BLW LLP
BALAZS LAZANAS & WELCH LLP

22 July 2009

AN INTRODUCTION TO AUSTRALIA'S INTERNATIONAL TAX SYSTEM
How is source determined?

Written by:

John Balazs
Partner
Balazs Lazanas & Welch LLP

CONTENTS

An Introduction to Australia's International Tax System: How is Source Determined?

This paper is concerned with the "rules" governing the determination of the source of assessable income.[1] Source is one of the two fundamental pillars on which the Australian income tax system is historically based. This paper will briefly examine the relevance of source, following which it will examine (i) the general principles governing the determination of source, (ii) statutory source rules, including the role of double tax agreements in determining source, and (iii) the source of statutory income.

1 INTRODUCTION

1.1 The Relevance Of Source

In 1978 Tom Magney delivered his seminal paper, "Source of Income".[2] Back then, section 25(1)(a) of the *Income Tax Assessment Act 1936* (the ***1936 Act***)[3] included gross income from all sources in the assessable income of a resident and section 25(1)(b) included gross income from all sources in Australia in the assessable income of a non-resident.[4]

Section 23(q) was the primary provision for residents with respect to foreign source income. It exempted income derived from foreign sources (other than dividends and certain amounts made assessable pursuant to the *Income Tax (International Agreements) Act 1953*)[5] if certain conditions were met. A limited foreign tax credit regime existed and, of course, there was no capital gains tax regime (except in a very limited way through section 26AAA and, depending on your view, section 26(a)).

For non-residents, the overriding provision was section 23(r) (either in its own right or in connection with section 25(1)(b)) supplemented by statutory provisions, including a special regime for the taxation of dividends (as defined), and a small number of double tax agreements that contained a source rule. Those statutory provisions included section 6C, a source rule for royalties derived by non-residents, section 25(2), a source rule for interest, and sections 38 to 43 (inclusive), source rules that were primarily concerned with dealings in goods.

What is the relevance of source today?

Sections 6-5(2) and 6-10(4) include ordinary income and statutory income from all sources in the assessable income of an Australian resident. Otherwise, source is now primarily an issue for an Australian resident in relation to the foreign income tax offset (in Division 770).[6] Source is, however, expressly mentioned in other contexts for an Australian resident.[7]

---

1 It will be appreciated that in 2009 the discussion is about the determination of the **source of assessable income**. It will further be understood that there are other uses of the word *source* or *sourced*, but it is not intended that the issues raised by, for example, sections such as section 177EA(17)(ga) of the *Income Tax Assessment Act 1936* (the ***1936 Act***) and section 202-45(e) of the *Income Tax Assessment Act 1997* (the ***1997 Act***) be dealt with in this paper.

2 The paper was delivered at The Taxation Institute of Australia's New South Wales Convention. See also "Some Aspects of Source of Income", T W Magney, Taxation Institute of Australia, 5th National Tax Retreat, August 1997.

3 Unless otherwise indicated, all legislative references are to the 1936 Act or the 1997 Act as the case may be (collectively, the ***Tax Acts***).

4 The expressions *non-resident* and *foreign resident* are used interchangeably in this paper.

5 The Act has since been renamed the *International Tax Agreements Act 1953*.

6 See Item 1 of Schedule 1 of *Tax Laws Amendment (2007 Measures No. 4) Act 2007.*

7 Section 23AF in relation to income derived in respect of an approved overseas project; section 23AH in relation to foreign branch income; sections 24F and 24G in relation to Norfolk Island residents and section 103A(4E)(e) in relation to the characterisation of a company as either a public or private company for the purposes of the 1936 Act.

For foreign residents sections 6-5(3) and 6-10(5) provide that, amongst other things, assessable income includes ordinary income derived directly or indirectly *from all Australian sources* and statutory income *from all Australian sources*. The expression "*Australian sources*" is defined in section 995-1:

> *Australian source*: ordinary or statutory income has an Australian source if, and only if, it is derived from a source in Australia for the purposes of the *Income Tax Assessment Act 1936*. (Emphasis added)

Sections 6-5(3) and 6-10(5) also refer to ordinary and statutory income, respectively, being included **on a basis other than source**, but just how far reaching this notion of assessability based on something other than source might be for a foreign resident is unclear. The example given in the Joint Explanatory Memorandum to *Income Tax Assessment Bill 1996, Income Tax (Transitional Provisions) Bill 1996* and *Income Tax (Consequential Amendments) Bill 1996* (the ***Joint Explanatory Memorandum***) is with respect to capital gains.[8]

Overriding the above rules are various exemptions and exclusions, including the rules governing the taxation of temporary residents in Subdivision 768-R and the withholding tax rules in Division 11A of Part III.

Source is also relevant in other matters, the most notable of which are:

(a) the taxation of trustees and beneficiaries pursuant to Division 6 of Part III and the recently enacted rules regarding managed investment trust income where reference is made to *amounts that are not from an *Australian source* in section 12-405(1)(e) of *Schedule1 of the Taxation Administration Act 1953*;

(b) sections 252A and 255;

(c) the determination of conduit foreign income in Subdivision 802-A; and

(d) the Other Income Article in Australia's double tax agreements (see for example paragraph 3 of Article 20 of the double tax agreement between Australia and the UK)[9].

1.2 Terminology

The Tax Acts expressly refer to source in a number of ways. In addition to *from all sources* and *from all Australian sources* the Tax Acts refer to:

- *from sources in a foreign country or countries* (section 6AB, section 160AE(2));
- *from a particular source* (section 6B(2A));
- *attributable to sources in Australia* (sections 92(1) and 92(2), and sections 97, 98, *98A and* 100);
- *from sources in a country other than Australia* (section 23AF(17));
- *from sources in a listed country or unlisted country* (section 23AH(15) – definition of *foreign income*);
- *attributable to sources out of Australia* (sections 99, 99A, 99D 102);
- *from sources in Australia* (section 252A);
- *from a source in Australia* (section 255(1));
- *from a source outside that country* (section 770-10(3));

---

8 At page 39.

9 Which reads: "Notwithstanding the provisions of paragraphs 1 and 2 of this Article, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention from sources in the other Contracting State may also be taxed in the other Contracting State."

- *from a source other than an Australian source* (section 768-910 and section 770-75(4));
- *from a source in a foreign country* (section 768-105); and
- *from sources in the Australian territory* and *from sources in the foreign territory* (section 11ZF of the *International Tax Agreements Act 1953*).

In most instances, there may well be no significant difference between, for example, *sources out of Australia* and *sources in a foreign country*, but there can be and one should not assume that similar expressions have the same meaning.[10]

2 THE SOURCE OF ORDINARY INCOME

2.1 The General Principle

It is common to begin any discussion of how source is determined with the words of Isaacs J (giving the judgment for the whole Court) in *Nathan v FCT* (1918) 25 CLR 183 at 189:

> The legislature using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of the given income is a practical, hard matter of fact.

This "principle" has been affirmed by the High Court in a number of cases, in particular, *FCT v Mitchum* (1965) 113 CLR 401 and *Esquire Nominees Limited v FCT* (1972) 129 CLR 177.

As Barwick CJ said in *Mitchum* at 407:

> The conclusion as to the source of income for the purposes of the Act is a conclusion of fact. … In each case, the relative weight to be given to the various factors which can be taken into consideration is to be determined by the tribunal entitled to draw the ultimate conclusion as to source.

It is perhaps best put by Stephen J in *Esquire Nominees* (at 223-224):

> As Evatt J observed in *FCT v W. Angliss & Co Pty Limited* (1931) 46 CLR 417 at 441, taxation by reference to source of income has long been a feature of fiscal legislation in Australia, income being depicted as a flowing stream fed from identifiable sources. To use "source" in such a context is not to employ any legal concept but rather a metaphorical expression – *FCT v United Aircraft Corporation*, per Rich J (1943) 68 CLR 525 at 537 - and in the task of applying this metaphor so as to determine fiscal consequences it has become accepted doctrine that the ascertainment of the actual source of a given income "is a practical, hard matter of fact", the source being "something which a practical man would regard as a real source of income" - *Nathan v FCT* per Isaacs J (1918) 25 CLR 183 at 189.

There is an interesting discussion in *Thorpe Nominees Pty Limited v FCT* (1988) 19 ATR 1834 of the *frequently cited passage* from *Nathan*. At 1844, Sheppard J said:

> The frequently cited passage from the joint judgment in *Nathan's case* that the actual source of a given income is a practical, hard matter of fact, if analyzed too closely, may raise a question in some minds about what it really means. For this reason some may question its usefulness as a guide in the inquiry which has to be made, but, in my respectful opinion, the judges in *Nathan's case* said what they did to emphasize the factual nature of the inquiry and that the touchstone was practical reality. That is the theme which runs through judgments in later cases. Obviously the word "hard" was not used in the sense of difficult, but as an indication to a person concerned with making the inquiry that it was necessary to be down-to-earth, practical and hard-headed about the task in hand.

---

10 The expression *foreign country* is defined for the purposes of all Acts (unless a contrary intention appears) by section 22(1) of the *Acts Interpretation Act 1901*.

Whilst Burchett J at 1846 said:

> Practical reality is not a test so much as an attitude of mind in which the Court should approach the task of judgment. Reality, like beauty, is often in the eye of the beholder. (Cf. the comments made by J.D. Jackson in an article in 51 Mod LR 549 at 557 et seq.) What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. For the word "source", in this context, has no precise or technical reference. It expresses only a general conception of origin, leading the mind broadly, by analogy. The true meaning of the word evokes springs in grottos at Delphi, sooner than the incidence of taxes. So the exactness which the lawyer is prone to seek must be consciously set aside; indeed, with respect to a choice between various contributing factors, it cannot be attained. The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income - where it came from - as a businessman would perceive it.

