A CRITICAL ANALYSIS OF THE FOREIGN TAX CREDIT IN AUSTRALIA AND ITS RELATIONSHIP TO THE IMPUTATION AND CONTROLLED FOREIGN ENTITIES LEGISLATION

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This paper critically evaluates the Foreign Tax Credit system operating in Australia. In doing so it considers the systems operating in the United Kingdom and the United States. The foreign tax credit system necessarily affects many areas of taxation, so this article considers the system in a wide context with some emphasis on the dividend imputation system, indirect credits and the controlled foreign entity provisions.

Introduction

The reason for a foreign tax credit is the collection problem created by the wide operation of s 25 of the Income Tax Assessment Act.[1] For a resident taxpayer, assessable income includes income from all sources. The collection problem arises where the income has a foreign source. Further difficulty is created where the foreign income is not repatriated to Australia and is retained offshore.

It has been generally acknowledged that tax should not be levied in Australia where tax is paid on income sourced in a foreign country.[2] This is subject to the proviso that the rate of tax on that foreign source income is comparable to the tax that would have been paid in Australia.

An allowance for the foreign tax can be made by using one of two basic methods. The first is to exempt the foreign income if it is liable for tax in the country in which it is sourced. The second is to tax that foreign income in Australia but allow a credit to the resident for the tax paid in the country of source.[3]

In Australia, the first of these methods operated under s 23(q) and s 46 of the ITAA until 1 July 1987, when a credit system was introduced. Since 1

1 Income Tax Assessment Act 1936 (Cth), referred to in this paper as ITAA.
2 This is simply to avoid international double taxation.
3 An alternative not directed to the double taxation question is simply to allow a deduction for the foreign taxes as a cost of doing business.

July 1990, Australia has had a mixture of exemptions, credits and deductions depending upon the nature of the income.

After a comparison of Australia's system with those operating in the US and UK, it will be possible to make some specific recommendations for Australia. These will essentially be of a policy nature.

Evaluating a foreign tax credit system

Before looking at the position in Australia and overseas, it is appropriate to consider the reasons for a foreign tax credit system and its possible effects. In addition, it is hoped to identify those areas that will determine the efficiency of a system.

Perhaps the starting point in evaluating any tax system is equity. Before the credit system the exemption provisions had the potential in certain circumstances of taxing Australian residents at different rates, depending upon whether the income was sourced in Australia or overseas. Accordingly, the foreign tax credit should be considered in the light of its effectiveness of taxing income at comparable rates regardless of where it is sourced.

Apart from equity it is necessary to consider neutrality. This basically means that a system should not interfere in the choice of investment in either the country of residence or in a foreign country.[4]

Foreign tax credit systems usually provide that the foreign tax credits cannot exceed the tax that would be levied on the foreign income if it was sourced in the country of residence. To allow this would have the effect of the credit reducing the residence country tax on income sourced in that country. These rules are referred to as the foreign tax credit limit. With a limit in place the foreign tax can exceed the creditable amount. This excess is often referred to as "overspill". Taxpayers will try to minimise overspill by recharacterising income that has an Australian source as foreign source income. The scope for this type of recharacterisation will depend upon the nature of the foreign tax credit limit.

In addition to the consideration of source as a general concept, it is necessary to have some regard to classes of income, as the source rules differ in relation to different types of income.[5] Just as it is necessary to look at source rules in relation to assessable income, it is also necessary to look at the deductions as between Australian and foreign source income. Under a foreign tax credit a credit limit can be partly avoided by trying to set foreign deductions off against Australian source income thereby enlarging the foreign tax base. This enlargement has the consequence of reducing the foreign tax rate which naturally limits and, in some cases, eliminates

4 Referred to as the principle of capital export neutrality. Vann and Parsons, "The Foreign Tax Credit and Reform of International Taxation" (1986) 3 Australian Tax Forum 131, 134. Also for a discussion on capital export neutrality and capital import neutrality see Bird "International Aspects of Tax Reform in Australia" produced in Head, *Australian Tax Reform in Retrospect and Prospect* (1989) 161, 164-165.

