Example 1 – Foreign asset held by Australian trust that is taxed as a corporate in the foreign country

30 June 2020 year

- $100,000 income
- $80,000 deductible expenses
- $4,000 foreign tax paid (@20%)
- Tax = accounting
- $20,000 (or 100%) of net income distributed to an Australian individual

The trust is a liable entity in at least one of the deducting countries and can therefore be a deducting hybrid pursuant to 832-550(c)(i).

There is a deduction/deduction mismatch of $80,000.

The amounts subject to Australian income tax for the purpose of calculating dual inclusion income and the neutralising amount is, where the trust has net income for the year, the amount that reasonably represents amounts included in the assessable income of another entity (other than another trust or partnership) – s 832-125(2)(c).

In determining this, the effect of Division 832 is disregarded – s 832-125(4).

Therefore, only $20,000 is included in the assessable income of another entity as only the net amount flows through under section 97.

Ignoring the effect of FITOs, only $20,000 of dual inclusion income is available to be applied which reduces the neutralising amount to $60,000. This results in the $60,000 of deductions denied to the trust with the individual assessable on $80,000 of net income. This may be even greater once the FITO adjustment is made (discussed in further example below).

This apparently inadvertent outcome comes about due to the issue of net vs gross amounts. A similar issue appears to be recognised in the s 832-110(5). This deems gross amounts to be one net amount to reduce the size of a deduction for the purpose of a deduction/deduction mismatch. There is no equivalent for dual inclusion income (i.e. no rule that deems the net amount of income that flows through an entity to consist of the gross item-by-item amounts that make up the net amount).

An alternate view may be that the $100,000 included in the assessable income of the trust reasonably represents the $20,000 amount included in the assessable income of the individual. Such a view would prevent such an inadvertent outcome.

Example 2 – Same as example 1, but there is an interposed LLC between the trust and the foreign asset

- Assume the LLC is a disregarded entity in both countries (e.g. a foreign hybrid company under Division 830)

The entity that is claiming the deductions is now a partnership for tax purposes (i.e. the LLC). As it is not a liable entity in either country it cannot be a deducting hybrid.

The Australian trust may be a deducting hybrid but will be assessed on the $20,000 profit that flows through from the LLC. There is no relevant deduction available to the trust and therefore no deduction/deduction mismatch. The trust will be assessed in the foreign country and pay tax on the $20,000 profit. The individual will be assessed on the $20,000 net income in Australia and be entitled to a FITO that flows through the trust.

A vastly different, but intuitively correct, outcome appears to occur where an entity that is transparent in both countries incurs the expenses and derives the income.

Example 3 – Same as example 1, but the trust has $20,000 of prior year tax losses available

- The trust deducts the prior year tax loss and has no net income for the year

$100,000 will be considered subject to Australian income tax as the trust is an entity and included the amount in its assessable income for the income year. Subsection 832-125(2) does not apply as the trust does not have net income for the year.

Therefore, the neutralising amount will be reduced to nil.

If the trust only had $19,999 of prior year losses (or other current year deductions) so that its net income was $1, you have the same issue arise. Only $1 may be considered subject to Australian income tax resulting in $79,999 of deductions being denied for the same reasons as example 1.

There appears to be an inappropriate outcome where the difference between $1 of net income and no net income can cause potentially millions of dollars of deductions being denied (albeit not necessarily permanently).

Example 4 – Example 1 with some modifications, beneficiaries with losses

<u>30 June 2020 year</u>

- $100,000 income
- $20,000 deductible expenses
- $16,000 foreign tax paid (@20%)
- Tax = accounting
- $80,000 (or 100%) of net income
- The trust is a unit trust with the units held in the following alternative scenarios:
  - A - An Australian company that has losses (otherwise a 30% taxpayer)
  - B - An Australian partnership that has losses
  - C - An Australian discretionary trust that has losses

The unit trust is a deducting hybrid (taxed as a corporate overseas) and there is a $20,000 deduction/deduction mismatch.

In scenario A, there is $80,000 that would be assessable to the corporate beneficiary under section 97 so that s 832-125(2)(c) is satisfied. This is regardless of the losses available in the company. The FITO adjustment in s 832-680(2)(d), based on the methodology in the EM, reduces this amount to $26,667 ([$80,000 x (1 - $16,000/$24,000)]. The neutralising amount is therefore reduced to nil and none of the deductions are denied to the unit trust.

In scenario B, the $80,000 would be included in the partnership's assessable income under section 97. However, due to the effect of the other deductions available to the partnership, no partner is

assessed on any amount of partnership net income. Instead, the partners will receive a deduction for their individual interest in the net loss of the partnership under section 92. Therefore, no amount has been included in the assessable income of an entity other than a trust or partnership so that no amount will be considered to be subject to Australian income tax. The unit trust will be denied $20,000 of deductions.

In scenario C, the $80,000 would be included in the discretionary trust's assessable income under section 97. However, due to the effect of the other deductions available to the discretionary trust, there is no net income for any beneficiary (or trustee) to be assessed on. Therefore, no amount has been included in the assessable income of an entity other than a trust or partnership so that no amount will be considered to be subject to Australian income tax. The unit trust will be denied $20,000 of deductions.

There appears to be anomalous outcomes whereby distributions to some loss entities (companies, individuals, super funds – assuming they are not considered trusts for these purposes) are considered to be subject to Australian income tax but distributions to other loss entities (trusts and partnerships) are not.