Notwithstanding the constant reiteration of the principle, there remains a tendency in some parts to regard previous decisions as prescriptive. In this regard, it is wise to keep in mind the words of Rich J in *FCT v United Aircraft Corporation* (1943) 68 CLR 525 at 538:

> As the question to be determined in this case is a question of fact a decision on one set of facts is not binding and is often of little help on another set of facts.[11]

2.2 Some Recent Examples

Bearing in mind the words of Rich J, it is nevertheless worth considering some relatively recent examples.

2.2.1 *FCT v Spotless Services Limited* (1995) 62 FCR 24 – Interest

Spotless is a case on the issue of the source of interest. The case found its way to the High Court, but the source issue was not in dispute before the High Court.

In the Federal Court all four judges, Lockhart J at first instance[12] and Northrop, Beaumont and Cooper JJ on appeal[13], found that the interest was sourced wholly in the Cook Islands.

The facts of *Spotless* are complex. This was because the arrangement was designed to source the interest in the Cook Islands and not just outside Australia (a Singapore source, for example, would not have assisted the taxpayer) whilst ensuring that the commercial risk that would go with having money lent to a Cook Islands company was also completely removed.

The facts can be very simplistically summarised as follows:

(a) Spotless Services Limited and its related company, Spotless Finance Pty Limited (collectively ***Spotless***) entered into a contract with European Pacific Banking Company Limited (***EPBCL***), a company incorporated in and tax resident in the Cook Islands, pursuant to which Spotless agreed to lend $40m to EPBL at interest.

(b) Although the relevant negotiations took place in Australia, the contract, itself, was made in the Cook Islands.

(c) The moneys lent to EPBCL were provided to EPBCL by way of a cheque drawn in the Cook Islands.

(d) The loan was evidenced by a certificate of deposit which was also provided in the Cook Islands.

---

11 See also Bowen CJ in *FCT v Efstathakis* (1979) 38 FLR 276 at 278.
12 (1993) 25 ATR 344.
13 (1995) 62 FCR 244.

(e) As security for the loan, Midland Bank plc (Singapore) provided a letter of credit in favour of Spotless.

What factors were determinative? The two given the most significance by Lockhart J (with whose analysis Northrop and Cooper JJ agreed on appeal at page 276) were:

(a) the place where the contract was made – which was held to be the Cook Islands; and

(b) the place where the loan was made, again the Cook Islands, as that was where the cheque for the $40m was handed over and the certificate of deposit was received.[14]

Matters that were not relevant included the fact that Spotless only carried on business in Australia and that the deposit was undertaken as part of its usual business, albeit with "surplus" funds. Neither was any weight given to the negotiations undertaken in Australia or to the letter of credit which was an essential element of the transaction and which was unconnected with the Cook Islands. Perhaps oddly, some weight appears to have been given to the fact that the borrower carried on business solely in the Cook Islands.

In arriving at their conclusion on source, all the judges chose to either distinguish expressly or implicitly the decision in *Thorpe* (discussed below).[15]

In *Spotless*, the placing of emphasis on where the contract was made and where the money was provided might be seen as elevating conclusions of fact reached in earlier cases, *CIR v Lever Bros and Unilever Limited* (1946) SAfPC 1 and *CIR v NV Phillips Gloeilampenfabrieken* (1954) 10 ATD 435, into rules of law. Clearly, this brings a large measure of artificiality to the outcome, a conclusion that was borne out by the result ultimately reached in respect of Part IVA by the High Court.[16]

2.2.2 *Thorpe Nominees Limited v FCT* (1988) 19 ATR 1834 – Dealing with Land

Thorpe predates *Spotless* and was distinguished in *Spotless*. The case concerned land in NSW that was to be developed and sold. With a view to avoiding tax being paid in Australia, various steps were implemented in 1974 seeking to convert what would be a profit with respect to the development of the land into a profit made through dealings with options. It was hoped that by shifting value into options granted at a significant undervalue to Thorpe Nominees Limited (as the trustee of a trust), that value could be realised as foreign source income of the trust that was not then taxable in Australia because of the decision in *Union Fidelity Trustee Co of Australia Limited v FCT* (1969) 119 CLR 177.

Consequently, various documents were executed in Switzerland that resulted in significant sums being paid to Thorpe Nominees Limited for selling the right to be nominated to related companies that subsequently exercised the options and acquired the land.

The issue in *Thorpe* was the source of the profit (assessed as ordinary income) made by Thorpe Nominees Limited. All three judges, Lockhart, Sheppard and Burchett JJ in the Federal Court looked at the issue as one of substance rather than form and concluded that the source of the profit was wholly from Australia where the land was situated.

---

14 (1993) 25 ATR 344 at 360.

15 See Beaumont J at 261 and Cooper J (with whom Northrop J agreed) at 276. For a detailed critique of the case, see "Some Aspects of Source of Income", T W Magney 12 -16 (see above at footnote 2).

16 (1996) 186 CLR 404.

Lockhart J's conclusion (at 1842-3) was that:

> Viewed as a matter of substance rather than form it is plain, in my opinion, that the source of the income in question is Australia not Switzerland. The activities in Switzerland were obviously part of a pre-arranged plan, which if not pre-arranged in every detail was at least pre-arranged in all important respects with only a few loose ends to be determined. … It would give undue weight to matters of form to regard Switzerland as the source of income in question. Having regard to the practical realities of the situation and the substance of the matter, the real source of the income in question was Australia. (Emphasis added)

The contrast with *Spotless* is most interesting and the distinction between the two is not as clear to the author of this paper as it was to the judges, especially Lockhart J.

2.2.3 *Esquire Nominees Limited v FCT* (1972) 129 CLR 177 and *Consolidated Press Holdings Limited v FCT* (2001) 207 CLR 235 - Dividends

Dividends are made assessable pursuant to section 44. Section 44 has an explicit rule that looks to the source of the profits and not to the source of the dividend.

Aside from section 44, there have been and still are situations in which the source of a dividend as a question of fact has been an issue (such as foreign tax credits). The cases that deal with the source of a dividend outside of section 44 include *Nathan, Commissioner of Taxation (NSW) v Freeman* (1956) 30 ALJ 42, *Esquire Nominees* and *Consolidated Press Holdings*.

The cases illustrate the diversity of possibilities.

Nathan determined that the source of the dividend for the purposes of the *Income Tax Assessment Act 1915* (Cth) was the place where the profits were made.

Freeman, on the other hand, concluded that for the purposes of the *Income Tax (Management) Act 1936* (NSW) it was the place where the shares were registered.

In *Esquire Nominees* the relevant facts were:

(a) Esquire Nominees Limited (***ENL***) was the trustee of a trust resident in Norfolk Island.

(b) In its capacity as trustee, ENL held one B class share in Mitchell Credits Limited (***MCL***), a company resident solely in Norfolk Island.

(c) MCL, in turn, beneficially owned all the shares in Pharmaceuticals Investments Limited (***PIL***), a company resident solely in Norfolk Island.

(d) PIL, in turn, beneficially owned all the shares in Mitchell Holdings Pty Limited, a company resident in Australia.

(e) Mitchell Holdings Pty Limited paid a dividend to PIL which was then paid on as a dividend to MCL and then on to ENL.

(f) The dividend paid by Mitchell Holdings Pty Limited was itself sourced from dividends received from an Australian resident company, Manolas Pharmacy Pty Limited, which dividend was paid out of profits of a business carried on in Australia.

Amongst the issues before the Court was the source of the dividend paid to ENL by MCL and, in particular, whether the dividend was exempt on the basis that it was income derived from sources in Norfolk Island.

At first instance, Gibbs J held (at 202) that the *reality* was *that the source, and the only source, of the income derived was in Australia* as that was the only place where business was carried on

by any entity that yielded any income. As that was Australia, the source of the dividend received by ENL was Australia.

On the appeal to the Full Court, only McTiernan J agreed with Gibbs J. The other three judges, Barwick CJ, Menzies and Stephen JJ, came to the conclusion that the income derived had its source wholly in Norfolk Island.

Barwick CJ said that a company such as MCL makes its profits by investment and that (at 212):

> Further, in my opinion, the place where the company makes its investment income will be the place where it has its central management and control.

Thus, because the source of company dividends will generally be the profits of the company that pays the dividend, the dividend income of ENL was sourced where the profits were sourced, which is where MCL had its central management and control, i.e. Norfolk Island.[17]

Menzies J took the view (at 222) that *Nathan* was authority for ***the law to be applied***, namely that the *source of a dividend is that place where the company made the profit out of which the dividend was paid.* Interestingly, whereas Gibbs J had concluded that MCL was not carrying on any business, Menzies J said that it was, holding that the profit-making business of a holding company which is the source of its dividend may merely be the receipt of a dividend from another company.

Stephen J took a different approach altogether by construing what was meant by *source* in the context of section 7(1) very narrowly. It was the immediate, "the quite proximate", source that was at issue according to his Honour.[18] Consequently, it was unnecessary to look beyond either the location of the share (held by ENL) (as in *Freeman*) or the source of the profits made by MCL (as in *Nathan*).

What is disappointing about the decision of the majority of the Full Court in *Esquire Nominees* is the proposition that source can be altered by interposing another entity between the original source and the recipient thereby converting profits of a particular character and source into profits of a wholly different character and source. It is not clear how the majority opinions truly fit within the words of Isaacs J in *Nathan*.