5 It is not proposed to consider source rules in Australia. For a discussion of these and their possible manipulation under international taxation see Vann and Parsons, ibid at 150-165.

overspill. The key to this ploy working successfully is to ensure that what is a relatively simple allocation is effectively hidden in a complex tax return. The stricter the foreign tax credit limit rules are then the more likely this type of activity can be overcome. Also relevant to the deduction question is the co-ordination of an imputation system and foreign tax credit system. This is best illustrated by the difficulties that can arise if a compensatory tax is used in relation to a dividend imputation system. As this occurred in the UK, the difficulties will be considered in Part 4 of this paper. As Australia did not adopt the use of a compensatory tax, these difficulties did not arise. However, relevant to Australia is the question of whether the benefit of imputation is cancelled out by the existence of the foreign tax credit. This needs to be considered because imputation credits depend upon a franking surplus, which in turn depends on Australian tax paid. The credit has the effect of reducing the amount of Australian tax paid. This problem will be further considered later in this paper.

Indirect credits also need to be considered. This term refers to a credit for the tax paid by a company on its income where a credit for that tax attaches to dividends. If the dividends are received by an Australian company, then, in addition to any withholding tax paid to the country of source, the question arises as to whether there is any credit given for the foreign tax paid on the income to which the dividend relates. The theory is that this achieves full integration. However, the complexity that this type of system brings to the legislation means it is not often provided for all shareholders and is limited to those with a sizeable stake of the foreign company. Without some form of indirect credit, residents may prefer that no dividend be paid and that profits be accumulated offshore. In this respect, the controlled foreign entity provisions will be relevant. Assuming there is provision made for indirect credits, then their relationship to the credit limit will also be relevant.

Rules dealing with foreign tax credits need to provide guidelines for what type of foreign tax paid will be eligible for a credit. The reason for this is that the tax paid must bear some relationship to the tax that would be payable in Australia. State taxes and other statutory taxes not of a revenue nature will usually have special rules either in foreign tax treaties or in the resident country foreign tax credit rules. In addition, royalties paid in a source country may be disguised as foreign taxes and this type of simple avoidance technique needs to be dealt with.

To summarise, a foreign tax credit needs to be considered under the following subheadings:

- foreign tax credit limits,
- the treatment of excess credits,
- the treatment of foreign losses,
- the allocation of deductions,
- the impact of dividend imputation,
- the treatment of indirect credits,
- the impact of controlled foreign entity provisions,

- treaty issues (tax sparing) and
- overall equity and neutrality.

Foreign tax credit in Australia

The foreign tax credit provisions in Australia are contained in Division 18 of Part III of the ITAA, comprising s 160AE to s 160AFF. The basic effect of the provisions is that Australian residents are liable to pay tax on the foreign source income and capital profits that are not exempt. However, a credit against Australian tax will be allowed for the foreign tax paid on foreign income or capital gains that are not exempt. It is important to note that the amount of credit is not to exceed the amount of the Australian tax payable on the foreign income.

The effect of the foreign tax credit limit is that the excess credit or overspill needs to be considered under the carry forward provisions. Division 18 allows excess credits to be carried forward for up to 5 years to be offset against Australian tax on foreign income of the same class. Alternatively, the credit can be transferred to another group company. Excess credits cannot be used to offset tax on Australian income.

As an example of the way in which the foreign tax credit limit operates at a basic level, assume a company earns foreign income of $100,000, subject to tax in the country of source of $60,000. The company will be given a credit for the tax paid. As a result, the tax liability that would otherwise exist of $39,000 does not arise. However, the company will have an overspill, or excess credit, of $21,000.

Under Division 18, the worldwide foreign tax credit limit operates to average foreign tax paid. However, certain interest income and offshore banking income need to be treated separately. These separate limits or "baskets" are based on the US system. By contrast, a country by country limit operates to pool income by reference to countries and not classes. The adoption of this "mini" basket approach, because of its averaging effect, operates more equitably than the country by country approach. In addition, it prevents the avoidance technique of incorporating a single offshore parent to pool all foreign income and thereby take advantage of averaging foreign tax and income. The reason for a separate class or limit in relation to interest is to prevent taxpayers using the worldwide limit to avoid overspill by making low taxed deposits in overseas money markets and so averaging down high foreign tax rates on other income.

