HOW TO CLAIM A FOREIGN TAX CREDIT

2002–03

Australian Taxation Office

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NAT 2338—6.2003

How self-assessment affects most individuals

Self-assessment means the Australian Taxation Office (ATO) uses the information you give on your tax return to work out your refund or tax bill. You are required by law to make sure you have shown all your assessable income and claimed only the deductions and tax offsets to which you are entitled.

What are your responsibilities?

Even if someone else – including a tax agent – helps you to prepare your tax return, you are still legally responsible for the accuracy of your information.

What if you lodge an incorrect tax return?

Our audit programs are designed to continually check for missing, inaccurate or incomplete information. If you become aware that your tax return is incorrect, you must contact us straight away.

Initiatives to complement self-assessment

There are a number of initiatives administered by the ATO which complement self-assessment. Examples include:

- a change in penalty provisions so that, if you take reasonable care with your tax affairs, you will not receive a penalty for honest mistakes – but please note that a general interest charge on omitted income or over-claimed deductions and tax offsets could still be payable
- the process for applying for private rulings
- your entitlement to interest on early payment or over-payment of a tax debt, or
- the process for applying for an amendment if you find you have left something out of your tax return.

Do you need to ask for a private ruling?

If you have a concern about the way a tax law applies to your personal tax affairs, you may want to ask for a private ruling.

A private ruling will relate just to your situation. Write to the ATO describing your situation in detail and ask for advice. To do this, complete an *Application for a private ruling for individuals* (NAT 4106—3.2001). If you lodge your tax return before you receive your private ruling, be aware that the ruling may alter the accuracy of your tax return.

The ATO publishes on its website all private rulings issued. What we publish will not contain anything which could identify you.

You can ask for a review of a private ruling decision if you disagree with it, even if you have not received your assessment. Details of the review procedures are sent to you when the private ruling decision is made. For more information on private rulings, visit the ATO website at **www.ato.gov.au**

Publications

To get any publication referred to in this book:

- visit our website at **www.ato.gov.au**
- phone our Publications Distribution Service on **1300 720 092** for the cost of a local call, or
- visit an ATO office or ATO*access* site.

All our publications are free.

Publications referred to in this book include:

- *Application for a private ruling for individuals* (NAT 4106—3.2001)
- *TaxPack 2003* (NAT 0976—6.2003)
- *TaxPack 2003 supplement* (NAT 2677—6.2003)

Feedback

Reader feedback helps us to improve the information we provide. If you have any feedback about this publication, please write to:

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As this is a publications area only, any tax matters will be passed on to a technical area; alternatively you can phone our Personal Tax Infoline on **13 28 61** for help.

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Australian Taxation Office
Canberra

ISBN 0 642 30888 8

About this publication

This publication is available free from the Australian Taxation Office (ATO). The ATO prohibits any party from selling it. We regularly revise our publications to take account of changes to the law.

If you have an enquiry relating to your circumstances which this publication does not cover, phone the Personal Tax Infoline on **13 28 61** or get help from a tax adviser.

Disclaimer and Commissioner's guarantee

The information in this publication is current at March 2003 and we have made every effort to ensure it is accurate.

As part of our commitment to produce accurate publications you will not be subject to penalties if you can demonstrate that you relied on something in this publication that was wrong or misleading. You may have to pay interest on omitted income or overclaimed deductions and tax offsets, depending on the circumstances of your case.

Who should use this publication?

This publication is for Australian resident individual taxpayers who:

- paid foreign tax on income they received from outside Australia and
- intend to use *TaxPack 2003* to fill in their returns.

Who can claim a foreign tax credit?

If you receive foreign income that is taxable in Australia and you paid foreign tax for which you were personally liable in respect of that income, you may be entitled to a foreign tax credit. Taxes for which credit is allowed are called creditable taxes.

If you are claiming a foreign tax credit in respect of a foreign capital gain, you should include a note on your income tax return that specifies the amount of the foreign capital gain included in your net capital gain.

Creditable taxes for all resident taxpayers

A credit can be allowed for:

- foreign tax which is similar to Australian income tax or capital gains tax
- foreign withholding taxes similar to the Australian withholding taxes on interest, dividends or royalties
- foreign taxes listed in Australia's double taxation agreements.

NOTE You are not allowed a credit for penalties, fines or interest.