The differences (at least as between Barwick CJ and Stephen J) are alluded to in *Consolidated Press Holdings Limited v FCT* (2001) 207 CLR 235. In that case, one of the issues in dispute with respect to Part IVA was whether a tax benefit existed. That in turn depended on, inter alia, whether the prospective dividend income from a company referred to as CPIL(UK) would have had a foreign or Australian source. The taxpayer argued that had dividends been paid by CPIL(UK) those dividends would have had an Australian source and that would have meant that there was no tax benefit.[19]

The Full Court (Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ) said at 261-262:

> The taxpayer contends that the supposed tax benefit relied upon by the Commissioner, (in effect, avoiding the operation of s 79D) depends upon the false hypothesis that the potential or prospective income to be derived by ACP if it had directly taken up shares in CPIL(UK), without the interposition of MLG, would have been income from a foreign source as defined in ss 79D(2) and 160AFD. The taxpayer submits that such income would have had an Australian source.

---

17 (1971) 129 CLR 177 at 213.
18 (1971) 129 CLR 177 at 225.
19 (2001) 207 CLR 235 at 260.

The Full Court rejected that argument adding at 262 that:

> The fund of profits of CPIL(UK), which would have been the source of dividends paid to ACP, would have been in the United Kingdom.[20]

2.3 Other Cases

There are many cases dealing with source; too many to discuss in this paper.[21] Those cases, just like those discussed earlier, offer no more than guidance. They do not lay down any rule or principle about the source of a particular form of income. The ones that are more commonly referred to include:

FCT v French (1957) 98 CLR 398, *FCT v Efstathakis* (1979) 38 FLR 276 and *Commissioner of Taxation v Cam & Sons Limited* (1936) 36 SR (NSW) 544, all of which are concerned with the source of employment income. Of these, *French* is the most significant. *French* was run as a test case. There the taxpayer had spent a short period of time working in New Zealand and the question was whether the income earned when he was in New Zealand was sourced in New Zealand.

A majority (Dixon CJ, Williams and Taylor JJ) of the Full Court said it was. As Williams J said (Dixon CJ concurring) at 415:

> It is the personal exertion which produces the income whether that personal exertion be exertion in the capacity of an employee or in the rendering of services or in the carrying on of a business. In these two cases the real source of the income in any practical sense must be the place where this personal exertion takes place.

McTiernan J said it was not.

Kitto J declined to answer the question, being of the view that further information was required before the question could be answered. His Honour (at 418-419) took the view that:

> To be in a position to answer that question we need, I think, to know more of the facts. At least we should know enough of the terms of the employment to be able to decide whether the respondent's right to remuneration depended upon the actual performance of services. I am not sure that the possibility should be left unexplored that what the respondent did in New Zealand was merely incidental to the performance of his work in Australia, and that, when regard is had to the performance of his service generally, together perhaps with the express or implied agreement of the parties as to the place for payment of his salary, the most practical conclusion may not be that no part of the salary should be attributed to a source out of Australia. I describe it only as a possibility. The proceeding before us is a case stated, and we have no authority to give a decision based upon inferences or reached by a weighing of probabilities.

As *Mitchum* subsequently showed, it cannot be said, as Kitto J pointed out, that it will always be the place where the services are performed that will be the source of employment or services income.

FCT v United Aircraft Corporation (1943) 68 CLR 525, *Tariff Reinsurances Limited v The Commissioner of Taxes (Victoria)* (1938) 59 CLR 194, *Premier Automatic Ticket Issuers Ltd* (1933) 50 CLR 268, 304 and *Studebaker Corporation of Australasia Ltd. v. Commissioner of Taxation (NSW)* (1921) 29 CLR 225 are all cases where the essence of the business or the transaction was the entering into of the contract/contracts and as a consequence the source was the place where the business was conducted/where the contracts were entered into.

---

[20] To this last statement the High Court appended the following footnote:

> *cf Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177 at 212 per Barwick CJ and 229 per Stephen J.

[21] A detailed discussion of most of the cases can be found in the two papers written by Tom Magney.

CIR (HK) v HK-TVB [1992] STC 723, perhaps by way of contrast, was a case where the place where business was carried on differed from the place where the contracts were made. The Privy Council concluded that the income was sourced in the place where business was carried on (i.e. Hong Kong) rather than where the contracts were made.

Those cases can also be contrasted with *Cliffs International Inc v FCT* (1985) 80 FLR 12. In *Cliffs* the taxpayer, a non-resident, was involved with the development of an iron ore joint venture project in Western Australia where it maintained an office. It was appointed the world representative, outside Japan, for the sale of iron ore by the joint venture and was paid commission on actual sales. The formal sales contracts were executed and payments were made in Australia. All negotiations and technical advising occurred outside Australia and the execution of contracts was said to be a *mere formality*.

Kennedy J at 32-34 concluded as follows:

> … I have formed the view … that, as a "practical, hard matter of fact", the source of the commission paid to Cliffs was overseas. To the extent to which it is possible for me to put myself in the place of a practical man, I do not believe that he would regard the real source of the income as having been in Australia. Cliffs is a company controlled in the United States, which was engaged by the participants by reason of the expertise which it had, or which was readily available to it, through its parent company, in negotiating sales of iron ore with prospective overseas purchasers. All of those negotiations took place overseas. The great bulk of the technical information which was used by Cliffs in those negotiations came either from the United States or from Japan. By the time that Cliffs had concluded its negotiations and secured offers to purchase iron ore, its work in obtaining contracts of sale effectively was done. All that remained was to submit the offers to the participants for their acceptance, which would appear to have been almost automatic, because the negotiations themselves were conducted within broadly pre- determined limits, and, in some cases, to complete the documentation. There is nothing to suggest that any contract submitted for approval to the Australian participants was ever the subject of further negotiations. When the negotiations were concluded overseas the execution of the contracts in Australia was, it seems to me, on the evidence, to have been very much a formality.

Liquidator, Rhodesia Metals Limited (in liquidation) v Commissioner of Taxes [1940] AC 774. In that case, the sole business operation conducted by an English resident company was the purchase and development of mining claims in Southern Rhodesia. The company was put into voluntary liquidation, and the liquidator sold the whole undertaking in return for cash and shares of the acquirer, another English company. The contract was negotiated and made in England and the consideration was paid and received solely in England. The Privy Council concluded that:[22]

> As a hard matter of fact the only proper conclusion appears to be that the company received the sum in question from a source within the territory, namely, the mining claims which they had acquired and developed there for the very purpose of obtaining that particular receipt.

Commissioner of Taxation (NSW) v Kirk (1900) AC 588 (PC), *Commissioner of Taxation (NSW) v Meeks* (1915) 19 CLR 568, *Commissioner of Taxation (WA) v D&W Murray Limited* (1929) 42 CLR 332; *FCT v W. Angliss & Co Pty Limited* (1931) 46 CLR 417 and *FCT v Hillsdon Watts Limited* (1937) 57 CLR 36 are all concerned with manufacturing or trading profits from dealings in commodities.

Australian Machinery & Investment Co. Limited v DCT (1946) 180 CLR 9[23] is a case nominally concerned with the source of income from dealings with shares and options. However, it would be more appropriate to characterise the case as one concerned with dealings in land as well as with shares and options as the case was concerned with a company that acquired mining leases in Western Australia which it exchanged for shares in Western Australian companies, following

---

22 Per Lord Atkin at 790.

23 See also (1946) 3 AITR 359.

which the shares in the Western Australian companies were exchanged for shares in English companies. Profits in respect of those dealings were subsequently realised in England.

Discerning a clear ratio from the case is difficult other than that the High Court concluded that the profits made in respect of the various dealings were partly sourced in Australia and partly outside and that the profit on certain options in a Victorian company, Mephan Ferguson Pty Limited, which were acquired and sold in England as part of the company's business carried on there (but otherwise seemingly unrelated to its core activities), had a source in England.

The Commissioner has issued at least 11 Interpretative Decisions (***ATO IDs***) that suggests that the case lays down a rule. For example, in ATO ID 2003/676 he says:

> The leading Australian authority on the source of profits from the sale of shares is *Australian Machinery and Investments Company Ltd v. Deputy Commissioner of Taxation* (WA) (1946) 180 CLR 9; 3 AITR 359; (1946) 8 ATD 81 where it was held that where shares are situated outside Australia and sold outside Australia, the profit on sale is derived wholly from a source outside Australia.

The same point is repeated in 10 other ATO IDs, although 7 have recently been withdrawn. The 7 withdrawn related to the application of section 79D and the previous foreign tax credit regime.

The case is often thought of as being **authority** for the source of profits from dealings in shares and options. That, of course, is not correct. The Asprey Committee[24] at paragraph 17.A7 suggested that the case could, at the very least, be taken to have rejected any general principle that the source of a profit made on the sale of shares is the place where the shares are situated.

The case is potentially relevant to profits made by non-residents trading in Australian shares or in non-Australian shares with the aid of the local funds management industry. In the ATO IDs, the Commissioner takes the position that *where shares are sold using an offshore broker, the buying and selling is undertaken and thus sourced, where the contract is concluded* outside Australia. See, for example, ATO ID 2002/903 and ATO ID 2004/563. For a situation where a non-resident contacts through a local broker, see ATO ID 2004/904; there the Commissioner says the source is in Australia.

The Commissioner's position is sometimes helpful and sometimes unhelpful. In each case the Commissioner's approach is based on a misunderstanding of the cases generally and the *Australian Machinery* case specifically.