Foreign tax[6] is tax imposed by the foreign country. In addition to the legislation, Taxation Ruling IT 2437 lists the taxes of various countries for which a credit can be obtained. A credit is only available for foreign tax for which the taxpayer was personally liable.[7] This was to prevent the possibility

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6 Section 6AB(2).
7 Section 160AF(1) (d).

of any trading of companies with excess foreign credits, although the concept of personally liable is reasonably wide in its ambit.[8]

Under Division 18 the first step is to determine the amount of foreign tax paid. Usually this is the foreign tax paid but it is reduced for credits and rebates allowed by foreign countries.[9] Where company dividends are received the underlying tax may be included. This will be discussed later in relation to indirect credits. Foreign income is then grossed up for the foreign tax that is paid on that income.[10] The next calculation is to determine the net foreign income, which is the foreign income reduced by deductions relating exclusively to foreign income, carry forward losses[11] and a proportion of deductions that relate to the foreign income. What are termed "apportionable deductions"[12] are excluded from the deductions that can be offset against foreign income in determining net foreign income.

Adjusted net foreign income is basically the lesser of the net foreign income or taxable income. However, the calculation becomes more complex where different classes of income are involved.[13] There is also some doubt where the relevant proportion of deductions needs to be considered for the purposes of determining net foreign income. Taxation Ruling IT 2446 suggests that head office expenses and interest on loans used for overseas purposes may be apportioned, but does not provide any real assistance. The greatest difficulty, and presumably the area of attempted minimisation, will be in the apportionment.

Where different classes of income are involved, the foreign tax credit must be calculated separately for each class. For this purpose there are three separate classes,[14] namely passive income under s 160AEA, offshore banking income under s 160AE(4) and (5) and other income under s 160AF(7).[15]

Passive income basically includes dividends, interest income, annuities, rental income, royalties, capital profits and various other amounts. Interest income is separately defined[16] to include payments of interest or payments in the nature of interest,[17] but excludes interest derived from active conduct of trade or business, including a banking business and offshore banking income.[18]

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8 See s 6AB(3), (3A) and (4). The *Explanatory Memorandum* to the legislation introducing Division 18 provided that a foreign tax will only be considered as an income tax if it is imposed on a basis substantially equivalent to income tax levied under the ITAA. This is unhelpful and accordingly some detailed consideration will be required where the foreign tax is anything other than a simple tax on income.

9 Section 160AF(1)(c).

10 Section 6AC.

11 Provided elections have been made under s 79E(6) or s 80(2C).

12 As defined in s 6(1).

13 Section 160AF(8).

14 Compare the four classes considered when calculating carry forward losses.

15 Section 160AF(7).

16 Section 160AE(3).

17 As defined by case law.

18 As defined in s 160AE(4).

The purpose of these provisions[19] is to quarantine different classes of income so that passive income usually derived in low tax countries does not absorb excess credits from income in high tax countries. Basically, it partially reverses the benefit of averaging high and low country tax that arises under the overall basis of calculating the foreign tax credit. In addition, it operates to prevent the simple avoidance technique of removing overspill by the use of cash investments in low tax countries or tax havens.

To prevent the recharacterisation of interest income to dividend income by pooling interest income in a foreign subsidiary and repatriating it as dividend income, s 160ADFA deems certain dividend income to be interest income. This is done by using tracing rules.

The co-ordination of the dividend imputation system and the foreign tax credit system is partly achieved by franking debits and franking credits arising from the foreign tax credit system. A franking credit is allowed when a foreign tax credit previously allowed is reduced[20] and a franking debit is allowed where a foreign tax credit is allowed.[21] Similar provisions have been inserted in relation to trusts, although some of the residence requirements have been altered in this regard.[22]

The indirect credit is also allowed by crediting the underlying tax when an Australian resident company receives a dividend from a related foreign company. As to the necessary relationship, this can be satisfied by establishing that a group of companies exists where the holding between each company in the group is at least 10% of voting power. In addition, the Australian resident company must hold at least 5% of the voting power of a company that is a member of the group.[23] Where there are companies in a chain, a special formula is provided to calculate the level of holding between indirect members of the group.[24]

