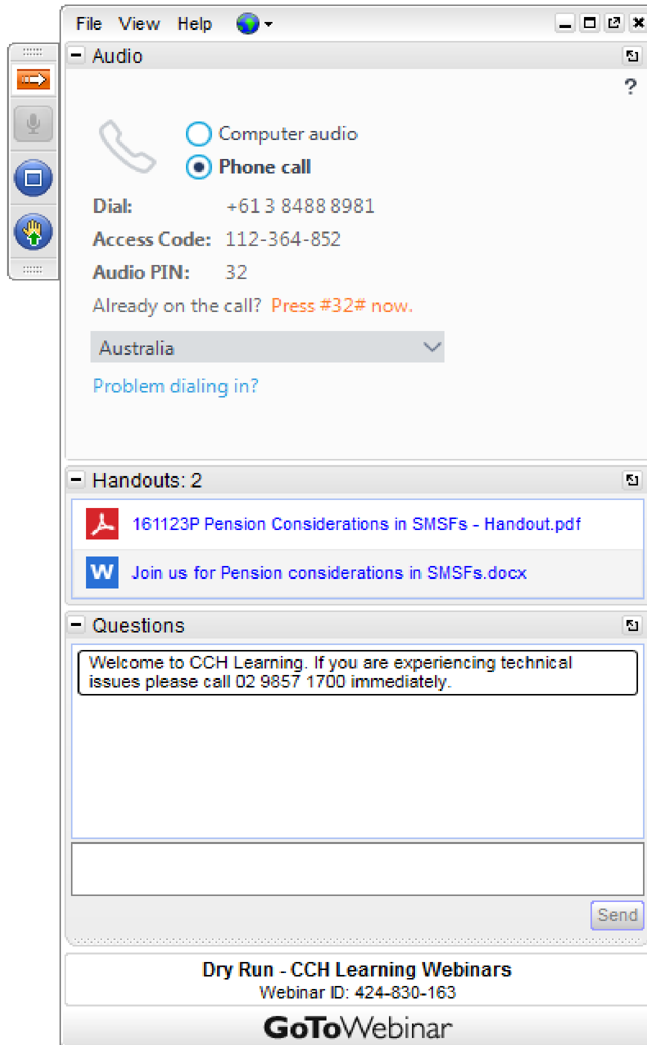

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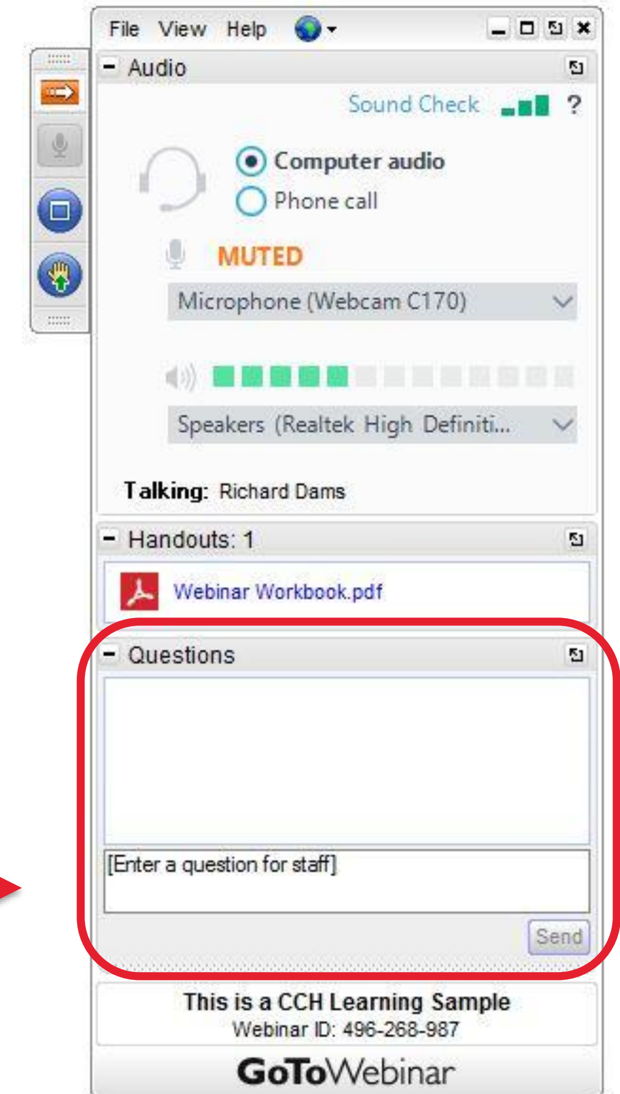