3 "AUSTRALIA" - SECTION 6AA

Section 6AA was introduced by *Income Tax Assessment Act (No 4) 1968*. It extends the meaning of "Australia" for certain purposes including the determination of the source of income.

By section 6AA, *Australia* includes various external territories and areas that are adjacent areas for the purposes of the *Sea Installations Act 1987*, the *Petroleum (Submerged Lands) Act 1967* and the *Petroleum (Timor Sea Treaty) Act 2003*.

The accompanying Explanatory Memorandum to *Income Tax Assessment Bill (No 4) 1968* states:

> Under the present income tax law, it is a general rule that residents of Australia are subject to Australian tax on income from all sources, both inside and outside Australia. On the other hand, non-residents are subject to Australian tax only on income that has a source in Australia.

---

[24] Taxation Review Committee, Full Report, 31 January 1975.

The provisions of the new section 6AA are designed to make it clear –

(a) that Australia has the right to tax income derived from, or in connection with, petroleum exploration or mining activities on the continental shelf when the income is derived by a person who is not a resident of Australia for income tax purposes; and

(b) that taxpayers, both resident and non-resident, are entitled to the same income tax deductions, including the special deductions available for capital expenditure incurred in petroleum exploration and mining, as they would be if their operations were carried out on the Australian mainland.

The expanded definition of Australia will have effect in respect of petroleum exploration or mining operations on the continental shelf and also activities associated directly or indirectly with those operations. Thus, the income from a petroleum drilling contract, or the remuneration of a non-resident employee working on an off-shore rig, will, to the extent that it has a source on the continental shelf, be treated as having a source in Australia.

Section 6AA has been extended in terms of its application and also applies to the carrying on of an environmental related activity.

4 STATUTORY SOURCE RULES

4.1 The Asprey Committee and the Review of Business Taxation (*RBT*)

In 1975 the Asprey Committee recommended the introduction of statutory source rules. At paragraph 17.70, the Committee stated:

> In the Committee's view, determinate rules are desirable in this area of the law. The rules, where possible, should seek to identify income as having a source in Australia where it can be seen to be the product of economic activity in this country.

The Asprey Committee went on to set out some proposals as regards the appropriate source rules in an appendix to chapter 17. Amongst the many recommendations, those concerned with income from the sale of shares is worth noting. In paragraph 17.A7 and the following paragraphs the Asprey Committee recommended that:

> A profit on the realization of shares acquired by a non-resident abroad and sold in the Australian market should, in the Committee's view, be regarded as having a source in Australia if the non-resident has a place of operations in Australia and action through that place of operations was instrumental in bringing about the sale. Where, however, the shares have been both purchased and sold in the Australian market in the sense that acts by the non-resident personally, or by his agent or representative, in Australia were instrumental in bringing about both the purchase and the sale, the resulting profit should be regarded as having a source in Australia. In this case whether or not the non-resident has a place of operations in Australia will be irrelevant.
>
> Under these principles many stock exchange transactions would generate profits which would have an Australian source.
>
> The difficulties for the Revenue in ascertaining and enforcing the liability of a non-resident to tax … could only be overcome by a general provision exempting from tax all profits by non-residents arising from stock exchange transactions in Australia. The Committee would not support such an exemption.

More recently, the RBT recommended (Recommendation 23.2(c) at 683-684)[25] that the existing source rules be consolidated in the tax law, subject to:

(i) a general source principle providing that income is to be sourced in Australia to the extent such income derives from:

- functions performed in Australia,
- assets located or used in Australia, or
- risks assumed in Australia;

(ii) the place where a contract is concluded being disregarded for source purposes; and

(iii) a specific source rule providing that, where a non-resident carries on business in Australia through a permanent establishment:

- the foreign source income attributable to that permanent establishment be subject to assessment in Australia; but
- this rule not apply to collective investment vehicles (CIVs).

Essentially, the recommendations of both the Asprey Committee and the RBT have been largely ignored.

4.2 Express Statutory Source Rules

The following list of express statutory source rules is not exhaustive as it ignores the rules in relation to Norfolk Island and other external territories set out in Division 1A of Part III.

4.2.1 Section 6C – the Source of a *Royalty*

Section 6C contains a source rule for income that is derived by a non-resident and consists of a *royalty* that is covered by either section 6C(1)(a) or section 6C(1)(b).

Sections 6C(1)(a) and 6C(1)(b) provide that:

(1) This section applies to income that is derived on or after 1 July 1968 by a non-resident and consists of royalty that:

(a) is paid or credited to the non-resident by the Commonwealth, by a State, by an authority of the Commonwealth or of a State or by a person who is, or by persons at least one of whom is, a resident and is not an outgoing wholly incurred by the Commonwealth, the State, the authority or that person or those persons in carrying on business in a country outside Australia at or through a permanent establishment of the Commonwealth, the State, the authority or that person or those persons in that country; or

(b) is paid or credited to the non-resident by a person who is, or by persons each of whom is, a non-resident and is, or is in part, an outgoing incurred by that person or those persons in carrying on business in Australia at or through a permanent establishment of that person or those persons in Australia.

Section 6C is not an exclusive rule.

---

25 Review of Business Taxation, *A Platform for Consultation*, Discussion Paper 2 Volume II, February 1999.

It can be seen that sections 6C(1)(a) and 6C(1)(b) are in effect almost identical (when definitions are read in) to sections 128B(2B)(b)(i) and 128B(2B)(b)(ii), although a point of difference is that section 6C refers to income (an undefined term) whereas for section 128B(2B) *income* is defined to include a royalty, in effect as defined in section 6(1).

The effect of section 128B(2B) is to render the deemed source rule in section 6C largely if not almost completely irrelevant.

In other words, amounts covered by section 6C will nearly always fall into the royalty withholding tax rules.

There are circumstances in which a royalty derived by a non-resident will not be subject to withholding tax. Those would be situations in which the amount is not a royalty for the purposes of a relevant double tax agreement and would fall to be taxed pursuant to the Business Profits Article, the Real Property Article or the Other Income Article (and would also be outside the withholding tax rules because of section 17A(5) of the *International Tax Agreements Act 1953*).

If either the Business Profits Article or the Real Property Article applied and Australia could then tax the royalty, the double tax agreement would give the income an Australian source, again rendering the section irrelevant. Presumably, if the Other Income Article is the only relevant article, then it is possible that section 6C would be the basis upon which the royalty would have an Australian source so that Australia would be allowed to tax the royalty under section 6-5 or section 6-10.

4.2.2 Section 6CA – Natural Resource Income

Section 6CA is a source rule for income derived by a non-resident that is not a *royalty* as defined in section 6(1) and is calculated, in whole or in part, by reference to the value or quantity of natural resources produced, recovered or produced and recovered.

If applicable, section 6CA deems the income, which is referred to as *natural resource income*, to be:

(i) attributable to sources in Australia for the purposes of Divisions 5 and 6 of Part III (i.e. partnerships and trusts); and

(ii) derived from a source in Australia for the purposes of sections 6-5, 6-10 and 255.

4.2.3 Section 26E – Retirement Savings Accounts

Section 26E(1) provides that all benefits and amounts paid from or provided in respect of a *Retirement Savings Account* are taken to have an Australian source.

4.2.4 Section 27 – Interest on Loans Raised in Australia by Governments Outside Australia.

Interest received directly or indirectly by a resident on such a loan is deemed to be derived from an Australian source.

4.2.5 Section 121EJ - OBU Income

Section 121EJ mandates that income of an Offshore Banking Unit (***OBU***) derived from *OB activities* of the OBU is taken to be derived from an Australia source.

4.2.6 Proposed Sections 420-25, 420-40 and 420-45 – Registered Emission Units

As part of the new rules being introduced in relation to the Carbon Pollution Reduction Scheme, amounts included in assessable income in respect of registered emissions unit will have a source in Australia pursuant to proposed sections 420-25(3), 420-40(6) and 420-45(4).

4.2.7 The *International Tax Agreements Act 1953* (the ***ITA Act***)

The ITA Act contains a number of source rules. Some, such as section 18 concerning the source of dividends, are set out in the body of the ITA Act. Most, however, appear in the various double tax agreements (***DTAs***) set out in the schedules to the ITA Act.[26]

For a discussion of the relationship between the ITA Act and the Tax Acts, refer to the decision of Middleton J in *GE Capital Finance Pty Limited v FCT* (2007) 159 FCR 473; [2007] FCA 558; 2007 ATC 4487.

Whether the deemed source rules in a DTA can make an amount taxable when it would not otherwise be taxable remains an open question. Lindgren J in *Undershaft (No 1) Limited v FCT* [2009] FCA 41 at para [46] said that a DTA does not give Australia a power to tax what is otherwise not subject to tax, but that statement does not necessarily represent the law as the statement appears to be an obiter dictum. The Commissioner has since suggested that the law should be changed to expressly give the Commissioner the power to tax.[27]

The DTAs are not identical, so it is essential to consider the terms of any relevant DTA to ascertain what it has to say on source. However, for the purposes of this paper, it is useful to look at one example, the UK DTA.

The UK DTA refers to source in three different ways. The first way is in Article 20, the Other Income Article. See below under heading 7 for a discussion of the Other Income Article.

Secondly, Article 21 provides that:

> Income or gains derived by a resident of the United Kingdom which, under any one or more of Articles 6 to 8 and 10 to 16 and 18, may be taxed in Australia shall for the purposes of the laws of Australia relating to its tax be deemed to arise from sources in Australia.

