

INTRODUCTION

The entities affected by the new rules are collectively referred to as foreign hybrids (for example, United Kingdom and United States (US) limited partnerships/limited liability partnerships (LPs), US limited liability companies (US LLCs) and other specifically identified entities). Typically, foreign hybrids are treated for foreign tax purposes as partnerships (i.e. the partner or member is subject to tax) in the foreign jurisdiction but as companies under Australia's current taxation laws.

The current Australian income tax law treats foreign hybrids as companies, so taxpayers with interests in them (as partners or members) are subject to the controlled foreign companies (CFC) regime or foreign investment fund (FIF) regime. However, the CFC provisions, and to a lesser extent the FIF rules, do not effectively cater for hybrids because these rules are based on a company model.

The effect of applying the current CFC provisions is that foreign hybrids may have a wider range of income subject to attribution. This increases the potential for double taxation because of the denial of deductions/credits for foreign tax paid when taxed in Australia. The CFC rules require the foreign hybrid to pay the tax (but in fact foreign tax is paid by the partner). In essence, the present application of the CFC rules to foreign hybrids means that income which is actually comparably taxed (but in the hands of a different entity) is being attributed. This is inconsistent with the underlying policy of the CFC rules.

The new rules will treat foreign hybrids as partnerships instead of companies, for the purposes of Australia's income tax laws. This change is designed to provide certainty and remove unintended consequences for taxpayers that result from the current taxation treatment of foreign hybrids under the CFC regime, and to a lesser extent the FIF regime.

NEW TAX TREATMENT FOR FOREIGN HYBRIDS

Under the new rules, foreign hybrids will be treated as partnerships for the purposes of Australia's income tax laws. The current treatment of foreign hybrids as companies (either under Division 5A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) dealing with corporate limited partnerships, or for US LLCs by virtue of subsection 6(1) of the ITAA 1936) will no longer apply.

A foreign hybrid that is an LP will be excluded from the operation of Division 5A of Part III of the ITAA 1936. A foreign hybrid that is a US LLC will be treated as a partnership under Division 5 of Part III of the ITAA 1936. Appropriate modifications to the income tax law will be made to ensure that the provisions of the income tax law apply to the US LLC (and its members) as if the US LLC is a partnership and its members are partners.

As a result, the partners/members in the foreign hybrid will now be taxed as partners under Division 5 of Part III of the ITAA 1936.

HYBRIDS SPECIFICALLY EXCLUDED FROM THE RULES

The new rules will *not* apply to hybrids which:

- a) carry on business in Australia (for example, resident corporate limited partnerships); or
- b) would otherwise be dealt with under the FIF regime, and not the CFC regime.

The first category will continue to be taxed as companies by virtue of Division 5A of Part III or subsection 6(1) of the ITAA 1936.

The second category deals with concerns that taxpayers with a relatively smaller holding in a foreign hybrid (otherwise known as retail investors) may not have access to sufficient information to be taxed as partners if partnership treatment were imposed. However, investors in such FIFs will be able to make an irrevocable election to have partnership treatment apply (this is discussed below).

FOREIGN HYBRIDS COVERED BY THE NEW RULES

Generally, apart from the specific exclusions mentioned above, three types of entities will be classified as a foreign hybrid and will now be treated as a partnership for the purposes of Australia's income tax laws. The entities to come within the new rules are:

1. Certain limited partnerships and limited liability partnerships (LPs).
2. Certain United States limited liability companies (US LLCs).
3. Other entities specifically listed.

Certain limited partnerships and limited liability partnerships

The new rules will apply to LPs formed under the laws of another country which:

- a) are not Australian resident corporate limited partnerships; and
- b) are treated for tax purposes as a partnership in that country for that year of income (whether by reason of a law, decree, proclamation, instrument or direction issued by a competent authority or an administrative arrangement of that foreign country); and
- c) are not treated as a resident taxable entity in any other country.