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Your Presenter

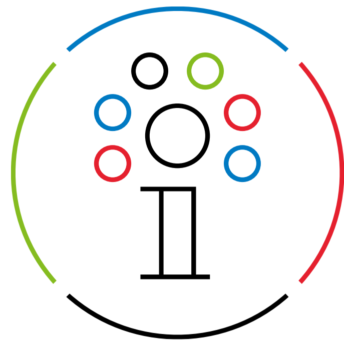
Mark Chapman

Director of Tax Communications

Today's session will cover

Foreign Income and the Foreign Income Tax Offset

- Tax treatment of different sources of foreign income, depending on residency of the taxpayer, source and type of foreign income eg:
  - pensions and annuities
  - business income
  - employment income
  - income from assets and investments
  - capital gains on overseas assets
- The impact of DTA's
- Eligibility for the FITO
- How to calculate the FITO
- Which foreign taxes to include in the calculation
- When to claim the FITO
- The interaction between the CGT discount and the FITO



Background

- Law treats residents and non-residents differently
- Australian residents are taxed on all of their worldwide income.
- Non-residents are taxed only on Australian sourced income
- Tax rates are different for residents compared to non-residents
  - Non-residents do not get the tax free threshold ($18,200)
  - Non-residents pay tax at 32.5% from the first dollar of income up to $120,000
- Therefore, resident taxpayers must disclose (and pay tax on) all of their worldwide income earned including:
  - Interest on overseas bank accounts
  - Foreign pensions
  - Rent from investment properties
  - Disposals of foreign assets
  - Shares/proceeds from employee share schemes
  - Wages and salaries
- They will be entitled to a FITO in respect of foreign tax paid on these sources

Residency: primary test

- Resides' test (section 6(1) ITAA 1936)
  - "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" Shorter Oxford Dictionary
- Take into account (TR2022/D2):
  - Intention and purpose of stay
  - Family and business/employment ties
  - Maintenance and location of assets
  - Social and living arrangements
  - Physical presence in Australia
- If taxpayer passes the 'resides' test, they are resident and no further tests need be considered
- If taxpayer fails the 'resides' test, consider the other three tests. If any ONE of these tests is passed, the taxpayer is resident.

Residency: statutory tests

- Domicile test (concept imported from UK law):
  - A person is resident in Australia if his/her domicile is in Australia, unless the person's permanent place of abode is outside Australia
    - the place that is considered by law to be your permanent home
    - usually something more than a residence.
    - Domicile of origin, domicile of choice, domicile by law
- 183 day test
  - Physically present in Australia for more than 183 days in a year
  - Need not be continuous
  - Does not apply if the person's place of abode is outside Australia
- Superannuation test
  - Eligible employee under the Superannuation Act 1976 or the spouse or child under 16 of such a person
  - Typically current public servants (but not former ones)

Residency: common scenarios

If you are:	You are generally
An overseas student enrolled in a course of more than 6 months duration at an Australia institution	Australian resident
Visiting Australia, working and living in one place and have taken steps to make Australia your home	Australian resident
Visiting Australia and travelling and working in various places	Foreign resident (possibly working holidaymaker)
Holidaying in Australia or here for less than 6 months	Foreign resident
Migrating to Australia and intend to live here permanently	Australian resident

Residency and the FITO

- There is no requirement that the individual claiming the offset must be an Australian resident (because of the non-discrimination rules in newer DTAs).
- This means that a foreign resident could theoretically be entitled to a FITO for foreign income tax paid on a source basis (ie on the basis that the source of the income is in the foreign country), provided that that income is also assessed in Australia on that income.
- This means however that the foreign resident would have to be taxed on foreign income in Australia – which generally cannot happen.
- Incidences where a foreign resident is entitled to a FITO are very rare and are not considered further in this session.