Before calculating the underlying tax, it is necessary to identify the part of distributable profits from which the dividend is paid. Section 160AFC(6) sets out the order in which distributable profits are taken to have been paid. Distributable profits are defined in s 160AE basically as amounts available for distribution as a dividend, regardless of whether of an income or capital nature. The underlying tax is then calculated pursuant to s 160AFC(2) and (4) and the calculations differ depending upon the number of companies in what is termed as "the dividend series".[25] The calculation is then the subject of adjustment where the dividend is in whole or part of an "exempting receipt". This is basically that part of a dividend that represents profits from a listed country or Australia that have been comparatively taxed, provided the dividend is paid as a non-portfolio dividend by a company resident in an unlisted country. The difference between listed and unlisted countries are

19 Section 160AF(7) and defined terms.
20 Section 160APT and s 160APK(c).
21 Section 160AQA and s 160APW(c).
22 See s 160ARRD.
23 Section 160AFB.
24 Section 160AFB(3).
25 Section 160AFC(1).

those that are regarded as taxing and not taxing respectively, on a basis comparable to that in Australia. The relevant section[26] is inserted to ensure that no credit is allowed for underlying tax that relates to that part of a dividend exempt from tax under s 23AJ.[27] Where the dividend is paid by a listed country company the calculation is again different and is provided for by s 160AFCD, which deals with amounts exempt under s 23AI.

It is interesting to note that the indirect credit system is effectively another imputation system in that company tax paid (foreign tax paid by a foreign company) is imputed to the (Australian company) shareholder. By way of brief comparison it can be noted that the indirect credit is only available to shareholders with an underlying interest above 10%, whereas the imputation system is available to all resident shareholders regardless of their level of holding in the company. The most likely reason for this difference is the complexity that would arise if the indirect credit were offered to all shareholders. The pass through of imputation for partnerships and trusts is widely provided for, but in relation to the indirect credit the position is much less clear. Some of the other differences are explainable, but others appear to have arisen simply because no consideration was given to the indirect credit as a form of imputation at the time of its introduction.

Turning then to the relationship between the CFE provisions in Australia and Division 18, it is important to note the basic thrust of the CFE provisions. The operative part in relation to companies is s 456, which has the effect of attributing income of a foreign company to Australian taxpayers despite the fact that no distribution may be made.[28] The provisions relating to controlled foreign trusts are similar and are found in Division 6AAA of the ITAA.[29] As discussed, the CFC provisions were always contemplated to overcome the difficulty of profits simply being quarantined off-shore to circumvent the operation of the foreign tax credit provisions. This is related to the more basic problem of the Australian revenue collectors not being able to tax residents on non-Australian sourced income. The operative provision of Division 18 is s 160AFCA. Basically credits are not allowed for tax paid by a CFC on amounts that are not attributed.

Where a CFC changes residence from an unlisted country to a listed country or Australia, then certain amounts can be attributed to Australian residents. In those circumstances, if the taxpayer is a company related to the CFC, a credit is allowed for the foreign tax paid in relation to the amount attributed. This is provided for by s 160AFCB. Section 160AFCC then allows a credit in relation to amounts under s 458, being attributions of a non-

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26 Section 160AFC(5A).

27 Not portfolio dividends to the extent that they are exempting receipts.

28 It is beyond the scope of this paper to discuss in detail the operation and effect of the CFC provisions.

29 While the provisions for trusts and companies differ in some significant respects, those differences do not appreciably impact upon the inter-relation between the foreign tax credit system and the CFE provisions. For the purposes of this paper, the provisions for trusts and companies are regarded as being broadly the same.

portfolio dividend from a CFC in an unlisted country to a CFC in a listed country.

Because of attribution s 23AI exempts income where it has already been the subject of tax by reason of attribution. In these circumstances, s 160AFCD deems part of the exempt payment under s 23AI to be income for the purposes of the foreign tax credit. On this basis a credit for some of these amounts is allowed.

As would be expected, special provisions operate in relation to deductions for losses. Section 79D has the effect of preventing a foreign loss relevant to income of a particular class from being offset against foreign income of another class or domestic income. As mentioned earlier, s 160AFD specifies four classes of assessable foreign income relevant to the loss provisions. These are basically the same as those relevant to calculating the credit plus modified passive income.[30]

Net losses of each class of income can be carried forward indefinitely to be offset against foreign income of the same class, provided the loss was incurred after 1 July 1989.[31] Where a foreign carry forward loss is offset against subsequent foreign income, the credit for foreign tax paid on that income is in some circumstances correspondingly reduced.