If you are not sure whether you can apply for a foreign tax credit, print SCHEDULE OF ADDITIONAL INFORMATION—QUESTION 19 on the top of a separate piece of paper and explain your situation. Include:

- your name, address and tax file number
- the precise name of the tax and the country in which it was levied
- the name of the law under which the tax was imposed
- whether the tax was levied by a national, state or local authority and the name of the authority
- a description of the tax and why you had to pay it.

Print **X** in the **YES** box at *Taxpayer's declaration* question 2a on page 8 of your tax return.

Sign and attach your schedule to page 3 of your tax return.

Foreign tax credit for a dividend paid from attributed income

If you are an Australian resident and you receive a dividend that has been wholly or partly paid out of income that was previously attributed to you and therefore already subject to Australian tax, the whole or part of the dividend will be exempt from tax. Attributed income is income that arises from an investment in a controlled foreign company, a foreign investment fund or foreign life policy, or from a transferor trust. Attributed income is shown at item **18** on your tax return (supplementary section).

Credit for foreign taxes paid after your assessment

You are only allowed a credit for foreign tax which you have actually paid. If you do not pay the foreign tax until after your original assessment, you will need to ask for an amended determination of your foreign tax credit entitlement if you wish to receive a credit.

Your assessment may also need to be amended to gross up your foreign income for any additional foreign tax that you may claim.

What evidence do you need to prove you have paid foreign tax?

You will need written evidence of payment of foreign tax, such as:

- a notice of assessment from the foreign tax authority and a receipt for the tax paid
- a statement from the foreign tax authority setting out the particulars that would normally be recorded on a notice of assessment and a receipt for payment
- a certificate for deduction of withholding tax issued by the person who pays the interest, dividend or any other income that is subject to foreign tax.

Keep the evidence with your other records. You may need to produce it at a later date.

How do you work out your foreign tax credit?

You will not be able to work out your foreign tax credit if you have shown exempt foreign employment income at **N** item **19** on your tax return.

The Australian Taxation Office (ATO) will work it out for you.

If this is the case, print SCHEDULE OF ADDITIONAL INFORMATION—QUESTION 19 on the top of a separate piece of paper and explain your situation. Include:

- your name, address and tax file number
- each type and amount of foreign income received and
- any foreign tax paid.

Print **X** in the **YES** box at *Taxpayer's declaration* question 2a on page 8 of your tax return.

Sign and attach your schedule to page 3 of your tax return.

If you have no capital gain or no exempt foreign employment income, work through the following steps to find out your foreign tax credit. A practical example follows step 8.

Step 1

Work out your taxable income. You will need to fill in the rest of your tax return before you can do this. Your taxable income is the amount at $ on page 3 of your tax return.

Step 2

Work out the amount of gross tax, Medicare levy and, if applicable, Medicare levy surcharge (MLS) payable on your taxable income by referring to the calculation pages in *TaxPack 2003*.

Step 3

Work out the average rate of Australian tax payable on your taxable income using the following formula:

$$\text{Average rate of tax} = \frac{\text{gross tax} + \text{Medicare levy} + \text{MLS} - \text{qualifying tax offsets}}{\text{taxable income}}$$

The qualifying tax offsets you can use to work out your average rate of Australian tax are:

- spouse, child-housekeeper or housekeeper
- overseas forces or zone
- medical expenses
- invalid relative
- parent or spouse's parent
- certain low income taxpayer.

A description of these offsets can be found in the tax offsets sections of *TaxPack 2003* and *TaxPack 2003 supplement*. Step 3 of the example on page 5 shows you how to work out your average rate of Australian tax.

Step 4

Work out if you have foreign income from more than one class. Foreign income is divided into different classes for the purpose of allowing a foreign tax credit. These are:

- passive foreign income
- lump sum payments from non-resident superannuation funds that are taxed under section 27CAA of the *Income Tax Assessment Act 1936*
- other foreign income.

Most taxpayers will only have passive foreign income and other foreign income.

What is passive foreign income?

Passive foreign income includes:

- foreign dividends, interest, rental income and royalties
- assessable foreign annuities
- amounts for the assignment of a patent or copyright
- foreign capital gains and passive commodity gains
- attributed foreign income.

If you paid foreign tax in respect of a foreign capital gain, you will need to work out how much of that foreign capital gain is reflected in your net capital gain (for an individual, your net capital gain is the amount shown at A, item **17** on your income tax return). This will depend on:

- the amount of the capital gain calculated for Australian tax purposes
- how you have applied any capital losses and net capital losses from earlier years
- whether any capital gains tax (CGT) concessions apply to the capital gain (for example, the CGT discount or small business concessions).