This is an unusual source rule in that it is one way. In most instances, the rule is two way; see for example Article 23(1) of the NZ DTA which reads as follows:[28]

> Income, profits or gains derived by a resident of a Contracting State which, under any one or more of Articles 6 to 8, 10 to 20 and 22, may be taxed in the other Contracting State shall, for the purposes of the law of that other Contracting State relating to its tax, be deemed to be income from sources in that other Contracting State.

The key point is that the various amounts (usually beginning with income from real property and going through to Government service) that Australia can tax under the DTA are deemed to have

---

26 Section 11(3) of the ITA Act is a source rule for the purposes of the German DTA that ensures that income that Australia has the right to tax under the DTA has an Australian source for Australian income tax purposes. See also sections 11S(2) (re China) and 11ZF(2) (re Taiwan) of the ITA Act.

27 15 June 2009 - http://www.ato.gov.au/corporate/content.asp?doc=/content/00197255.htm.

28 In the current Japan DTA and the German DTA there is no equivalent provision. However, in the case of the German DTA, section 11(3) of the ITA Act provides *that for the purposes of the Assessment Act, income derived by a person who is a resident of the Federal Republic of Germany for the purposes of the German agreement, being income that under Articles 6 to 8 and 10 to 16 of the agreement may be taxed in Australia, shall be deemed to be derived from sources in Australia*.

an Australian source so that the Australia source requirements of sections 6-5 and 6-10 are satisfied.

Thirdly, Article 22(1)(a) provides that subject to the Australian rules from time to time in force in relation to foreign tax credits, Australia shall allow a credit for UK tax paid under UK law and in accordance with the UK DTA in respect of income or gains derived by a person who is an Australian resident from sources in the UK. Article 22(3) then deems the income or gains *owned* by an Australian resident (for the purposes of the UK DTA) that may be taxed in the UK in accordance with the UK DTA to *arise from sources* in the UK *for the purposes* of Article 22(1).

At paragraph 1.237 of the Explanatory Memorandum to the *International Tax Agreements Amendment Bill 2003* it is said in relation to Article 22(3) of the UK DTA that:

> This provision is variously included in Article 21 (*Source of income*) or Article 22 (E*limination of double taxation*) of Australia's tax treaties and has the operative effect of ensuring that where an item of income or gain is taxable in both countries, double taxation relief will be given by the recipient's country of residence in accordance with paragraphs 1 and 2 of this Article. In this way, income or gains derived by a resident of Australia, which is taxable by the United Kingdom under this treaty, will be treated as being foreign income for the purposes of the ITAA 1936 and the ITAA 1997, including the foreign tax credit provisions of the ITAA 1936.

4.3 De Facto Statutory Source Rules

There are a number of de facto statutory source rules.

4.3.1 Section 44

Strictly speaking, section 44 is only in part a de facto statutory source rule. Its purpose is to determine the basis upon which dividends both actual and deemed are made assessable and, as part of that, it contains a de facto source rule that displaces the usual source rule for *dividends* as defined in section 6(1) as well as deemed dividends. In this respect, *non-share dividends* are not deemed dividends.

Section 44 now provides that:

> (1) The assessable income of a shareholder in a company (whether the company is a resident or a non-resident) includes:
>
> (a) if the shareholder is a resident:
>
> (i) dividends (other than non-share dividends) that are paid to the shareholder by the company out of profits derived by it from any source; and
>
> (ii) all non-share dividends paid to the shareholder by the company; and
>
> (b) if the shareholder is a non-resident:
>
> (i) dividends (other than non-share dividends) paid to the shareholder by the company to the extent to which they are paid out of profits derived by it from sources in Australia; and
>
> (ii) non-share dividends paid to the shareholder by the company to the extent to which they are derived from sources in Australia; and
>
> (c) if the shareholder is a non-resident carrying on business in Australia at or through a permanent establishment of the shareholder in Australia, and the company is a resident::

(i) *dividends* (other than non-share dividends) that are paid to the shareholder by the company and are attributable to the permanent establishment, to the extent to which they are paid out of profits derived by the company from sources outside Australia; and

(ii) non-*share* dividends that are paid to the shareholder by the company and are attributable to the permanent establishment, to the extent to which they are derived from sources outside Australia.

Prior to the introduction of the 1997 Act, the relationship between section 44 and the general rules embodied in sections 25 and 23(r) was considered by the High Court in *Parke Davis & Co v FCT* (1959) 101 CLR 521. There the non-resident taxpayer argued that the deemed dividend it received (pursuant to section 47) on the liquidation of a non-resident company was sourced outside Australia under general principles and that because of section 23(r) that deemed dividend was exempt from Australian tax.

The High Court (Dixon CJ, Fullagar, Kitto, Menzies and Windeyer JJ) said that section 44 contained its own source rule that is consistent with the other general provisions of the 1936 Act *fulfilling or carrying out* the policy of the 1936 Act regarding source as set out in section 23(r). Therefore, under the 1936 Act, the fact that the deemed dividend paid in *Parke Davis* might have had a foreign source did not prevent the taxpayer being assessed under section 44.

Section 44 has been rewritten since *Parke Davis* was decided. Notwithstanding the various changes made to section 44, nothing in the 1997 Act would appear to alter the position (especially now that section 23(r) has been repealed) set out in *Parke Davis* with respect to *dividends* as defined in section 6(1). Consequently, section 44 (through sections 44(1)(a)(i), 44(1)(b)(i) and 44(1)(c)(i)) continues to ask not what is the source of a dividend but what is the source of the profits from which the dividend is paid.

However, that question (as to what is the source of the profits from which the dividend is paid) is only of relevance when section 44 (solely or together with another provision such as section 47, section 47A or Division 7A of Part III) is the provision that makes a dividend or a deemed dividend other than a *non-share dividend* potentially assessable.

Where the question of assessability concerns a *non-share dividend*, the issue is once again governed by general principles. This is made clear by sections 44(1)(a)(ii), 44(1)(b)(ii) and 44(1)(c)(ii) which refer to the source of the non-share dividend.

Bearing in mind that a *non-share dividend* (see section 974-120) will most often be paid as a legal matter as interest, discount or an amount in the nature of interest, the source of a *non-share dividend* may well be determined in a way that is similar to the cases dealing with interest, such as *Spotless*, *Phillips* and *Lever Bros*, cases that all broadly give little emphasis to the source from which the payment is made.

If the last proposition is correct, then opportunities exist for potentially avoiding both dividend withholding tax and assessability. For example, if a foreign company were to carry on business in Australia funded primarily by non-share equity provided by a foreign resident, the distributions in respect of that non-share equity which are paid by that company would not be subject to withholding tax[29] and would not necessarily be caught by section 44(1)(b)(ii), even though there is in effect a distribution that is sourced in a nominal sense from the profits made in Australia and which would have been subject to tax if the distribution had taken the form of a dividend.

[29] Section 128B(1) requires the paying company to be a resident. Section 128AAA(1) provides that Division 11A of Part III applies to a non-share dividend in the same way as it applies to a dividend and section 128(1AB) also makes it clear that for withholding tax purposes interest does not include a return on an equity interest in a company.

The Explanatory Memorandum to the *New Business Tax System (Debt And Equity) Bill 2001* expressly considers this source issue and, not surprisingly, offers a different perspective. The relevant paragraphs are as follows:

> 2.81 If a non-share distribution is a non-share dividend it is generally included in the assessable income of the non-share equity holder. Unlike dividends paid on shares, non-share dividends might be paid even if the paying company has no profits. Therefore, the inclusion of such dividends in assessable income does not depend on them being sourced from profits (as it does for shares). This is reflected in the amended section 44, which also include a clarificatory note providing a non-exhaustive list of some of the provisions of the income tax law to which the section is subject. ***[Schedule 1, item 57, subsection 44(1) of the ITAA 1936]***
>
> 2.82 If the recipients of non-share dividends are non-residents, the source of the dividends is relevant. In these cases, the recipient is assessable in respect of the non-share dividend only if it is derived from sources in Australia. **For this purpose, it is relevant to consider that the underlying purpose of the debt/equity rules is, generally, to treat non-share dividends in a similar way to normal dividends. Although questions of source are governed by the facts of each particular case, the source rules applicable to dividends are the more appropriate ones to apply.** In a typical case, the place of residence of the entity paying the non-share dividends will be the source from which the dividends are derived. (Emphasis added)

It remains to be seen if the Courts will follow this suggestion, which presupposes that there are source rules regarding the taxation of dividends as distinct from conclusions of fact about the source of dividends, conclusions which, as has been mentioned above, have varied significantly in the cases dealing with the source of dividends.

4.3.2 Divisions 12 and 15 of Part III

Division 12 of Part III, through Section 129, provides that where a ship belonging to or chartered by a person whose principal place of business is outside Australia carries passengers, livestock, mail or goods shipped in Australia, then 5% of the amount paid or payable to that person in respect of such carriage is deemed to be *taxable income* of that person derived in Australia.

Broadly speaking, the scheme of Division 15 of Part III is that premiums received by a non-resident insurer are subject to Australian tax (irrespective of where the contract is executed) if either the insured property is in Australia or the event insured against can only happen there or the insured person is an Australian resident, and the insurance was entered into through the instrumentality of an agent or representative in Australia of the overseas insurer.

Division 15 of Part III effectively reverses the decision in *Tariff Reinsurances Limited v The Commissioner of Taxes (Victoria)* (1938) 59 CLR 194. In that case it was decided that the income derived by a non-resident company from a contract of reinsurance (negotiated and entered into in England) whereby it reinsured the liabilities of the Automobile Insurance Co. of Australia Limited had a source outside Victoria because the English company did not carry on business in Victoria.