Foreign pension payments

- Foreign pensions are generally assessable
  - A deduction may be available for the Undeducted Purchase Price:
    - This is the amount which equates to the original contributions to the pension fund out of taxed income
  - Some UK pensions are entitled to a standard deduction (8%) as are some Dutch pensions (25%)
  - Otherwise, apply to the ATO using the UPP determination form
  - To the extent that pensions are also taxed overseas, a FITO arises
  - No FITO arises in relation to untaxed pensions overseas
- Some foreign pensions are tax-free:
  - Pensions paid by the US government (at any level, state or federal)
  - UK war widows pension
  - New Zealand pensions which would be exempt from tax in New Zealand

Transfers from a foreign super fund

- Is the foreign retirement fund actually regarded as a foreign superannuation fund for Australian tax purposes? If it is not, the transfer will be subject to tax under ITAA36 s 99B.
- There are strict rules about what constitutes a foreign superannuation fund. It must **exclusively** provide a narrow range of benefits including the payment of superannuation benefits upon retirement, invalidity or death of the individual.
- That excludes accounts allowing withdrawals for other purposes, for example, housing or education.
- Some popular US retirement schemes, such as individual retirement accounts, which allow pre-retirement drawdowns for housing and school fees, are not considered superannuation funds. Transfers to Australia from such funds at any time would be taxable under s 99B and may crystallise significant tax liabilities in Australia.

Transfers from a foreign super fund

- Where the scheme is not a qualifying super fund – taxed under s99B
- The corpus of the trust is excluded from taxation under s 99B(2)(a).
- Therefore, the taxpayer is likely to be taxed under s 99B on the difference between the value received and the level of contributions paid in to the foreign pension over time (the corpus).
- This is very different to the tax treatment if the fund is regarded as a superannuation fund, in which case only the growth in the fund since the taxpayer became an Australian resident would be taxed.

Transfers from a foreign super fund

- **Where the super scheme is a qualifying super fund**
- Foreign superannuation lump sums are tax free provided they are transferred within 6 months of the individual member becoming a resident of Australia (ITAA97 s 305-60).
- If the payment or transfer of funds occurs more than 6 months after becoming resident, the **applicable fund earnings** are included in the taxpayer's assessable income. These are:
  - the excess in Australian dollar terms over the amount that was vested in the fund just before the individual became a resident
  - less further contributions after the individual became an Australian resident
  - less any other amounts transferred into the foreign fund from other foreign funds.
- The effect is that the taxpayer is assessed only on the income arising in the fund during the residency period. Earnings during periods of non-residency, and contributions and transfers into the fund, do not form part of the taxable amount when the lump sum benefit is paid.
- This will result in tax being levied on the individual in relation to the growth, if any, in the foreign fund since the taxpayer's Australian residency commenced at the taxpayer's prevailing marginal tax rate.
- Care needs to be taken when calculating the FITO – a FITO is only available to the extent that the benefit is taxed in Australia, which will be different to the amount taxed overseas. Therefore, foreign tax needs to be apportioned between the part of the fund that is taxable in Australia and the part that is not.

Impact of DTA's

- Liability to pay foreign tax may also be affected by any applicable DTA.
- In many cases, there is a DTA in place between the foreign jurisdiction and Australia governing the assessability of Australian tax residents to tax in the overseas jurisdiction and Australia.
- Australia has tax treaties with more than 40 jurisdictions.
- The DTA does not – usually - prevent the income from being taxed in Australia, it merely stipulates whether, how (and occasionally at what rate) the income is taxed in the overseas jurisdiction.
- Therefore, in all cases, the FITO could be relevant.
- Rental income
  - Income derived by an Australian resident will be taxed in the overseas jurisdiction in which the property is situated.
- Dividends
  - Dividends paid by an overseas company to an Australian resident shareholder may be subject to WHT in the overseas state (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).
- Business income
  - Business profits of an Australian entity will be taxed in the overseas jurisdiction where it operates through a permanent establishment situated there and the profits are attributable to that permanent establishment.
- Interest
  - Overseas interest is subject to a (usually 10%) WHT in the overseas jurisdiction