Capital losses and net capital losses can be applied against capital gains in the order that you choose. To maximise your foreign tax credit entitlement, you may choose to offset losses first against domestic capital gains or foreign gains in respect of which you have not paid tax.

For example, you sell a property that you acquired in January 2000 in a foreign country. Under that country's tax laws, you make a capital gain of $12,000 and you pay tax in relation to that gain. For Australian tax purposes, your capital gain calculated in accordance with parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (ITAA 1997) is $10,000.

You have made a capital loss of $2,000 in relation to the sale of another property in Australia. You must apply this loss against your foreign capital gain. You then apply the CGT discount to the remaining capital gain. Your net capital gain is $4,000. Because your net capital gain relates entirely to a foreign capital gain in respect of which you have paid foreign tax, this is the amount that is included in working out your passive foreign income.

What are lump sum payments from non-resident superannuation funds?

Certain lump sum payments made from non-resident superannuation funds are subject to special tax rules under section 27CAA. These payments form their own class of foreign income.

What is 'other foreign income'?

'Other foreign income' is foreign income that does not fit into either of the other classes of income. It includes income from commercial activities, salary or wages and most pensions.

Step 5

Work out your net income for each class of foreign income. Net foreign income is so much of your assessable income as is foreign income of that class, less the following deductions:

- expenses directly related to that class of foreign income other than relevant debt deductions
- any domestic loss carried forward from a previous year that you have elected to use against your foreign income
- other deductions relating to that class of foreign income other than relevant debt deductions.

What is a debt deduction?

Debt deductions are, broadly, deductible costs incurred in obtaining and maintaining debt finance. The term is defined in section 820-40 of ITAA 1997. Examples of debt deductions include interest, amounts in the nature of interest and fees in respect of debt.

What is a 'relevant debt deduction'?

A 'relevant debt deduction' is a debt deduction to the extent that it is not attributable to any of the taxpayer's overseas permanent establishments.

The example on page 5 shows you how to work out your net income for each class of foreign income.

Step 6

Work out the adjusted net foreign income (ANFI) for each class of foreign income. This involves allocating any apportionable deductions that you are able to claim between each class of foreign income. Apportionable deductions are those deductions of a concessional nature which do not relate directly to income-producing activities—for example, gifts to eligible charitable organisations.

If you don't have any apportionable deductions, your ANFI will equal your net foreign income.

There are three methods for working out ANFI. Where net foreign income is less than the sum of taxable income and apportionable deductions, as is most often the case, ANFI for each class of income equals:

$$\text{Net foreign income} \times \frac{\text{taxable income}}{\text{taxable income} + \text{apportionable deductions}}$$

The other methods are:

- If your net foreign income consists of one class of income and the amount exceeds the sum of your taxable income plus apportionable deductions, your ANFI will equal your taxable income.
- If your net foreign income consists of two or more classes of income and your combined net foreign income from all classes exceeds the sum of your taxable income plus apportionable deductions, your ANFI for each class will equal your taxable income divided proportionately into each class of income.

Step 7

Work out the foreign tax credit limit for each class of foreign income.

The foreign tax credit that you are entitled to receive is limited to the lesser of:

- the foreign tax you have paid on that class of foreign income and
- the Australian tax payable on that class of foreign income.

The Australian tax payable in relation to a class of foreign income equals:

ANFI × average rate of Australian tax

The amount of credit you are able to claim in Australia may be further limited by a double tax agreement Australia has with the country in which you earned the income. If you received income from a country which has a double tax agreement with Australia and that agreement limits the amount of tax that the foreign country can levy on your income, the amount of foreign tax credit you are allowed is limited to the amount payable under the agreement. If the foreign country has deducted more tax than is permitted under the agreement, you will need to seek a refund of the excess tax from the tax authority of that country.

The double tax agreements can be found as *Schedules to the International Tax Agreements Act 1953*. This Act is available via the ATO's legal database at **www.ato.gov.au**.

For further information, phone the ATO on **13 28 61**.