Certain US limited liability companies

The new rules will apply to US LLCs which:

- a) are not Australian resident companies; and
- b) are treated for US tax purposes as a partnership or 'disregarded entity' for that year of income (whether by reason of a law, decree, proclamation, instrument or direction issued by a competent authority or an administrative arrangement of the US); and
- c) are not treated as a resident taxable entity in any other country.

Other entities listed

The new rules will also apply to other entities specifically listed in Regulations. Such other entities will be listed at a later date only so as to achieve similar tax results for comparable arrangements as they are identified. The list will *not* include any trust-like entities, for example, Anstalts and Stiftungs.

TAXPAYERS AFFECTED

Investors with a CFC interest

Attributable taxpayers with direct interests in foreign hybrids that, under current law, are CFCs will no longer have to apply the CFC rules, but instead will have to apply the partnership rules in Division 5 of Part III of the ITAA 1936.

Attributable taxpayers that have indirect interests in foreign hybrids, through an interposed CFC that is not a foreign hybrid will continue to apply the CFC rules to the interposed CFC, but in doing so, will treat the CFC as being a partner in the foreign hybrid.

Investors with a FIF interest

Taxpayers with direct and/or indirect interests in foreign hybrids that, under current law are FIFs, will **not** have the new rules apply, unless they elect for such treatment.

FIF investors irrevocable election to have partnership treatment apply

Taxpayers with direct or indirect interests in foreign hybrids that would otherwise be dealt with under the FIF regime (and not the CFC regime) will be able to, on a case by case basis, make an irrevocable election to have the same treatment apply as for those with larger interests. This provides flexibility, particularly for institutional investors who may have access to the necessary information, may prefer to have their interest(s) treated as an interest in a partnership.

OVERVIEW OF HOW THE CHANGES WILL AFFECT THESE INVESTORS

The following table compares the application of the current law to the new rules by the type of investment a taxpayer is likely to have in a foreign hybrid.

	Type of investment	Current law application	New law application
1.	Directly held <i>CFC interest</i> in a foreign hybrid.	CFC rules currently apply.	1. Division 5 of Part III of the ITAA 1936, dealing with partnerships, will apply. <i>See below: Partnership treatment – direct investment</i>
2.	Indirectly held <i>CFC interest</i> in a foreign hybrid through another CFC (that is not a foreign hybrid).	CFC rules currently apply, with the foreign hybrid treated as an ‘eligible’ CFC in its own right.	2. Foreign hybrid will be treated as a partnership. The CFC rules will apply to the first tier CFC, including its interest in the partnership. <i>See below: Partnership treatment within the CFC rules</i>
3.	Directly held <i>FIF interest</i> in a foreign hybrid.	FIF rules currently apply.	3(a) no change as the investment is excluded from the new rules; or 3(b) taxpayer elects for partnership treatment. <i>Where the irrevocable election is made see below: Partnership treatment – direct investment</i>
4.	Indirectly held <i>FIF interest</i> in a foreign hybrid either: 4(a) through one or	CFC rules or FIF rules depending on the facts of the investment.	4(a) CFC rules apply, with the foreign hybrid treated as either: i) a partnership by election (<i>See below: Partnership</i>

	Type of investment	Current law application	New law application
	<p>more CFCs; or</p> <p>4(b) through one or more FIFs,</p> <p>where the first tier CFC/FIF is not a foreign hybrid.</p>		<p>treatment within the CFC rules); or</p> <p>ii) a FIF of the eligible CFC, therefore, no change.</p> <p>4(b) no change (FIF rules will continue to apply in the same manner, even if taxpayer elects for partnership treatment for the second tier FIF).</p>

Partnership treatment – direct investment

The foreign hybrid will be treated as a partnership under Division 5 of Part III of the ITAA 1936. It follows that a member of, or partner in, the foreign hybrid will include in assessable income its ‘individual interest’ in the net income or loss of the partnership under section 92 of the ITAA 1936.