Impact of DTA's

- Royalties
  - Royalties are subject to a (usually 5%) WHT in the overseas jurisdiction
- Employment income
  - Generally, salaries, wages and similar remuneration derived by an Australian resident from an employment exercised in a foreign state are taxed in the foreign state (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, remuneration derived by an Australian resident in respect of foreign employment is taxable only in Australia if the:
    - recipient is present in foreign state for a period of 183 days or less in any 12 month period commencing or ending in the year of income of the foreign state; and
    - remuneration is paid by, or on behalf of, an employer who is not a resident of the foreign state, or is borne by or deductible in determining the profits of a permanent establishment which the employer has in Australia; and
    - remuneration isn't borne by, or deductible in determining the profits of a permanent establishment which the employer has in the foreign state.
- Capital Gains
  - Where an overseas asset is sold, it is subject to the capital gains laws (if any) of the overseas country.

The foreign income tax offset

- Division 770 ITAA 1997.
- Provides relief from double taxation. Income and gains are taxed overseas and then a credit is available in the Australian tax return for the $AUD value of that tax paid.
- 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
  - include the income or capital gain you paid foreign income tax on in your assessable income for Australian income tax purposes.
- The FITO can only be claimed after the amount of foreign tax is actually paid – not in relation to foreign tax that is accrued but not paid (eg, the foreign tax return has been submitted but the tax has not been paid)
- If the foreign income tax is paid in a later Australian tax year, the taxpayer needs to go back and amend the original tax return containing the foreign income. Normal two year POR does not apply to this amendment – the taxpayer has 4 years from the date the foreign tax was paid to submit the amendment (see later case study).
- All foreign income, deductions and tax payments must be converted to $AUD at the applicable rate.

The foreign income tax offset

- The FITO is a non-refundable tax offset, which reduces the income tax payable (including Medicare levy and Medicare levy surcharge) but cannot create a loss
- The FITO is applied after all other non-refundable tax and non-transferable offsets.
- Therefore, if the FITO exceeds the amount of tax otherwise payable for the year, the excess is lost.
- The excess cannot be transferred to another taxpayer and it cannot be carried forward to a later income year.

Foreign tax paid on taxpayer's behalf

- A taxpayer is deemed to have paid foreign income tax in respect of an amount of income where the tax has effectively been paid by someone else on their behalf under an arrangement, or under a foreign tax law (s 770-130). This deeming provision is intended to apply in cases where the tax has been paid by:
  - deduction or withholding (see next slide for the impact on dividends)
  - a trust in which the taxpayer is a beneficiary
  - a partnership in which the taxpayer is a partner (ID 2010/94), or
  - the taxpayer's spouse, eg where the foreign country taxes husband and wife as one unit.

Foreign Dividends

- Normally, the foreign tax must be paid by the entity claiming the offset. However, a FITO is received in relation to foreign WHT, eg on dividends, interest, etc.
- Example:
- An Australian resident receives a dividend from an overseas company from which the company deducted a %age in foreign tax before paying this to the Australian resident.
- Can a FITO offset be claimed for the WHT?
- FITO rules:
  - 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, deem this tax to have been paid on behalf of the taxpayer. Therefore a FITO can be claimed. The gross dividend is included in the Australian tax return and a FITO claimed for the WHT.
- Example (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.*
  - *When she fills in her Australian tax return, Emma includes $400 at Other net foreign source income item 20 and she may be able to claim a foreign income tax offset of $60 at Foreign income tax offset*

Case Study – Foreign Income Tax Offset Amendment Periods

- *(From Australian Practical Tax Examples, volume five by Mark Chapman, Wolters Kluwer publishing)*
- 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 1 June 2019 but, because of financing delays, settlement did not take place until April 2021.
- Under the double tax agreement 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 1 June 2019. The capital gain was included in Cameron's 2018–19 Australian tax return.
- Cameron lodged his 2018–19 tax return in October 2019. He could not claim any foreign income tax to offset the Australian tax liability as he had not yet paid Canadian tax on the capital gain. It was not until December 2021 that Cameron lodged a Canadian tax return for the 2019 Canadian tax year. Cameron paid the Canadian tax on the capital gain in January 2022.
- Is Cameron entitled to claim a foreign income tax offset (FITO) in relation to the Canadian tax paid on the capital gain even though his usual amendment period expired in November 2021?