As to the carry forward of excess foreign credits, the relevant provisions are in s 160AFE. A resident taxpayer is allowed to carry forward excess credits for up to five years following the year when the credit arose. Credits must be absorbed in the order in which they arise. Again credits are only available to be offset against income of the same class in relation to which the credit arose. Credits can also be transferred between companies in a group.[32]

In some developing countries, where tax holidays or incentives are given, the effect for residents of Australia investing in those countries is that the benefit of the foreign tax credit is lost without special provision. The reason is that the foreign tax credit is only given in relation to foreign taxes actually paid. The special provision in the Australian legislation is in s 160AFF, which allows the Minister to make regulations for "tax sparing". In some cases these regulations will be in addition to tax sparing that occurs under some double tax treaties.

The United Kingdom

In the UK, relief by credit may be given under the terms of a treaty or unilaterally in the absence of a treaty.[33] In either case the computation of the credit is the same. If no credit relief is given at all for foreign tax paid, then the relief can be given by deduction, namely reducing the income chargeable

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30 Interest income, off-shore banking income and all other assessable foreign income are the other three.

31 The carry forward period is limited to seven years for prior losses.

32 As to the grouping provisions see s 160AFE(2)(b). The effect is similar to s 80G requiring 100% common ownership for the whole of the relevant period.

33 Income and Corporation Taxes Act 1988 (ICTA) s 788 and s 790.

to tax in the UK by the amount of the foreign tax.[34] In addition, there is provision for indirect credits. This will be discussed later.

The relevant credit provisions are in the Income and Corporation Taxes Act (ICTA) at Part XVII Chapter II.[35] The excess credit limit operates such that the amount of the credit is not to exceed the difference between:

(a) the amount of income tax which would be borne by the individual taxpayer if that taxpayer was charged to income tax on total income from all sources including the grossed up foreign income; and

(b) the tax borne by the taxpayer on total income minus the foreign income as computed.[36]

The difference is basically the UK tax attributable to the overseas income and is therefore the limit of the credit.

For corporations, the formula is altered to provide that the credit is not to exceed the mainstream corporation tax (MCT) applicable to the relevant income.[37] The system is further complicated by the compensatory tax scheme. Since 1984, the legislation has made it clear that the foreign tax credit is deductible before ACT.[38] The legislation was further amended in 1986 to limit the amount of ACT that could be offset against the company's tax liability to the lesser of:

(a) the ACT limit calculated as if the foreign income was the company's only income for the relevant period; and

(b) the amount of MCT which, after deducting the foreign tax credit, the company is liable to pay in respect of that income.

In the case of both individual and corporate taxes where more than one source is involved each is treated separately, but in order. As the order can be determined at the taxpayer's discretion it is best to take the income taxed at the highest rates first. This country by country approach has the result that averaging by using offshore entities to pool income from all offshore sources can achieve a better use of foreign tax credits.[39]

Unlike provisions in Australia, there is no allowance for the carry forward of excess credits. Because overspill is lost, the tendency to order affairs to obtain the maximum use of credits is much greater. This is evidenced be the series of amendments made to the legislation in 1984 and 1986 to overcome the avoidance techniques developed in relation to the introduction of the credit and ACT.

Turning then to the indirect credit, the treaty provisions usually require at least a 10% holding in the foreign company. If no agreement applies the unilateral relief provisions require the recipient company to control directly

34 ICTA s 811.

35 Section 792 to s 806.

36 ICTA s 796(1).

37 ICTA s 797(1).

38 ICTA s 797(4). Before this there was some argument as to the correct order.

39 These offshore entities are usually referred to as "mixer" companies as they mix the income from all foreign sources to obtain the advantage of averaging foreign tax paid.

(or through a holding company) 10% of the voting power of the foreign company. Since 1971 the provisions have been extended to apply to dividends passed through a chain of companies, provided the requisite interest is held at each level of the chain. The relief is subject to the following limitations:

(a) No relief is given in respect of a dividend from a UK resident company, except for the underlying corporation tax, including any tax relieved by a tax credit. The effect is that any overseas tax unrelieved in the company's hands is excluded;[40]

(b) The tax for relief at each point in the chain is determined by regarding the overseas company entitled to the dividend as if it were a UK resident company, and applying the statutory provisions for relief accordingly.[41]

While the UK provisions broadly make no provision for different classes of income, it should be noted that the rules differ for banks and certain loan interest.