There is an exception for foreign losses, which are quarantined in the partnership. New rules will also apply to limit the deductibility of any limited partner’s share in any partnership losses, specifically domestic losses. Note that the new loss provisions will also apply to limit any net capital loss made by a limited partner/member from any capital gains tax (CGT) event happening in relation to the foreign hybrid.

Quarantined foreign losses

Foreign losses will be quarantined within the foreign hybrid and will not be available for distribution to the respective partners/members.

At a practical level, the new loss limitation rules (discussed immediately below) do not apply to foreign losses.

New loss limitation rules for limited partners only

It is an internationally accepted practice to limit the availability of losses of a foreign hybrid to its partners/members where their liability is limited. For example, loss limitation rules apply to hybrids in the United Kingdom, the United States and Canada. Similar loss limitation rules were introduced for venture capital limited partnerships.

The new rules will only apply to those partners whose liability in relation to the foreign hybrid is limited.

Where there is a partnership loss, subsection 92(2) of the ITAA 1936 allows a partner a deduction for his or her individual interest in the loss. Under the new rules, the deduction allowable to a limited partner in a foreign hybrid in respect of this loss cannot exceed the amount of the partner’s financial exposure to the loss.

Similarly, any net capital losses made from one or more CGT events happening in relation to the foreign hybrid or one of its CGT assets, cannot exceed the amount of the partner’s financial exposure to the loss.

It is intended that the partner’s financial exposure to the loss will be calculated as:

1. The amount of **capital contributed** by the limited partner (it is intended that the partner's capital contributions would include contributions made in a variety of different forms, for example, from cash to marketable assets like land and more sophisticated equity instruments such as certain types of subordinate debt. Capital contributed will also include any of the partner's share of the partnership net income that is retained in the foreign hybrid.);
2. **Less** the sum of the following:
 - the amount of contributed capital the partnership has repaid to the partner; and
 - capital losses and or unapplied foreign hybrid capital losses from a CGT event in relation to the foreign hybrid or one of its CGT assets used to reduce any capital gains not related to a foreign hybrid in previous years; and
 - partnership loss deductions and 'outstanding amounts' allowed in previous years; and
 - the amount of any debt interests issued by the partner or on the partner's authority, to the extent that they are secured by the partner's interest in the foreign hybrid (for example, through non-recourse financing, guarantees, stop-loss agreements etc).

The capital contributed will have to be "at-risk" for 180 days to ensure that any losses available to a partner/member are commensurate with the financial exposure over time. For example, where a partner contributes capital on the last day of an income year, this amount will be excluded from the 'capital contributed' for that income year.

There are further special rules to deal with carry forward losses of the foreign hybrid incurred while taxed as a company (for example, before the application of the new rules). These are discussed under *Transitional issues*.

An example of the application of the loss limitation rules for limited partners is at Appendix 1.

Branch profits exemption

Section 23AH of the ITAA 1936 provides an exemption from Australian taxation of certain foreign branch profits and capital gains derived by Australian resident companies in a listed country. Generally, the exemption is available for foreign income earned by an Australian company from a business conducted at or through a 'permanent establishment' in a listed country. Other conditions to be satisfied include:

- for income derived in a broad-exemption listed country, the foreign income must not be 'eligible designated concessional income'; and
- for income derived in a limited-exemption listed country, the income is not adjusted tainted income or the permanent establishment passes the active income test.

This exemption will be available for direct investments made by an Australian resident company in a foreign hybrid, in the same way that it is currently available for branch profits derived through ordinary partnerships. Whether the branch profits exemption is available will be decided on a case by case basis depending on the facts and circumstances of the relevant individual taxpayers.

Distributions

On application of the new rules, the foreign hybrid will no longer be treated as a company. Therefore a distribution from the foreign hybrid will change from being a dividend to a partnership distribution.

Partnership treatment within the CFC rules

Where an Australian taxpayer indirectly holds a CFC interest in a foreign hybrid through a CFC, the current CFC rules regard both entities to be separate and distinct CFCs of the Australian taxpayer.