Case Study – Foreign Income Tax Offset Amendment Periods

- As at January 2022, Cameron is entitled to claim a FITO in relation to the Canadian tax paid on the capital gain, notwithstanding that his standard amendment period of 2 years expired in November 2021.
- ITAA97 s 770-190(1) allows taxpayers a special amendment period of 4 *years* after an “amendment event” happens. Relevant to Cameron, an “amendment event” includes the payment of foreign tax (ie Canadian tax) that counts towards the FITO for the year (s 770-190(2)).
- This amendment period of 4 years overrides the standard amendment periods in ITAA36 s 170.
- The four-year amendment period also applies where there has 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 that year (s 770-10(1)). In Cameron’s case, the capital gain was assessable in Australia in 2018–19. Therefore, the Canadian tax paid in respect of the gain is eligible for relief as a FITO for 2018–19.
- Cameron 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.

The foreign income tax offset – what constitutes foreign taxes?

- "Foreign income tax" is intended to cover taxes that are substantially equivalent to Australian income tax (s 770-130(3) ITAA 1997)
- These can be levied by a federal or a state authority (eg some US states levy their own income tax in addition to the federal income tax). In addition, it covers taxes levelled at a supra-national level (eg, the European Union).
- This means:
  - a tax on income
  - a tax on profits or gains, whether of an income or capital nature, or
  - any other tax that is subject to an agreement covered by the *International Tax Agreements Act 1953* (DTA's), eg a tax sparing amount, such as under the Philippines DTA.

The foreign income tax offset – what constitutes foreign taxes?

- This does not include:
  - Social security contributions (such as NIC's in the UK or similar) - Case 8/2014 refers, which dealt with Irish "pay related social insurance" (PRSI) deducted from salary and found that it was not an income tax.
  - Payroll taxes
  - Stamp duty or land taxes
  - VAT, GST or similar taxes on consumption
  - Inheritance taxes
  - Annual wealth taxes

Calculating the foreign income tax offset

- Two methods:
  1. To claim a foreign income tax offset of up to $1,000, record the **actual** amount of foreign income tax paid that counts towards the offset (up to $1,000)
  2. Where the amount of the FITO is greater than $1,000, work out the foreign income tax offset limit, which is the maximum amount of offset that can be claimed (and could be less than the actual amount of foreign tax paid)
     - Any foreign income tax paid in excess of the limit can't be claimed, can't be carried forward to a later income year and isn't refundable.

Calculating the Foreign Income Tax Offset

- Where the amount of foreign income tax paid is greater than $1,000, calculate the FITO offset limit.
- This is the difference between the actual tax payable in relation to all sources of income and the tax liability which would have applied if foreign income and deductions were ignored.
- Calculating the FITO offset limit:
  - Step One: Calculate the normal tax payable for the period, including Medicare levy and Medicare levy surcharge but excluding any tax offsets
  - Step Two: Calculate the tax payable for the period assuming:
    - Assessable income does not include any foreign income for which foreign tax is paid
    - Deductions exclude any expenditure which relates to earning the foreign income
  - Step Three: Subtract the result of Step Two from the result of Step One
  - The resulting figure is the FITO limit.

Calculating the Foreign Income Tax Offset

- Example:
  - Marie earned $34,000 in 2022/23, of which $12,000 is foreign income.
  - Her deductions totaled $2,870 of which $700 relates to the foreign income
  - Tax payable on taxable income of $31,370 is $3,079.30 (including Medicare levy)
  - She paid foreign tax of $3,400 in relation to the foreign income.
  - The FITO is therefore the lower of $3,400 and the FITO limit.
  - The FITO limit is calculated as follows:
    - Assessable income excluding foreign income: $22,000
    - Less deductions excluding deductions which relate to foreign income: $2,100
    - Taxable income = $19,800
    - Tax on taxable income = $309.70
    - Subtract this from her actual tax on taxable income: $3,079.30 - $309.70 = $2,769.60
  - FITO is the lower of $3,400 and $2,769.60 = $2,769.60
  - The difference between the foreign income tax that Marie has paid and the offset limit cannot be refunded or carried forward to a future income year.