Similar to the Australian provisions, some treaties do provide tax sparing relief, referred to in the UK provisions as "pioneer relief". The broad effect of the relevant provision[42] is that overseas tax forgiven or forgone in the overseas territory is to be treated as if it were overseas tax paid in that territory. The section allows for the relief to be provided by treaty and provides that it can be made retrospectively.

The UK also has CFE provisions which basically distinguish between listed and unlisted countries and eligible designated concession income in relation to listed countries.[43] The charging provision[44] charges the distribution with MCT. Distributions are apportioned in accordance with ICTA s 752. Controlled Foreign Entities are basically treated as taxpayers for the purposes of determining chargeable profits. However, as occurs in Australia, the legislation provides for extensive adjustment.

Double tax relief is provided in relation to the disposal of shares in a CFC.[45] In particular, if the limit on credit in ICTA s 796 or s 797(1) applies to restrict the relief available to the recipient of the dividend, then the wasted relief is the smaller of:

(a) the amount by which the available relief is reduced by that limit; and

(b) the amount of foreign tax other than underlying tax for which credit would be available.

This wasted relief is relieved by ICTA Schedule 26 para 4(5).

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40 ICTA s 801(4)(a).
41 ICTA s 801(4)(b).
42 ICTA s 788(5).
43 ICTA Part XVII Chapter IV s 747 to s 756.
44 ICTA s 747(4)(a).
45 ICTA Schedule 26 para 3.

The UK system does appear to be fair and reasonable. However, by the use of a country by country approach there may be a tendency to use offshore mixer companies to average high and low tax country income. This is overcome to an extent by the CFE provisions, but the practice may well continue. It is noteworthy that there is no provision for the carry forward of excess credits and to this extent the system appears a little more discriminatory than the Australian system. One important advantage over the Australian provisions is that the UK provisions appear on their face to be less difficult to understand. As a result the cost of compliance may operate in favour of the UK provisions.

The United States

As in Australia and the UK, the US seeks to tax its residents on their worldwide income. To prevent double taxation, the US allows a credit for taxes paid in foreign countries. The credit is elective and the relevant election must be made on a year by year basis. If no election is made for foreign tax credit treatment the taxpayer is allowed a deduction for foreign taxes paid or accrued.[46]

In relation to the foreign tax credit limit in the US, amendments made in 1986 increased the number of separate limitations or baskets thereby increasing the system's complexity and reducing the amount of allowable credits. The reason for the increased number of baskets was, according to Congress, to prevent averaging of foreign taxes referred to as cross crediting. There are at least eleven categories or baskets of income for calculating the foreign tax credit. Nine of these are in IRC s 904(d) being:

- passive income
- high withholding tax interest
- financial services income
- shipping income
- dividends from non controlled IRC s 902 corporations[47]
- dividends from a domestic international sales corporation (DISC) or former DISC
- taxable foreign trade income
- certain Foreign Sales Corporation income and
- all other income (the residual basket)

In addition there are separate limitations relating to oil and gas extraction income[48] and distributions from “possessions corporations”.[49]

Passive income is defined generally to include dividends, interest, annuities, certain rents and royalties, gains on sales of property such as stock, commodities transactions, foreign currency gains and income

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46 US Internal Revenue Code 1986 (IRC) s 901(a), s 164(a)(3) and s 275(a)(4).
47 These will be discussed later.
48 IRC s 907(a).
49 IRC s 901(g).

equivalent to interest.[50] However, the definition specifically excludes income that would fall into another basket in IRC s 904(d).

Excess credits may be carried back two years and forward five years.[51] Credits must be applied in the order in which they arose and, by the operation of IRC s 904(d), can only be used in relation to income within the same basket. While the credit limit in IRC s 904(a) operates as an overall limit, the effect of the section is that the limitation carry back or carry forward provisions and the rules for determining taxable income must be applied separately in relation to each basket.