Scenario C also highlights a separate issue in whether a trust is a liable entity in Australia which may be relevant for other aspects of Division 832. The trust may have chosen to accumulate the income due to having trust income available for distribution that year despite the tax loss. While the trustee is not assessed and liable to pay tax that year, the trust may nevertheless be considered to be liable in respect of its income or profits for the income year as this is to be determined on the basis that income or profits would exist as per s 832-325(4).

Example 5 – Individual is a deducting hybrid

30 June 2020 year

- $30,000 income from a foreign rental property (12 x $2,500 monthly rental payments)
- $20,000 deductible expenses in relation to the property
- $2,000 foreign tax paid (@20%)
- The individual has $15,000 of other taxable income

There is a $20,000 deduction/deduction mismatch.

The dual inclusion income is calculating starting with the $30,000 that would be assessable to the individual. Based on the EM formula and s 832-680(2)(c)-(d) this would be:

$30,000 x (1 - $2,000/(ATG))

ATG represents the Australian tax on the gross $30,000 assessable amount or using the words of the legislation "the amount of *tax that would, having regard only to the assessable amount and the rate at which tax is imposed on the entity, be payable on the assessable amount"

It is unclear if the rate of tax imposed on an entity being an individual is a marginal rate or an average rate. Further, it is unclear whether the requirement to have regard only to the assessable amount is also a requirement in determining the rate at which tax is imposed on the individual. If so this means that the other taxable income of the individual is disregarded. Additionally, given that individual amounts need to be considered on an item-by-item basis as either being dual inclusion income or not, this can change the analysis again. This could lead to many different interpretations:

A – The individual would have $25,000 of taxable income disregarding the effects of Division 832. Tax is considered to be imposed at a rate of 19% being the marginal rate. ATG = $5,700 (i.e. $30,000 x 19%). Dual inclusion income = $19,474 (i.e. $30,000 x $3,700/$5,700). Deductions of $526 are denied.

B – The individual would pay $1,292 of tax on $25,000 of taxable income disregarding the effects of Division 832 ($6,800 x 19%). Tax is considered to be imposed at a rate of 5.168% being an effective rate. Tax payable on $30,000 at this rate is $1,550.40 which is less than the amount of the foreign tax offset. There is no dual inclusion income. Deductions of $20,000 are denied.

C – Regard is only had to the assessable amounts in determining the rate of tax. $2,242 of tax is imposed on $30,000 at marginal rates representing a tax rate of 7.47%. ATG = $2,242. Dual inclusion income = $3,238 (i.e. $30,000 x $242/$2,242). Deductions of $16,762 are denied.

D – Regard is only had to each assessable amount on an item-by-item basis in determining the rate of tax. No tax is imposed on any of the individual $2,500 items of income due to the tax-free threshold of $18,200. There is no dual inclusion income. Deductions of $20,000 are denied.

This does not consider the effect of the Medicare Levy (or surcharge) as they are not *tax as defined in the Act (even though FITOs can be applied against the Levy). Further, these do not consider the effect of the LITO/LMITO which effectively change the effective rate of tax that applies but by way of offset.

We believe that no matter which interpretation is taken, the “right” result is not achieved for individuals.

By way of contrast, consider the situation where a SMSF taxed at 15% is the taxpayer with the exact same set of facts. ATG would simply be $4,500 (i.e. $30,000 x 15%). Dual inclusion income would be $16,667 ($30,000 x $2,500/$4,500). The SMSF would be denied $3,333 of deductions. Its taxable income becomes $28,333 consisting of $13,333 from the foreign rental property and $15,000 of other taxable income. It would be liable to pay tax of $4,250 and receive a FITO of $2,000 resulting in a net tax liability of $2,250.

Importantly, it does not matter whether the $15,000 of other taxable income is Australian or foreign sourced. As the $2,000 FITO exactly absorbs the tax payable on the $13,333 (at 15%) in relation to the foreign rental property so that the offsets cannot be used to shelter other foreign income. If the deductions were not disallowed (so that only $10,000 was assessable on the net rent) and the other $15,000 were foreign sourced, the FITO limit for the SMSF would exceed $2,000 so that the offsets would be used against other foreign income. This methodology in the Act appears to have the effect of quarantining the FITOs so that they only apply to reduce tax payable on amounts of dual inclusion income.

The mathematical relationship does not hold up once marginal rates of tax apply. There may be a “right” amount of deductions to deny. This could be worked out by reverse engineering an outcome which results in the FITO from the dual inclusion income exactly equalling the FITO limit to prevent sheltering of other foreign income, but there does not appear to be a way to get there based on the words of the legislation. The effect of certain offsets and levies for individuals complicates this further.

We believe the application of the dual inclusion income rules where individuals are involved is an area of considerably uncertainty that warrants public guidance by the ATO.

Example 6 – Widely held trust

Assume a widely held unit trust has investments in foreign assets and has 1,000 unitholders consisting of a mix of individuals, companies taxed at 30%, companies taxed at 27.5%, unit trusts, partnerships, family trusts, superannuation funds in accumulation phase, superannuation funds in pension phase and tax-exempt charities.

The unit trust is a liable entity in the foreign country. It makes a net profit and pays foreign tax. It has net income in Australia.

There are various deductions claimed in Australia and the foreign country.

In determining what dual inclusion income is available to be applied to reduce the neutralising amount of the deducting hybrid mismatch, the trust would have to know the tax profile of every investor and trace through every entity to the ultimate recipient taking into account all the issues raised in the examples above. This may have to be done before many of the unitholders and the ultimate beneficiaries/partners of the unitholders lodge their tax returns for the year.

We have several managed funds in our client base and do not know practically how it is possible to determine dual inclusion other than making several assumptions based on the entity profile of the unitholders. We would welcome public guidance for the managed fund industry.