Calculating the Foreign Income Tax Offset

- Hint:
  - If the AUD$ value of the actual amount of foreign tax paid is $1,000 or less, there is no need to calculate the FITO limit.
  - In other cases, generally the FITO is the AUD$ value of the actual amount of foreign tax paid.
  - It cannot be assumed that this is the case however.
  - It is always necessary to calculate the FITO limit just in case!
- To the extent that the foreign tax paid exceeds the amount claimable as an offset, the tax benefit of the excess is lost. It can't be carried forward to be used in determining the offset in subsequent income years, nor can it be transferred (s 63-10).
- Example:
- 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. The taxpayer's offset is therefore $15,000. The $5,000 excess foreign tax cannot be carried forward in calculating the offset in any subsequent income year.
- Where it appears that part of an offset may be "wasted" in a particular tax year, the taxpayer could accelerate the derivation of Australian income into that year, therefore increasing the Australian tax. This would have the effect of enabling the full benefit of the offset to be obtained.

Capital Gains Tax and the FITO

- 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.
- In relation to individuals, this can mean that a FITO is only available in respect of 50% of the foreign tax – because of the 50% discount, only 50% of the gain is taken into account in determining the taxpayers net capital gain for the year.
- See example.
- If the taxpayer has a net capital loss in Australia for a year, the foreign tax on the capital gain can't be claimed because it was not paid in respect of an amount included in assessable income.

Case Study – FITO and the CGT discount

- On 4 January 2000, Michael Simpson acquired an investment property in Florida, United States for US$250,000 (A$410,000), including purchase costs. On 16 October 2021, Michael signed a contract to sell the property, with settlement occurring on 1 December 2021. The sales price was agreed to be US$1,000,000 (A$1,430,000), after selling costs.
- Michael is advised that the profit on sale of US$750,000 will be subject to United States income tax on capital gains, partly at a rate of 15% and partly at a rate of 20%. On 16 September 2022, Michael pays United States tax amounting to US$135,000 (A$205,000).
- Michael wishes to understand the Australian CGT implications of his transactions, including whether he can claim a credit for the 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 2021–22 and no capital losses brought forward from earlier years. His other income for the year exceeds $180,000.
- *(Taken from Australian Practical Tax Examples by Mark Chapman, Wolters Kluwer)*

Case Study - FITO and the CGT discount (cont'd)

- The disposal of the property in the United States gives rise to CGT event A1. The capital gain is calculated by deducting the asset's cost base (in Australian dollars) from the capital proceeds (in Australian dollars). This gives a capital gain of A$1,020,000.
- Where a capital gain arises from the sale of an asset owned by the taxpayer for at least 12 months, the gain can be discounted by 50% where it is made by an individual (ITAA97 s 115-25). This reduces the amount of the capital gain to $510,000. This is the net capital gain that is included in Michael's assessable income for the 2021–22 income year, the year the contract of sale is signed (s 102-5).
- This amount is subject to income tax at Michael's marginal tax rate, being 45%, plus 2% Medicare levy. His total income tax liability in relation to the transaction is $239,700 ($510,000 × 47%).
- In order to avoid double taxation, Michael will be entitled to a foreign income tax offset (FITO) in relation to the United States tax paid. This would reduce his tax liability calculated above.

Case study – FITO and the CGT discount (cont'd)

- If a 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.
- In *Burton v FC of T* (2019), the taxpayer derived capital gains from investments made in the United States. Those gains were subject to tax in the US and Burton paid the applicable United States tax. The gains were also taxable in Australia as capital gains but were subject to a 50% discount as the investments had been held for more than a year.
- The taxpayer claimed a FITO under ITAA97 Div 770 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 taxpayer's assessable income, only **50%** of the amount of the United States tax paid should count towards the FITO.
- The Court upheld the Commissioner's view on the grounds that the amount that is included in assessable income is the **net** capital gain (s 102-5), 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 for 50% of the United States tax paid.