Under the new rules the CFC will be regarded as a partner/member in the foreign hybrid. Therefore, in certain circumstances the foreign hybrid may become a controlled foreign partnership for the purposes of the CFC rules (i.e. for tracing purposes).

The notional assessable income of the CFC includes the CFC's share of the net income of the foreign hybrid. The net income of the foreign hybrid is calculated in accordance with the partnership provisions of Division 5 of Part III of the ITAA 1936. However, it is assumed that:

- the foreign hybrid derived only certain income and gains, based on whether the CFC passes the active income test, the residency of the CFC, and the source of the income;
- the operation of the Act is modified (the modifications that apply to the foreign hybrid are similar to those that apply for working out notional assessable income and deductions of a CFC); and
- the foreign hybrid is treated as a resident of the same listed or unlisted country as the CFC under paragraph 399(1)(b) of the ITAA 1936.

More detailed information on how partnerships are treated within the CFC rules is available in the ATO publication *Foreign income return form guide*, NAT 1840-5.1998 available at www.ato.gov.au or from ATO publications distribution services at 1300 720 092.

APPLICATION OF CAPITAL GAINS TAX TO FOREIGN HYBRIDS AND INVESTORS

The CGT provisions will apply to foreign hybrids in the same manner as the provisions currently apply to partnerships.

Application of CGT to foreign hybrids

Any capital gain or capital loss from a CGT event happening in relation to the foreign hybrid or one of its CGT assets will not be dealt with at the hybrid level. This is in accordance with section 106-5 of Part 3-1 of the *Income Tax Assessment Act 1997* (ITAA 1997). Section 106-5 of the ITAA 1997 will be modified to ensure flow through taxation operates appropriately where a foreign hybrid is a partner/member in a "tier" of two or more foreign hybrids.

Note that there is an exception for any CGT event happening in relation to a depreciating asset, as the foreign hybrid will be treated as owning the asset (section 40-40 of the ITAA 1997).

Application of CGT to partners/members

At a broad level, the CGT provisions will apply to partners/members of foreign hybrids:

- a) from the date of commencement of the new rules;
- b) whenever there is a CGT event in relation to an asset held by the foreign hybrid;
- c) on the entry of partners/members to the foreign hybrid;
- d) on the exit of partners/members from the foreign hybrid; and
- e) in accessing the CGT discount.

a) Commencement of the new rules

On commencement of the new rules there is a need for each partner/member to assign a reasonable approximation of cost to its interest in each of the CGT assets of the foreign hybrid. This is discussed under “Setting tax costs for the partner’s/member’s interest in the assets of the foreign hybrid” in *Transitional Issues* below.

b) CGT event in relation to an asset held by the foreign hybrid

Any capital gain/loss from a CGT event happening in relation to a foreign hybrid or one of its CGT assets will be made by the partners individually (section 106-5 of Part 3-1 of the ITAA 1997). There is an exception for depreciable assets as these continue to be dealt with at the hybrid level (section 40-40 of the ITAA 1997). Partners/members of the foreign hybrid will have to calculate their share of capital gains/losses that were previously dealt with at the hybrid level. However, capital losses of limited partners will be subject to a loss limitation rule. The nature of this loss limitation rule is discussed above under the *New loss limitation rules for limited partners only*.

c) On the entry of partners/members to the foreign hybrid

Each admission of a partner/member to a foreign hybrid may result in a CGT event for each existing partner/member, in relation to their respective interests in each asset of the hybrid. However, where there is no equivalent taxing point in the foreign jurisdiction on admission of a new partner, foreign tax is not imposed. Where the foreign jurisdiction imposes tax once the asset is actually disposed of, there is a potential for double taxation in respect of any unrealised capital gains in the assets of the foreign hybrid at the time the new partner is admitted.

For example, where there is an interest in the underlying assets of a foreign hybrid in a listed country, the capital gains resulting from the admission of a partner will be designated concession income and either attributable income (in the case of indirect investment through a CFC) or a capital gain (which is not exempt under section 23AH of the ITAA 1936).

