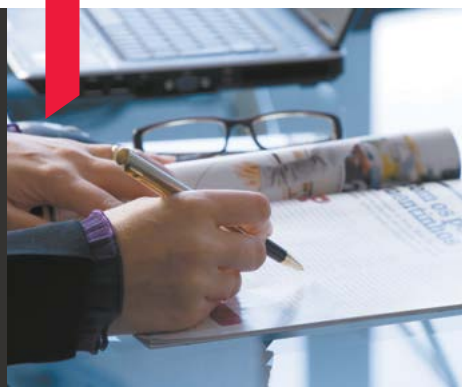
SEPTEMBER 2019

TECHNICAL UPDATE



50 PER CENT CGT DISCOUNT ON FOREIGN CAPITAL GAINS CLAWED BACK BY GOVERNMENT

Australian resident taxpayers who are entitled to 50% CGT discount on capital gains on foreign assets may effectively lose up to half of the benefit of the CGT discount; this is because the Australian tax offset for any foreign tax they have paid on the foreign capital gain will be cut in half.

FULL FEDERAL COURT DECISION

The Full Federal Court has reaffirmed the Federal Court's decision to allow only 50 per cent of the foreign income tax offset (FITO) for US tax paid on the sale of long term investments, as only 50 per cent of the capital gains were taxable in Australia. This result highlights a problem with the FITO rules. The problem arises because the rules do not recognise that both the US and Australia allows concessions on capital gains made on long-term investments (held for more than 12 months) but the methods by which this is achieved are different in each country.

FOREIGN INCOME TAX OFFSET

A taxpayer can claim a full credit or offset for foreign income tax paid if 100 per cent of the income (including capital gains) is included in their Australian assessable income. However, if less than 100 per cent of the income or capital gains are assessable in Australia (e.g. if it is a 50 per cent discounted capital gain), a credit for only the same proportion of foreign tax paid (i.e. 50 per cent) will be allowed against the Australian tax payable.

BURTON'S CASE

This interpretation of how the FITO rules apply was recently confirmed by the Full Federal Court in *Burton v FCT [2019] FCAFC 141.* In this case, the taxpayer was an Australian resident who owned long term investments in the US. He sold the US investments and paid US tax on the capital gains. In the US, he was entitled to concessional treatment for assets held for more than 12 months, which meant he paid tax on the whole of the gains at the concessional rate of mostly 15 per cent, which is less than half the 35 per cent rate he would have paid if it was not a long term investment.

As the taxpayer was an Australian tax resident, he was also subject to capital gains tax (CGT) in Australia on the gains from the US long term investments and entitled to concessional treatment by way a CGT discount. The net capital gain was discounted by 50 per cent, which meant that only 50 per cent of the capital gain was included in the taxpayer's assessable income and taxed at his marginal tax rate.

In his tax return, the taxpayer claimed the whole of the US tax paid as a credit against his Australian income tax. However, the ATO allowed only 50 per cent of the US tax paid to be counted toward the FITO because only 50 per cent of the net capital gain was included in the taxpayer's assessable income in Australia.

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FULL FEDERAL COURT'S DECISION

Both the Federal and Full Federal Courts were concerned with the proper interpretation of the FITO provisions, in particular s 770-10 of the ITAA 1997. This provision states that '……an amount of foreign tax counts toward the FITO if it is paid in respect of an amount that is all or part of an amount included in assessable income…..'

The Full Federal Court held that the words of the provision were concerned with the amounts actually included in Australia assessable income. This was made clear by the provision that determines what amounts of capital gains are included in assessable income (s102-5 ITAA 1997). In applying the provision, only net capital gains are included in assessable income. A net capital gain is calculated by reducing a capital gain by any capital losses first and then reducing the gain by the discount percentage. The effect of applying the discount percentage to the capital gain was to exclude 50 per cent of the gain from the taxpayer's Australian assessable income. As a result, the taxpayer was entitled to a FITO only in relation to 50 per cent of the US tax paid. This meant only half of the FITO was available to reduce the taxpayer's Australian income tax otherwise payable on the same gain.

FITO RULES

It is clear from the decisions of both the Federal and Full Federal Court that this is the correct interpretation of the FITO provisions. The concern is the legislation does not recognise the different ways in which countries such as the US and Australia provide essentially the same concessional treatment for capital gains. In the US, for the most part tax is paid at a discount rate of 15 per cent (about half the normal tax rate) on the whole gain. While in Australia, only 50 per cent of the gain is included in the calculation of the net capital gain that is then included in assessable income, which is assessed at the taxpayer's full marginal tax rate.

The effect of this on the FITO rules is to limit the tax offset to 50 per cent of the US tax paid. The result being that the taxpayer's FITO will be lower resulting in their overall Australian and US income tax payable on the sale of the US investments may be up to half again as much than it would be if it was an Australian investment.

EXAMPLE

Paul is an Australian resident taxpayer who sells a foreign investment asset he has held for more than 12 months for a capital gain of $100,000 and the tax rate on the long-term capital gain in the foreign country is at half the 40 per cent normal tax rate in the foreign country. For ease of calculation, assume his Australian Marginal tax rate is 40 per cent (ignoring Medicare levy).

		Foreign asset (Aus $)	Australian Asset (Aus $)
a.	Foreign country capital gain	100,000	-
b.	Foreign tax paid @20%	20,000	-
c.	Australian capital gain	100,000	100,000
d.	Australian discounted capital gain (cx50%)	50,000	50,000
e.	Australian gross tax @40%	20,000	20,000
f.	Less FITO (bx50%)	10,000	-
g.	Australian net tax (e-f)	10,000	20,000
	Total foreign and Australian tax (b+g)	30,000	20,000

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