For example, if you receive a foreign pension or annuity which is taxable in Australia and tax has been deducted from the payment by the country that paid it, you may have to claim a refund of that tax rather than a foreign tax credit. This would be the case if tax was deducted from a pension or annuity you received but, because of a double tax agreement Australia has with that country, Australia is the only country allowed to tax your pension. Claiming a refund generally involves filling in a special claim form. This is available from the tax authority of the country that paid the pension or annuity. Step 7 of the example on page 5 will show you how to work out your foreign tax credit limit.

Step 8

Write the amount of credit you are able to claim—from step 7—at **O** item **19** on your tax return.

An example to help you work out your foreign tax credit

Albert is an Australian resident and is not married. He previously lived in the United Kingdom and now receives a pension and dividend, interest and rental income from the United Kingdom. Albert worked for and was paid by an American company in the United States for 80 days during the year and by his Australian employer in Australia for the remainder of the year.

All foreign income, deductions and foreign tax paid must be converted to Australian dollars. The following table, **Conversion to Australian dollars**, shows you how to do this. Phone the ATO on **13 28 61** to find out the exchange rates.

Conversion to Australian dollars

Type of foreign income	*Convert foreign income to Australian dollars at:*
Foreign pensions, annuities and deductions	the average exchange rate for the year or the rate that applied at the time you received each payment. If it was not remitted, use the exchange rate that applied on 30 June 2003. Convert any tax paid at the same rate used to convert the income.
Other non-salary or wage foreign income such as dividends, interest or capital gains	the exchange rate that applied at the time the income was remitted to Australia. If it was not remitted, use the exchange rate that applied on 30 June 2003. Convert any tax paid at the same rate used to convert the income.
Foreign capital gains	the time of the transaction or event for each transaction or event involving an amount of foreign currency (or the market value of property expressed in a foreign currency). For example, if an amount included in the cost base of an asset is expressed in foreign currency, convert that amount into Australian currency on the date that the expenditure was incurred. Convert capital proceeds on the date of the CGT event.
Foreign business income	the average exchange rate applicable to the trading period during which the income is earned. Convert tax paid at the rate applicable on the day it was paid.
Employment income	the average exchange rate applicable to the period during which the income was earned. Convert tax paid at the rate applicable on the day it was paid.

For more information on the conversion to Australian dollars refer to *Taxation Ruling IT 2498—Income tax: foreign tax credit system: currency translation of foreign income: trading stock and depreciable plant: basis of returning foreign income: capital gains/ losses*.

Below are details of Albert's income, expenses and the foreign tax he paid. All of Albert's foreign income amounts have been converted to Australian dollars.

Gross income	$
Employment income from Australia	22,000
Employment income from United States	6,000
Pension from United Kingdom	4,000
Rental income from property in United Kingdom	1,000
Dividend income from United Kingdom	600
Interest income from United Kingdom	400
Total gross income	**34,000**

Expenses	$
Medical expenses	2,500
Expenses incurred in deriving employment income from Australia	2,000
Expenses incurred in deriving employment income from United States	450
Expenses incurred in deriving rental income from United Kingdom	250
Gift to an eligible charitable organisation	200
Interest (debt deductions) incurred in deriving dividend income	70
Expenses (debt deductions) incurred in deriving interest income	30
Total expenses	**5,500**

Foreign tax paid	$
Employment income from United States	1,800
Dividend income from United Kingdom	60
Interest income from United Kingdom	40
Rental income from United Kingdom	300
Total foreign tax paid	**2,200**

Example

Working out Albert's foreign tax credit

Step 1

Work out Albert's taxable income.

	$
Assessable income	34,000
less allowable deductions*	3,000
Taxable income	**31,000**

*Albert cannot claim a deduction for his medical expenses but he can claim a tax offset for them for amounts above $1,250**. He does this at step 2.

Step 2

Work out the tax and Medicare levy Albert must pay on his taxable income.

	$
Tax payable on taxable income	5,680
Medicare levy payable on taxable income ($31,000 x 1.5%)	465
Total tax and Medicare levy	6,145
less tax offset for medical expenses ($2,500 – $1,250**) divided by 5	250
Total tax payable	**5,895**

Albert has reduced his tax payable by the medical expenses tax offset he is able to claim. As Albert is not married and his taxable income is less than $50,000, he is not liable for the Medicare levy surcharge.

**Under a proposed measure, the threshold amount of $1,250 is to be increased to $1,500. At the time of printing, this measure had not become law.

Step 3

Work out the average rate of tax payable on Albert's taxable income.