Case study - FITO and the CGT discount (cont'd)

- The Court held that only half of the United States tax paid could be said to be "in respect" of the income as taxed in Australia.
- Due to the operation of the CGT 50% discount, Australia did not tax all of the gain; it taxed 50% of it. That was the income in respect of which Australian tax was payable. Only half of the United States tax paid could be said to be in respect of the income taxed in Australia.
- Applying these principles to Michael's case, he is not entitled to a FITO in respect of the entire amount of the United States tax paid (A$205,000). Recognising that only half of the gain is included in Michael's assessable income, he is entitled to a FITO of $102,500.
- This will reduce his Australian income tax liability in relation to the disposal of the property to $137,200 ($239,700 – $102,500).

Questions

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Or contact me via:

- Mark Chapman
- Director of Tax Communications
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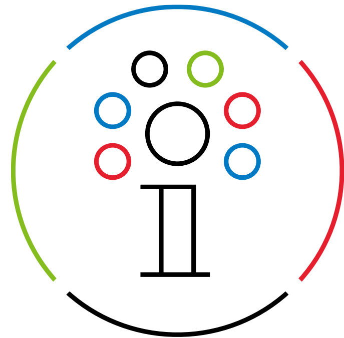
- 0415 844 388
- mchapman@hrblock.com.au



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Susannah Gynther,
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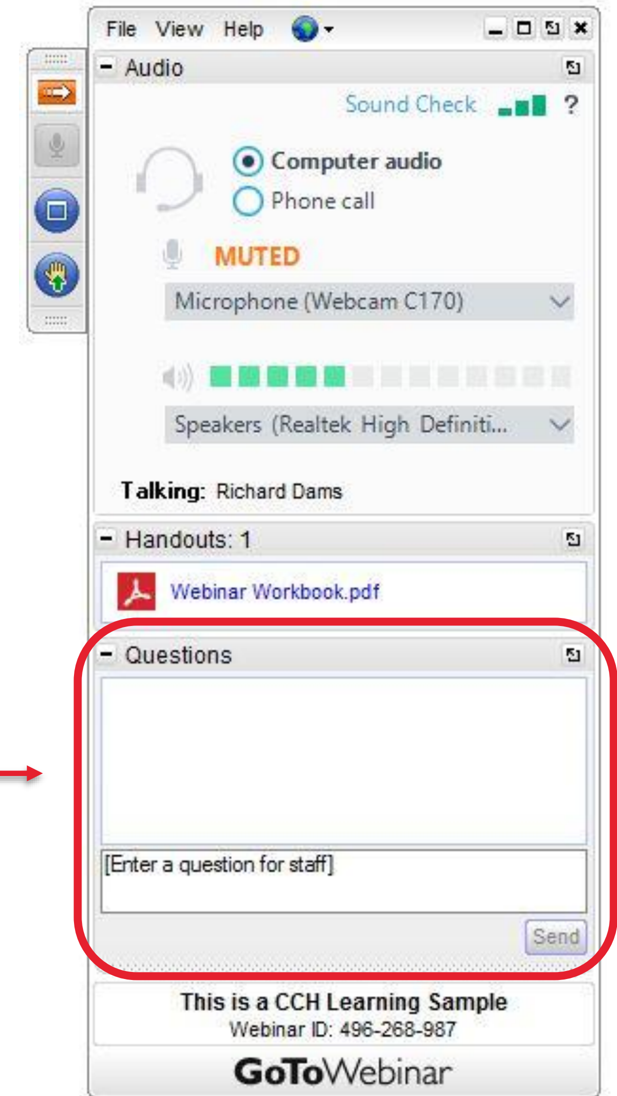

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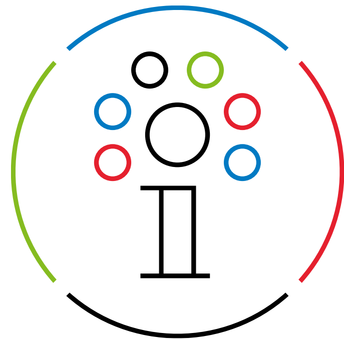

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Questions

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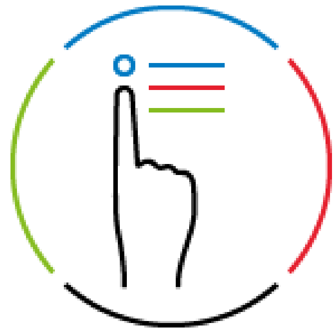

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