Section 142 operates to give premiums on contracts of insurance entered into by a non-resident insurer an Australian source if the insured property at the time the contract is made is in Australia or the insured event is one that can only happen in Australia, unless the contract was made through a principal office or branch of the insurer in Australia.

If section 142 applies, section 143 provides that 10% of the total amount of the premiums paid or payable in a year shall be the insurer's taxable income for that year from those activities unless the insurer can establish the actual profit or loss in respect of the premiums to the Commissioner's satisfaction, in which case the taxable income shall be calculated by reference to the actual receipts and expenditures.

There is also a special rule within Division 15 of Part III (section 148) for reinsurance that makes 10% of the reinsurance premiums paid to a non-resident reinsurer the taxable income of the reinsurer if the insurer (not the reinsurer) entering into the contract wants to claim a deduction for the reinsurance premiums payable under the reinsurance contract.

4.3.3 Section 128B

Clearly, section 128B imposes withholding tax on dividends, interest and royalties regardless of source. However, the effect of sections 128B and 128D is to re-characterise what is taxed by providing de facto source rules.

4.3.4 Partnership and Trust Income

Sections 92(1), 97(1), 98A(1) and 100 all contain a de facto statutory source rule because those sections include an amount in the assessable income of a "non-resident" by reference to the source of the underlying partnership or trust income. In each case, the assessable amount is limited to so much of the non-resident's share of the net income of the partnership or trust as is *attributable to sources in Australia*.

The reference here is to the source of the net income so that the non-resident's assessable income is limited to its "proportionate share" of the net income[30] that is attributable to sources in Australia, which naturally requires one to enquire as to the source of the amounts that go to make up the net income of the partnership or the trust. This raises interesting issues with respect to net capital gains where, for example, the trust is an Australian resident trust, but the sources of the gains made are outside Australia and the beneficiaries are non-residents.

Section 6B(2A) is a specific provision that seeks to deal with the issue of source when income is derived as a consequence of a trust or some other situation where the beneficial owner may not be the person in receipt of the income. It has featured in a ruling and two interpretative decisions – TR 2007/4 and ATO IDs 2007/48 and 2007/108.

The section provides that:

> For the purposes of this Act, an amount of income derived by a person shall be deemed to be income derived from a particular source:
>
> (a) except where paragraph (b) applies -
>
> (i) if the person derived the amount of income by reason of being beneficially entitled to an amount that is derived from that source; or
>
> (ii) if the person derived the amount of income as a beneficiary in a trust estate and the amount of income can be attributed, directly or indirectly, to income derived from that source or to an amount that is deemed, by any other application or applications of this subsection, to be an amount that is income derived from that source; or
>
> (b) if the income so derived is, by virtue of subsection (1), (1A) or (2), attributable to a dividend, passive income or interest income derived from that source.

[30] See, inter alia, *Zeta Force Pty Limited v FCT* (1998) 84 FCR 70 and *Bamford v FCT* [2009] FCAFC 66.

The relevant explanatory memoranda simply tell us the obvious; namely that the section *specifies basic rules to identify the particular source of income derived by a person in given situations*.[31]

The section does deal with the source of statutory income in a limited way in that it has something to say about statutory income that arises as a consequence of a partnership or a trust and seeks to carry through to the person beneficially entitled or the beneficiary, as the case may be, the source of the income derived by the partnership or the trustee.

The role of the section was originally to assist with the claiming of foreign tax credits (as it was introduced as part of the *Taxation Laws Amendment (Foreign Tax Credits) Act 1986*). However, as ATO ID 2007/108 demonstrates, the Commissioner sees it as having a wider role to play with respect to the question of source.

In ATO ID 2007/108, the Commissioner considered whether the taxpayer, a temporary resident, could benefit from section 768-910, which provides that statutory income of a temporary resident from a source other than an Australian source is non-assessable non-exempt income. The income in question was derived by the taxpayer as a life tenant of a UK resident trust. The trustee had derived Australian source income. The Commissioner relied on section 6B(2A) and cases such as *Syme v Commissioner of Taxation (Vic)* (1914) 18 CLR 519 (a decision of the Privy Council), *Charles v FCT* (1954) 90 CLR 598 and *FCT v Tadcaster* (1982) 13 ATR 245 to conclude that the income derived by the trustee retained its character as it passed through the trust and was therefore not covered by section 768-910.

4.3.5 Subdivision 855 – "Taxable Australian Property"

Foreign residents have never been subject to tax in Australian on capital gains (under the "CGT") by reference to source except perhaps where partnerships and trusts are involved.

Subdivision 855 continues to use a de facto measure as the basis for tax. This time it is *taxable Australian property* in lieu of what was previously *assets having the necessary connection with Australia* and before that *taxable Australian assets*.

4.3.6 Employee Shares and Options

An interesting example of a de facto statutory source rule concerns "employee share schemes" in Division 13A of Part III and the related temporary resident rules in Subdivision 768-R. The various changes that have been made to these rules over the last few years are designed, in theory, to apportion the taxing rights with respect to the benefit by reference in effect to the principle in *French*.

The Explanatory Memorandum to *New International Tax Arrangements (Foreign-Owned Branches And Other Measures) Bill 2005* explains some of the changes as follows:[32]

- Income assessed under the employee share scheme provisions, like other employment income, is able to qualify for existing exemptions for offshore employment, and be treated as employment income for foreign tax credit and loss purposes.

- For relevant shares or rights acquired when employed offshore, the employee share scheme provisions apply at the time of first becoming an Australian employee. Income attributable to employment subsequently performed in Australia will be taxable.

---

31 See the notes to clause 7 of the Explanatory Memorandum to *Taxation Laws Amendment (Foreign Income) Bill 1990* and to clause 4 of the Explanatory Memorandum to *Taxation Laws Amendment (Foreign Tax Credit) Bill 1986*.

32 Paragraph 4.12.

- Amounts are not assessable under the employee share scheme provisions to the extent that the share or right acquired relates to relevant employment offshore while not an Australian resident.

Correspondingly, at paragraph 1.36 of the Explanatory Memorandum to *Tax Laws Amendment (2006 Measures No. 1) Bill 2006* it is stated that:

> The overriding policy consideration when it comes to the treatment of gains or losses on employee shares or rights held by temporary residents is to make sure that their employment remuneration while in Australia is subject to Australian tax despite the concessions being provided to them. Net gains on employee shares and rights are not totally ignored which would otherwise often be the case under the general CGT treatment of temporary residents

The level of complexity involved is remarkable when it is recognised that the relevant aim is simply to allow Australia to tax what is in effect income or a gain that has an Australian source.

4.3.7 Section 40-290

Section 40-290 provides that:

> You must reduce the amount (the ***balancing adjustment amount***) included in your assessable income… if your deductions for the asset have been reduced under section 40-25.

Broadly, section 40-25 requires a deduction for depreciation to be reduced if the depreciating asset has been used or held ready for use for a purpose other than a *taxable purpose*.

Taxable purpose is defined in section 40-25(7) and includes the purpose of producing assessable income. Assuming that the matter is not covered by one of the parts of the definition of taxable purpose such as the purpose of exploration or prospecting, this means that the balancing adjustment amount is, in effect, generally only made assessable to the extent that it relates to the derivation of ordinary or statutory income from an Australian source.

4.3.8 Foreign Exchange Gains

It is simply noted that Subdivision 775-B clearly operates by reference to a de facto source rule because of the way the Subdivision is structured. Instead of looking at the source of the gain, the Subdivision links the assessability of the gain to the characterisation of the underlying event.

For example, a gain made in respect of interest that a non-resident derives that is subject to withholding tax is excluded by section 775-25 (as it is made non-assessable non-exempt income).

Correspondingly, a gain made in respect of an income receipt from, for example, the sale of goods where the income from the sale is assessable would be made assessable by section 775-15 (there being no relevant exclusion) regardless of the source of the gain.

4.3.9 Section 6AB

Section 6AB(1) tells us that:

> A reference in this Act to foreign income is a reference to income (including superannuation lump sums and employment termination payments) derived from sources in a foreign country or foreign countries, and includes a reference to an amount included in assessable income under section 26D, 102AAZD, 456, 457, 459A or 529 of this Act, or section 305-70 of the *Income Tax Assessment Act 1997*.[33]

[33] See also sections 6AB(1A) and 6AB(1C).

Originally, certain types of statutory income, such as attributable income under the transferor trust, foreign investment fund and controlled foreign company rules, being expressly included in the definition of foreign income, therefore had a foreign source for the purposes of the foreign tax credit rules.

The changes that have been made with the introduction of the foreign income tax offset regime mean that this statutory source rule may be of little or no benefit.

4.4 Section 136AE – the Commissioner's Determination

Section 136AE, if applicable, serves several purposes, one of which is with respect to the determination of the question of source.

The gateway to sections 136AE(1) and (2) is a determination by the Commissioner that a corresponding provision in section 136AD applies. Therefore, for those sections to apply (in respect of a supply) there must have been a supply under an *international agreement*, a determination by the Commissioner that the parties were not dealing at arm's length, no consideration was received or receivable, or the consideration received or receivable in respect of the supply was less than the arm's length consideration, and a further determination by the Commissioner that the section should apply.

If as a consequence of the application of a relevant provision in section 136AD a question arises as to source of income, then the relevant provision of section 136AE allows the Commissioner to determine the source or sources of the income.

It is, however, also the case that sections 136AE(4), (5) and (6) allow the Commissioner to make a determination as to source in circumstances in which none of the requirements of sections 136AE(1) and (2) are met.