Albert's average rate of Australian tax

$$= \frac{5{,}895}{31{,}000} \times \frac{100}{1}$$

$$= 19.0\%$$

Step 4

Work out if Albert has more than one class of foreign income.

Albert has foreign rental income, foreign dividends and foreign interest, which all fall into the passive foreign income class. He also has foreign employment and foreign pension income, which fall into the other foreign income class. As Albert has income from both classes, he will have to do two separate calculations.

Step 5

Work out Albert's net foreign income for each class.

Albert needs to work out the net foreign income for two classes of income—passive foreign income and other foreign income.

Albert's passive foreign income	$
Gross foreign rental income less expenses ($1,000 – $250)	750
Gross foreign dividend income less expenses (other than relevant debt deductions) ($600)	600
Gross foreign interest income less expenses (other than relevant debt deductions) ($400)	400
Net passive foreign income	**1,750**

Albert's other foreign income	$
Gross employment income from the United States less expenses ($6,000 – $450)	5,550
Gross pension from United Kingdom	4,000
Net other foreign income	**9,550**

Step 6

Work out the ANFI for each class.

This involves allocating the apportionable deduction—a $200 donation to a charitable organisation—across both classes of foreign income.

ANFI for Albert's passive foreign income:

$$= 1{,}750 \times \frac{31{,}000}{31{,}000 + 200}$$

$$= 1{,}739$$

ANFI for Albert's other foreign income:

$$= 9{,}550 \times \frac{31{,}000}{31{,}000 + 200}$$

$$= 9{,}489$$

Step 7

Work out the foreign tax credit limit for each class of foreign income.

Work out the amount of Australian tax payable on each class of foreign income. This is done by multiplying Albert's ANFI—worked out at step 6—by his average rate of Australian tax—worked out at step 3—for each class of income.

Passive foreign income = $1,739 x 19.0% = $330.41

Other foreign income = $9,489 x 19.0% = $1,802.91

These are the amounts of Australian tax payable on each class of income.

Albert can claim a tax credit for the lesser of foreign tax paid or Australian tax payable on his foreign income from each class.

Tax payable on his passive foreign income

As Albert paid $400 in foreign tax on this income and this is more than the amount of $330.41 of Australian tax payable, he can claim a foreign tax credit of $330.41. The extra $69.59 of foreign tax that he paid can be carried forward and applied against the Australian tax payable on any passive foreign income he may earn in the next five years.

Tax payable on his other foreign income

As Albert paid $1,800 in foreign tax on this income and this is less than the amount of $1,802.91 of Australian tax payable, he can only claim a credit of $1,800.

Albert must now add the amount of tax credit he can claim on his passive foreign income to the tax credit he can claim on his other foreign income.

Tax credit Albert can claim on his passive foreign income	$330.41
Tax credit he can claim on his other foreign income	$1,800. 00
Total foreign tax credit he can claim	$2,130.41

Step 8

Note the amount of tax credit that Albert can claim on his tax return.

Albert would write $2,130.41 at **O** item **19** on his tax return.

Carry forward of excess foreign tax credits

You will have an excess foreign tax credit for an income year if the amount of foreign tax you have paid in respect of a class of foreign income exceeds the Australian tax payable on that class of foreign income.

You may carry forward an excess foreign tax credit for the five years immediately following the income year when it arose. You may only use the excess credit for a class of foreign income if there is a credit shortfall for the same class of income in a later year. A credit shortfall occurs if the credit allowed for a class of income is less than the Australian tax payable on that class of income.

You cannot claim a foreign tax credit in a year that you incur a loss for a class of foreign income because the Australian tax payable for that class of income is nil. You may, however, carry forward the foreign tax credit to a later year to apply to the same class of income.

However, you are required to keep your own records of your excess foreign tax credits if you are carrying the credits forward to a later date.

Lodge online via *e-tax*

e-tax

Australian Taxation Office

If you are looking for an easy and convenient way to do your tax return, look no further than *e-tax 2003*. It is available free from the Australian Taxation Office. *e-tax* can estimate items such as capital gains and your tax refund or tax debt. *e-tax* allows you to complete your tax return confidentially and at your leisure, seven days a week. Tax returns lodged using *e-tax* generally take only 14 days to process. *e-tax* is available for use from 1 July 2003. For more information on *e-tax*, visit the ATO website at **www.ato.gov.au**.

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