To deal with the potential for double taxation, it is intended to develop a rule to provide that where:

- there is an admission of a partner/member to a foreign hybrid resulting in a capital gain in respect of an asset of the hybrid; and
- the foreign jurisdiction would normally impose tax only once the asset is actually disposed of,

any capital gain of a partner/member on the disposal of the interest in each of the assets of the foreign hybrid will not be designated concession income.

d) On the exit of partners/members from the foreign hybrid

If a partner/member disposes of its interest in the foreign hybrid this will be a disposal of the fractional interests in each asset held by the hybrid, as the hybrid will be treated as a partnership. Where the foreign jurisdiction treats the disposal as a disposal of the *interest in the partnership* (for example, in the case of a disposal of an interest in a US LP or LLC), rather than a disposal of the *underlying assets in the partnership*, the capital gain may be eligible designated concession income. This may be the case where the gain in relation to the disposal of the *underlying assets* has not been subject to foreign tax. Rather, it is the gain in relation to the disposal of the *interest in the partnership* which has been subject to tax.

It is proposed to develop a rule to remove any potential for double taxation on the same economic gain.

e) Access to the CGT discount

Partners/members who are qualifying Australian taxpayers, such as individuals, complying superannuation entities, trusts, or shareholders in an Australian listed investment company, may be able to access the CGT discount on capital gains that are currently dealt with at the hybrid level.

There is a transitional issue concerning the 12-month ownership requirement before the CGT discount is available. This is discussed under *Transitional Issues* below.

TRANSITIONAL ISSUES

The transitional issues arising from the application of the new rules are detailed below.

Setting tax costs for the partner's/member's interest in the assets of the foreign hybrid

Certain limited partnerships and limited liability partnerships

On commencement of the new rules, there is no change in the ownership attributes of the assets of foreign hybrids that are LPs. The partner may have details of the date(s) and cost(s) of the acquisition of the partner's interest in the assets of these LPs. However, on commencement of the new rules a reconstruction of the partnership accounts would be required for each partner to take into account any disposals or further acquisitions of partnership assets, and any admissions to and/or retirements from the partnership. The partner's cost of the acquisition of the partner's interest in the assets would then have to be adjusted to take into account any income tax deductions that have been claimed or a non-assessable recoupment of expenditure is received in relation to the assets.

Therefore, instead of requiring each partner to make these calculations, a rule will provide that each partner must assign a reasonable approximation of a share of the foreign hybrid's cost to the partner's interest in each of the assets. This rule is set out below under "Method to assign a cost to the interest in the assets of the foreign hybrid". This rule will also cater for circumstances where partners in the LPs do not have all of the details of the date(s) and cost(s) of the acquisition of the partner's interest in the assets of these LPs.

Certain US limited liability companies

On the commencement of new rules to foreign hybrids that are US LLCs, the asset held by a member in the foreign hybrid will no longer be treated as a share in a company, but will be treated as a fractional interest in each asset of the hybrid, as the hybrid is treated as a partnership.

Partnership treatment will apply after the date of commencement of the new rules. The effect of this is that, in applying the provisions of the Act, the member will be treated as having acquired an interest in the assets of the partnership as a partner, rather than acquiring a share as a shareholder.

The members of the foreign hybrid will be treated as collectively owning the assets that are currently owned by the hybrid. A rule will provide that each member will need to assign a cost to its interest in each of the assets of the foreign hybrid at the commencement of the new rules (the commencement time). This will be based on the method outlined immediately below under “Method to assign a cost to the interest in the assets of the foreign hybrid”.

Method to assign a cost to the interest in the assets of the foreign hybrid

A partner/member in a foreign hybrid must assign a reasonable approximation of a share of the foreign hybrid’s cost to its interest in each of the assets by the following method:

Step 1: Determine the foreign hybrid’s tax cost of the asset immediately before the commencement time.