In relation to losses, a loss incurred in any foreign tax limitation basket will offset US source income to the extent that the aggregate amount of all such losses exceeds the aggregate amount of foreign income earned in all other baskets.[52] The effect of this is that a loss allocated to a particular foreign basket will reduce other foreign source income before it reduces US source income. The rule is to reduce the total foreign tax credits available. Losses are allocated proportionally among the baskets in which the taxpayer earns income in the loss year.[53] Where the aggregate amount of foreign losses exceeds the aggregate amount of foreign income, US source income is reduced. This overall foreign loss will be recaptured in future years by re-characterising a portion of the taxpayer's foreign source income as US source income. The amount of recapture is equal to the lesser of the total of the overall foreign loss and 50% of the taxpayer's foreign source income.[54] The taxpayer has the option of recapturing greater than 50% if it so desires.

A separate rule applies to foreign losses that were previously allocated to foreign income. Under this rule, foreign source income attributable to a particular basket that was allocated to an earlier loss will be re-characterised as income from the basket, the income of which previously offset the loss.[55] The purpose of this re-characterisation is to return the balance to all baskets to ensure that the basket limitations are properly applied.

Where a loss allocated to the US does not exceed the foreign source income for the year, the loss is allocated amongst the foreign income in each basket on a proportionate basis.[56] This rule only applies after any foreign losses have been allocated amongst the foreign income baskets to prevent easy avoidance of the limitation rules.

Dividends, interest and royalties from a CFC are subject to look through provisions for determining the proper foreign tax limitation basket.[57] The same type of income from a non controlled corporation under IRC s 902 received by corporate shareholders are placed in a separate limitation

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50 IRC s 904(d)(2)(A)(i).
51 IRC s 904(c).
52 IRC s 904(f)(5)(A).
53 IRC s 904(f)(5)(B).
54 IRC s 904(f)(1).
55 IRC s 904(f)(5)(C).
56 IRC s 904(f)(5)(D).
57 IRC s 904(d)(3).

basket.[58] All other dividends, interest, rent and royalties from foreign corporations fall into the passive income basket.

The basket approach, where there are a large number of baskets, becomes amazingly complex as a result of the look through provisions. The result is that dividend income is allocated to separate baskets in proportion to the ratio of earnings and profits of a particular category to the total earnings and profits.[59] Interest income is treated as income from a separate category to the extent that it is allocated to income of the CFC in that category. Fortunately, the CFC provisions include a de minimus exception that excludes the operation of attribution where the amount involved is small. In those circumstances, amounts received will be treated as residual basket income.[60]

The indirect credit is allowed in relation to the IRC s 902 companies. These are non-controlled foreign corporations where the taxpayer meets the ownership requirements of s 902(a). As with Australia and the UK, the requirement is basically a 10% control of voting power. The limitation in these cases is calculated on a company by company basis and, as a further restriction, the credit is limited where the dividend is attributable to interest income where the withholding rate exceeds 5%.[61] The indirect credit also applies to group companies to allow the benefit of the indirect credit to pass through each company in the chain.[62]

Tax sparing was allowed under former IRC s 902(d). It is now allowed only in a limited number of cases. In the US it appears that the main objection to tax sparing credits is that they give a positive advantage to overseas traders, thereby breaking the fundamental rule of neutrality between citizens abroad and those in the US. Another objection is that the provisions give the largest tax benefits to those countries with the highest nominal tax rates without any necessary relationship to the fundamental needs of the country. As a counter to these arguments, tax sparing has been endorsed in the UK on the basis that it avoids penalising those entities that elect to trade offshore in developing countries.

As the US has no dividend imputation rules, the difficulties that can arise in co-ordinating the foreign tax credit in these circumstances need not be considered. Naturally, the problems associated with non integration between companies and dividend recipients remains unremedied and double taxation of company profits continues.

Conclusions

Each of the three systems appears to operate equitably with only a number of minor differences. Capital export neutrality operates reasonably equally between the three systems. This point will be returned to later.

