

Changes to Foreign Loss Quarantining rules

There have been some significant changes in the treatment of foreign losses during the last financial year.

WHAT CHANGES AFFECT FOREIGN DEDUCTION? INCOME

A foreign loss occurs when deductions which relate to assessable foreign income exceed the amount of income derived for that class. Where expenses exceed income for a particular class of foreign income, the tax law prevents the loss from being deducted against income of other classes or from domestic assessable income. This is referred to as foreign loss quarantining. The quarantined foreign loss can still be offset against income of the same class in a later income year

For income years commencing on or after 1 July 2001, debt deductions are no longer subject to foreign loss quarantining. Instead, debt deductions can now be claimed against total assessable income. Under the changes, the definition of 'foreign income deduction' to which the foreign loss quarantining provisions apply, now excludes debt deduction, to the extent they are not attributable to any overseas permanent establishment of the taxpayer. A permanent establishment is essentially a place through which a

business is carried on, such as a branch.

Debt deductions are, broadly, deductible costs in obtaining and maintaining debt finance. Examples of debt deductions include interest, amounts in the nature of interest and fees in respect of debt.

EXAMPLE

John, an Australian resident taxpayer, has a rental property overseas and has borrowed in Australia to buy that property. In a given income year he has:

Income: \$7,000

Expenses: Deductible repair \$3,000 and interest \$5,000.

UNDER OLD LAW:

John's foreign income deductions amount to \$8,000 (the interest expense and repairs).

This exceeds the foreign income of \$7,000 by \$1,000. The \$1,000 loss would have been quarantined.

This \$1,000 loss could be carried forward and applied to offset future foreign sourced income of the same class.

UNDER NEW LAW:

John's foreign income deductions amount to \$3,000 (the interest expense is a debt deduction and therefore no longer a foreign income deduction).

Because John's total foreign income deductions do not exceed his foreign income of \$7,000, no amount is quarantined.'

The \$5,000 interest expense (a debt deduction) can be offset

against John's total assessable income.

FOREIGN INCOME TAX OFFSETS

This is now determined on a whole-of-income basis and not on a class-of-income basis (that is, quarantining into separate baskets has been repealed).

A foreign income tax offset is available to a taxpayer for foreign income tax paid on an amount that is all or part of an amount included in assessable income. Entitlement to the tax offset arises only to the extent that the foreign income tax has been paid on an amount included in assessable income.

The foreign income tax offset is subject to an offset limit. If the total foreign income tax paid is less than or equal to \$1,000, or the taxpayer wishes to limit their tax offset to \$1,000 (the \$1,000 de minimis cap), they are not required to do a foreign income tax offset limit calculation – the tax offset equates to the total foreign income tax paid on the amount included in assessable income (up to \$1,000).

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