For example, if a non-resident carries on a business in Australia at or through a *permanent establishment* (as defined in section 6(1)) of the non-resident in Australia and a question arises as to the source of income, then the Commissioner is potentially empowered to make a determination as regards the source of income.

The same applies in respect of a resident carrying on a business in a country other than Australia at or through a *permanent establishment* of the resident in that other country or if the resident carries on business in an area covered by an international tax sharing treaty.[34]

If section 136AE allows the Commissioner to make a determination regarding source, section 136AE(7) says that:

> In the application of the preceding provisions of this section in determining the source or sources of any income derived by a taxpayer … the Commissioner shall have regard to:
>
> (a) the nature and extent of any relevant business carried on by the taxpayer and the place or places at which the business is carried on;
>
> (b) if any relevant business carried on by the taxpayer is carried on at or through a permanent establishment--the circumstances that would have, or might reasonably be expected to have, existed if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer and other persons; and
>
> (c) such other matters as the Commissioner considers relevant.

[34] An international tax sharing treaty is defined in 6(1).

The Explanatory Memorandum to *Income Tax Assessment Amendment Bill 1982* simply restates the general statements made in the legislation:

> Sub-section 136AE(7) sets out the criteria to which the Commissioner is to have regard in determining the source or sources of any income … . The Commissioner is to have regard firstly, to the nature and extent of any business activities of the taxpayer and the place or places at which the business was conducted - that is, to the taxpayer's actual circumstances including the degree to which it operates in one country or another. Secondly, and most importantly, in a case where business is carried on by a taxpayer at or through a permanent establishment, the Commissioner must postulate the circumstances that would have existed, or might reasonably be expected to have existed, if the permanent establishment were a distinct and separate entity dealing at arm's length with the taxpayer and other persons. This basic principle is in provisions included in each of Australia's double taxation agreements for determining the amount of profits of an enterprise that are to be attributed to a permanent establishment. Lastly, the Commissioner is to have regard to other relevant matters.

There is, as yet, no case on the extent of the Commissioner's power to determine source pursuant to section 136AE. The Explanatory Memorandum does suggest that the Commissioner is not entirely free to make a determination that disregards the likely circumstances, but it certainly remains an open question as to what constraints there are on the Commissioner in making his determination.

4.5 The Repealed Provisions

Sections 38 to 43 (Subdivision C of Division 2 of Part III) were repealed late last year. These provisions nominally dealt with businesses that were carried on partly in and partly out of Australia and which involved the sale of goods. They were not so much source rules as rules for allocating profits and making those profits allocated to Australia assessable income (which is akin to a source rule).

The rules were subject, of course, to the overriding application of a relevant double tax agreement.

Basically:

- Sections 38 and 39 were relevant, respectively, to sales by manufacturers and non-manufacturers of goods into Australia and applied to determine the profit from the sale that would be *derived in Australia* and potentially taxable in Australia with some degree of certainty.

- If sections 38 and 39 applied but the profit could not be ascertained to the Commissioner's satisfaction, then the Commissioner determined the profit (section 40).

- Section 41 contained a deeming provision which, if applicable, deemed there to be a sale of the goods in Australia.

- Section 42 was a default rule that allowed the Commissioner to determine the Australian source profits where the other (earlier) provisions did not apply with respect to the question of whether any profit was derived from sources in Australia if the matter related to any of:

    - goods being manufactured, produced or purchased in one country and sold in another;
    - successive steps of manufacture or production in different countries; or
    - contracts that were made in one country but performed in another.

In effect, these rules resulted in a determination of de facto Australian source profits that section 43 then made assessable income.

According to the Explanatory Memorandum to *Tax Laws Amendment (Repeal of Inoperative Provisions) Bill 2006*, these provisions ceased to perform any role after the enactment of the transfer pricing rules in 1982 (see paragraph 2.33). It is not immediately apparent why this is so in all cases, but it is clearly true in relation to non-arm's length dealings.

The other repealed source rules are section 25(2), which deemed interest secured on property in Australia to have an Australian source in certain circumstances, and section 23(r), the general rule for non-residents that exempted foreign source income. [35]

Section 23(r) was rewritten on the introduction of the 1997 Act.[36] It was stated in the Joint Explanatory Memorandum at page 39 that:

> Most ordinary and statutory income from foreign sources is not assessable to foreign residents.

At page 44, the Joint Explanatory Memorandum then went on to say that:

> Paragraph 23(r) of the *Income Tax Assessment Act 1936* provides that 'income derived by a non-resident from sources wholly out of Australia' is 'exempt from income tax'. The 1936 Act contains a few provisions which assess an amount on a basis not strictly expressed as having an Australian source eg. the capital gains and losses provisions bring to account gains and losses on the disposal of a 'taxable Australian asset' rather than on Australian-sourced capital gains and losses.
>
> Under the current law, paragraph 23(r) does not exempt these amounts. It is merely a corollary of the general income provision, subsection 25(1), which assesses non-residents on all their income from sources in Australia.
>
> The core provisions will not change this position. However, because of the rewording of the source rules for assessable income of non-residents in subclauses 6-5(3) & 6-10(5), paragraph 23(r) on its face would no longer perfectly complement these rules.
>
> Consequently, it has been rewritten with additional words in parenthesis clarifying that the paragraph does not exempt income that a specific provision assesses on a basis other than having an Australian source.

In repealing section 23(r), paragraph 2.16 of the Explanatory Memorandum to *Tax Laws Amendment (Repeal of Inoperative Provisions) Bill 2006* states that:

> It is clear that the paragraph performs no function because amounts of ordinary or statutory income that a foreign resident derives from a non-Australian source are never included in assessable income in the first place unless a specific provision does so on a basis other than their source (see subsections 6-5(3) and 6-10(5) of the *Income Tax Assessment Act 1997* (ITAA 1997)). The fact that those provisions stop amounts of ordinary income from being included in assessable income makes them exempt income (see subsection 6-20(2)) and amounts that would otherwise be included as statutory income are not 'income' in the first place. (Emphasis added)

---

35 Item 40 of Schedule 1 of the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006*

36 Section 23(r) as amended read:

> *Subject to section 22A, the following income shall be exempt from income tax:*
> *(r) income derived by a non-resident from sources wholly out of Australia (except income that a provision of this Act includes in a taxpayer's assessable income on some basis other than having an Australian source);*

5 SECTION 3AA OF THE ITA ACT

The ITA Act also contains a "de-sourcing" rule (for want of a better expression).

If applicable, section 3AA[37] "overturns" (with respect to the question of source) the impact of section 3(11) of the ITA Act and the equivalent provisions of a DTA[38] (collectively ***section 3(11)***).

Section 3(11)[39] provides:

> Where:
>
> (a) a beneficiary of a trust estate (not being a prescribed trust estate) who is a resident of a country with which, or with the government of which, Australia, or the Government of Australia, has made an agreement before the commencement of this subsection[40] is presently entitled, either directly or through one or more interposed trust estates, to a share of the income of the trust estate derived from the carrying on by the trustee in Australia of a business through a permanent establishment in Australia; and
>
> (b) under the agreement, the income is to be dealt with in accordance with the article (in this subsection referred to as the business ***profits article***) of the agreement relating to the taxing of income of an enterprise of a Contracting State where the enterprise carries on a business in the other Contracting State through a permanent establishment in the other Contracting State;
>
> for the purpose of determining whether the beneficiary's share of the income may be taxed in Australia in accordance with the business profits article:
>
> (c) the beneficiary shall be deemed to carry on in Australia, through a permanent establishment in Australia, the business carried on in Australia by the trustee; and
>
> (d) the beneficiary's share of the income shall be deemed to be attributable to that permanent establishment.

Essentially, section 3(11) deems a presently entitled beneficiary of a trust to have carried on business in Australia through a permanent establishment and to have income attributable to that permanent establishment if the trustee carries on business in Australia through a permanent establishment in Australia.

When section 3(11) is read with the associated Source of Income Article in the relevant DTA or the ITA Act, the beneficiary is taken to have derived Australian source income.

Not long after section 3(11) took effect it was decided that section 3(11) was inappropriate with respect to "funds management" and section 3AA was introduced to undo the effect of the Source of Income Articles and similar provisions in the ITA Act.

Consequently, in those circumstances in which section 3(11) is applicable and section 3AA is also applicable, the question of whether the income and profits that are attributed to the beneficiary have an Australian source is determined by reference to the *ordinary rules for determining source of income for domestic law purposes*.[41]

---

37 Inserted by *New International Tax Arrangements (Managed Funds and Other Measures) Act 2005*; assented to on 21 March 2005.

38 See, for example, Article 7(9) of the US DTA and Article (2) of the Protocol to the Mexico DTA.

39 Inserted by section 3 of the *Income Tax (International Agreements) Amendment Act 1984*.

40 19 October 2004.

41 Paragraph 2.5 of the Explanatory Memorandum to *New International Tax Arrangements (Managed Funds and Other Measures) Bill 2005*.

Without wishing to oversimplify the matter, the key requirement of section 3AA is that the beneficiary is presently entitled directly or indirectly to a share of the income of a *widely held unit trust* derived from the carrying on by the trustee in Australia of *funds management activities* through a *permanent establishment* in Australia, where *funds management activities* is defined to mean:

> activities carried on by:
>
> (a) a managed investment scheme (as defined by section 9 of the *Corporations Act 2001*) that is a widely held unit trust; or
>
> (b) a managed investment scheme (as so defined) that is a unit trust that is closely held by one or more of these:
>
> (i) a managed investment scheme (as so defined) that is a widely held unit trust;
>
> (ii) a complying superannuation entity;
>
> (iii) a life insurance company.