58 IRC s 904(d)(1)(E).
59 IRC s 904(d)(3)(D).
60 IRC s 904(d)(3)(E).
61 IRC s 904(d)(2)(E)(ii).
62 IRC s 902(c)(3)(B).

While the country by country approach is easier to comply with, it tends to increase the ability to overcome credit limits by using offshore mixer companies as a method of avoidance. It is acknowledged that the CFC provisions can act as an anti-avoidance mechanism. However, it is submitted that mixer companies could still prove to be advantageous in averaging foreign taxes, even with CFC provisions in place. The basket approach, particularly as it operates in the US, serves to limit the extent of credits and overcomes the averaging problems associated with a country by country approach. The lack of credits in basket systems is alleviated (as in the US and Australia) by the existence of carry forward provisions for excess credits. Perhaps the reason the UK has no carry forward provisions is that it operates on a country by country basis. The real difficulty with the basket system is its complexity. While this is not so much of a problem in Australia, the US legislation clearly illustrates the problem.

The potential for avoidance in relation to the ordering of losses and deductions appears to have been overcome in each system. The US system is the most comprehensive (and accordingly the most complex).

In the UK, the early difficulties with ACT appear to have been overcome and the credit operates well with the imputation system. In Australia, it appears that the foreign tax credit and the imputation system are well co-ordinated, although Australia did not have to contend with the problems of allocation and a compensatory tax. Source rules can give rise to anomalies in the concurrent operation of the two systems.

The indirect credit is necessary to achieve equality, however its complexity is a disadvantage. In looking at the indirect credit as a method of integration as compared to dividend imputation, some of the differences in Australia in the operation of the two systems are unfortunate. There is little to be gained by attempting to make the two systems similar in operation other than to make the legislation easier to apply. Some of the difficulties and complexities of the indirect credit (as a form of imputation) are highlighted by the basket approach where proportionate attributions of income by type are necessary.

Tax sparing appears to be well provided for in both the UK and Australia. As for the US, it has made its own decision about the undesirability of tax sparing. Whether to provide for it or not depends to an extent upon a charitable notion not to severely disadvantage those that wish to invest in developing countries. Either with or without it, there are arguments that a foreign tax credit system does not operate with equity and neutrality. For Australia, it is submitted, it should be retained.

As for the CFE provisions, it is appreciated that these are necessary to prevent the simple avoidance technique of accumulating profits offshore without repatriation of profits. However the overwhelming complexity has a lot to answer for. In addition, the CFE provisions only partly address the deferral problem, as they do not generally relate to offshore operations in non tax haven countries (listed countries). The Australian provisions, while perhaps the most comprehensive, are clearly the most unreadable. Sub Part F of the IRC in the US is little better, but the UK provisions are somewhat more readable than the others. It was always acknowledged that Australia would have CFE provisions, so it is unfortunate that both the foreign tax credit and CFE provisions were not introduced to the legislation as a single integrated package (as occurred in Canada).

On the point of neutrality, it would not be surprising to see international companies decide not to establish a permanent business in Australia because of the complexity and (as a natural consequence) the cost of complying with unreadable and, to the uninitiated, unintelligible legislation.[63] This is not to say that without the CFE provisions Australia's foreign tax credit would be entirely acceptable.

Not only from the point of view of anti-avoidance, the credit system as a whole is considerably more complex than the previous deduction system. While the deduction system may be simple, it is an unacceptable alternative in terms of its overall equity.[64]

To conclude, the basics of the Australian system are worth retaining. The complexity is not. As an exercise for simplification, the ITAA foreign tax credit and CFE provisions (notably being some of the most recent) deserve early attention. Perhaps if the system were less complicated there may be a case for expanding the basket approach to improve the overall equity of the system.

Considerable complexity arises because the international elements of the Australian system were "add-ons" to the then existing domestic system. With all parts of the system now in place and operating, there is a need for a review of the entire tax system including the international elements. This need is becoming more urgent as Australia realises that much of its future now rests with the fortunes of Asia and the increasing tendency towards global integration of business.

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63 This is more in the nature of capital import neutrality. It has been suggested that capital export neutrality and capital import neutrality are incompatible to an extent and that capital export neutrality should be preferred. See Bird, above n 4 at 165.

64 See the Taxation Review Committee Full Report 1975, (*The Asprey Report*) at 257-260. This is based upon the assumption that capital export neutrality is preferable for Australia to a more selfish, and perhaps narrow minded, approach of increasing the tax base to the detriment of overall international symmetry. See Bird, above n 4 at 172-174.