The "de-sourcing" rule in section 3AA is itself subject to one exception, namely, if a transfer pricing adjustment is made pursuant to the Business Profits Article or the Associated Enterprises Article of a relevant DTA.[42]

6 THE SOURCE OF STATUTORY INCOME

It is perhaps only in the writer's mind that the source of statutory income is a vexed question. By definition, statutory income is not income, although it may have its origin in something that is income or which produces income or a capital gain.

In *French*, Kitto J said at 417:

> The Australian Act, in such provisions as ss. 23(q) and 25, assumes that it is possible to identify, with respect to every amount of income, some activity event or thing which may properly, though metaphorically, be described as the source from which that income has been derived …[43]

The same may be said of statutory income.

It will be recalled from the earlier discussion of *Parke Davis* that in that case the non-resident taxpayer argued that the deemed dividend it received (pursuant to section 47) on the liquidation of a non-resident company was sourced outside Australia under general principles and that because of section 23(r) that deemed dividend was exempt from Australian tax.

In rejecting that argument the High Court (Dixon CJ, Fullagar, Kitto, Menzies and Windeyer JJ) said at 527-528 that:

> We think that s. 44 (1) is intended to provide the territorial criteria for including a dividend in the assessable income of a shareholder. Section 44 (1) (b) gives the criterion for judging the source of a dividend in the case of a shareholder who is a non-resident. For s. 44 (1) (b) provides that the assessable income of a shareholder in a company shall, if he is a non-resident, include dividends paid to him by the company to the extent to which they are paid out of profits derived by it from sources in Australia. By force of s. 47, the transaction I have described must be treated as having resulted to the extent of 106,414 pounds in a dividend. By that I do not mean an actual dividend, but part of a distribution which in terms is to be deemed to be a dividend. The question that remains under s. 44 (1) (b) is whether the source from which that

---

42 Section 3AA(3). It should also be noted that the new managed investment fund withholding tax rules will be relevant in determining the tax position.

43 See also Barwick CJ in *Union Fidelity* at 181.

> dividend was paid was in Australia, and that question is answered by the facts in the case stated which show that to the extent of 106,414 pounds the profits included in the distribution represented income earned in Australia. So far as ss. 44 (1) and 47 are concerned that would appear to bring the imputed dividend, if I may so call it, within the assessable income. But there remains to be considered the operation of s. 23 (r), considered, of course, in conjunction with s. 25 (1) (b).
>
> Section 23 (r), it has been argued, is an overriding provision which must be considered before you go to the process through which I have gone of applying s. 44 (1) (b), or for that matter, s. 47. Doubtless it is not impossible to construe the Act so as to give s. 23 (r) an overriding effect, an effect which would mean that at all hazards and despite all other considerations it must be applied to control every other provision and to do so independently of what subsequently appears. At all events the argument began with that contention; it was then said that it is well settled that prima facie the source of a dividend paid to a shareholder is the share, that the locality of the share is fixed by the register upon which the shareholder is registered and that therefore the register determines conclusively in point of law what is the locality which is the source of the dividend. An alternative view of the construction of the Act is that s. 23 (r) is a general provision expressing a policy of the Act, a general provision that you might expect the Act to carry into effect as to particular subjects by specific provisions, and that where in the rest of the Act there are specific provisions with respect to sources of income, those provisions may be taken as fulfilling or carrying out or, if the word is preferred, as being epexegetical to, s. 23 (r).
>
> We take the latter view of the place of s. 23 (r) in the Act, and we are of opinion that s. 44 (1) (b) is an explicit provision to which effect must be given. It is true that the paramount policy expressed in s. 23 (r) of confining the assessable income of a non-resident to his income from sources wholly within Australia remains, but it is not right to interpret s. 23 (r) independently of every other provision of the Act. It is not right to suppose that in its application to income consisting of dividends it must have an operation that is independent of anything that may be found upon the same subject in any subsequent provision of the Act and on that supposition to treat it as necessarily meaning that inasmuch as a shareholder derives his dividend from his share the locality of the source of the dividend is the locality of the share and that that is the place of the register upon which the shareholder is registered in respect of the share. On the contrary, it must be read with s. 44 (1) (b) which is the particular provision giving specific effect to s. 23 (r) in the case of dividends. When s. 44 (1) (b) is read with s. 23 (r) there is no apparent inconsistency; on the contrary s. 44 (1) (b) appears to carry out the scheme of the general provision in providing that the assessable income of a shareholder in the company, when the shareholder is non-resident, is to include dividends paid to him by the company to the extent only to which they are paid out of profits derived from sources in Australia.
>
> (Emphasis added)

The underlying assumption in *Parke Davis* is that statutory income – *the imputed dividend* - had a source. It was, however, unnecessary for the High Court to decide if the deemed dividend did indeed have a source and what that source was because section 44(1)(b) contained its own source rule.

But if there is no source rule express or implied in the assessing provision, how does one ascertain the source of statutory income? Moreover, when can one be certain that the legislative intention is to include statutory income in the assessable income of a foreign resident on a basis other than that the statutory income has an Australian source?

Presumably, the answer to the first question is that it is to be ascertained in accordance with the principle in *Nathan* if there is no relevant statutory source rule such as section 44(1)(b) or section 139B(1A) or a relevant DTA. This may seem blindingly obvious to some, but it is by no means clear from the way the legislation is drafted. One might be forgiven for thinking that if something is a statutory construct, how is it that it has a source unless it is given one by its creator, the draftsman of the Tax Acts?

Clearly, in many cases, the source of statutory income can be factually linked directly to an act or an activity or to an item of property that can be regarded as the source as a matter of fact; see

most recently Lindgren J in *Fowler v FCT* [2008] FCA 528 at paragraph [52]; (2008) 167 FCR 425 at 434. But that may not always be the case.

With respect to the second question, it is something that may not always be obvious and will require careful consideration of the terms of the legislation. Some examples are given earlier in this paper in relation to employee shares and options, depreciating assets and exchange gains. Those provisions are like section 44(1)(b) in *Parke Davis*. However, others are likely to exist and await your discovery of them.

7 OTHER MATTERS

7.1 Apportionment

One clear aspect of the cases on source is that the Courts have been prepared to apportion source - see *Australian Machinery & Investment Co. Limited v DCT* (1946) 180 CLR 9.

This was more prevalent in the early cases, particularly those concerned with manufacturing and trading profits involving legislation other than the 1936 Act and the 1997 Act – see, for example, *Commissioner of Taxation (NSW) v Kirk* [1900] AC 588 (PC), *Commissioner of Taxation (NSW) v Meeks* (1915) 19 CLR 568, *Commissioner of Taxation (WA) v D&W Murray* Limited (1929) 42 CLR 332 and *FCT v W. Angliss & Co Pty Limited* (1931) 46 CLR 417.

More recently, the cases have tended to determine a single geographic source, but that is probably a function of the cases coming before the Courts rather than a shift in judicial attitudes and approaches to the question of apportionment.

7.2 The Other Income Article

It is a feature of Australia's DTAs to include a provision along the lines of paragraph 3 of Article 20 of the UK DTA.[44] That paragraph provides that:

> Notwithstanding the provisions of paragraphs 1 and 2 of this Article, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention from sources in the other Contracting State may also be taxed in the other Contracting State.

In other words, income not dealt with in the preceding Articles of the UK DTA, for example, which has an Australian source may also be taxed in Australia and vice versa. This presumably brings one back to general principles as to the determination of source – the *Nathan* test - and the **express** statutory source rules other than those embodied in the UK DTA, bearing in mind that *sources* is an undefined term (see Article 3(3) of the UK DTA).

7.3 Conduit foreign income – 802-30

There is no direct reference to source in Subdivision 802-A, although section 802-30 is headed, "**Foreign source income amounts**". The Explanatory Memorandum to *Tax Laws Amendment (Loss Recoupment Rules and Other Measures) Bill 2005* tells us at paragraph 5.22 that:

> Broadly, conduit foreign income is a foreign amount derived by an Australian company which the company has available to distribute as a profit to its shareholders. Much of that income or gain is exempt from Australian tax when derived by the company and so would be subject to withholding tax when distributed to the company's foreign owners. This is the income that these provisions are primarily targeting. Foreign amounts that are normally included in an Australian company's assessable income are excluded from conduit foreign income in the first instance because they generate

---

[44] There is no equivalent provision in the Other Income Article of the OECD Model Tax Convention on Income and on Capital, Article 21. Australia, Canada, Mexico, New Zealand, Portugal and the Slovak Republic each reserve their position and seek to maintain the right to tax income from sources in their own country.

franking credits that allow the net profit amount to be distributed to foreign shareholders free of further Australian tax *[Schedule 2, item 1, subsection 802-30(2)]*. If foreign tax credits reduce the Australian tax liability in relation to the assessable foreign income then an amount is included in conduit foreign income. This is explained in paragraphs 5.63 to 5.67.[45]

8 CONCLUSION

In the 30 years since Tom Magney published his first paper on the issue, the landscape regarding the determination of source has changed. Unfortunately, the legislative changes that have occurred have been haphazard and have in some cases resurrected old issues and naturally created others.

Cases such as *Esquire Nominees* and *Spotless* show that opportunities for manipulation of source potentially exist notwithstanding the fact that the issue is in the main one of fact. Resolving matters through Part IVA is unsatisfactory. Clearly, the arguments for introducing statutory source rules remain valid.

---

[45] Recently, Division 802-40 has been amended to take account of the change from the foreign tax credit system to the new foreign income tax offset regime.