Step 2: Multiply the result in step 1 by the partner/member’s percentage interest in the partnership at commencement time.

Step 3: Add any premium paid or subtract any discount received by the partner/member on acquiring the interest (i.e. the share) in the foreign hybrid based on the formula:

$$\frac{\text{the foreign hybrid's tax cost of the asset at commencement time}}{\text{the foreign hybrid's total tax cost of all assets at commencement time}} \times \text{Premium paid/discount received}$$

The premium paid (or discount received) in step 3 is the excess (or deficit) of the total amount paid by the partner/member for its interest in the foreign hybrid compared to that proportion of the hybrid’s net assets, at the time the interest in the hybrid is acquired by the partner/member.

The method to calculate the foreign hybrid’s **tax cost** of the asset will depend on the type of asset of the foreign hybrid as indicated in the following table.

Asset of the foreign hybrid	What is the asset’s tax cost?
Trading stock	The tax cost is the value of the trading stock (refer to Subdivision 70-C of the ITAA 1997).
Depreciating asset	The tax cost is the adjustable value of the depreciating asset (calculated under section 40-85 of the ITAA 1997). Generally, this is the cost of the asset less its decline in value.
CGT asset that is not trading stock or a depreciating asset	The tax cost is the cost base of the asset (refer to Subdivision 110-A of the ITAA 1997). The use of the concept of cost base takes into account any recoupment of outlays via tax deductibility to the foreign hybrid, and allows the integrity provisions in the cost base regime to continue to apply.

Existing carry forward losses of the foreign hybrid

It is proposed that carry-forward losses of the foreign hybrid incurred while taxed as a company (i.e. before the application of the new rules) will not be deductible to the partner/member of the hybrid once it is treated as a partnership. However, if the foreign hybrid ceases to be treated as a partnership (for example, if it no longer meets one of the criteria), any tax loss that occurred before the entity was treated as a partnership may qualify for deduction to the entity. This is in line with the approach adopted in the recently introduced venture capital limited partnership provisions.

Capital gains tax discount implications

There is a 12-month ownership requirement before the CGT discount is available. Under current taxation treatment:

- a corporate limited partnership under Division 5A of the ITAA 1936 is treated as owning its CGT assets; and
- a US LLC is actually the legal owner of its CGT assets.

Under the new rules the foreign hybrid that is currently a corporate limited partnership will no longer be treated as owning the CGT assets (instead the partners will own an interest in each of the CGT assets), and the members in a US LLC will be treated as having an interest in each of the CGT assets.

The 12-month ownership requirement will commence when the partner/member acquired the interest in the asset being disposed of. Therefore, the CGT discount will be available to partners/members of the foreign hybrid.

Mismatch between member's/partner's income years and the statutory accounting period of the foreign hybrid

A rule will be introduced to ensure that the statutory accounting period of a foreign hybrid that is currently treated as a CFC will end immediately before the start of the income year in which the partnership treatment applies. This rule will remove the timing differences (that would otherwise have been a problem) between the domestic income year (of the Australian taxpayer) and the statutory accounting period for a CFC (i.e. the foreign hybrid). This is similar to the operation of subsection 319(6) of the ITAA 1936, where, if a CFC ceases to exist, its statutory accounting period ends immediately before the company ceases to exist.

Interaction with the venture capital rules

The recently introduced venture capital provisions in the *Taxation Laws Amendment (Venture Capital) Act 2002* provide a tax exemption on profits from the disposal of investments in eligible venture capital businesses to certain non-residents. This policy intention will be preserved on commencement of the new rules.

COMMENCEMENT DATE FOR PARTNERSHIP TREATMENT

The legislation to give effect to the new rules is to apply from the start of the Australian partner's/member's 2003-04 income year, or the statutory accounting period beginning after 30 June 2003 where a CFC is a partner/member in a foreign hybrid. For a taxpayer with a 30 June balance date, the date of commencement will be 1 July 2003.

However, taxpayers will have the option of applying the measure from the 2002-03 income year. Taxpayers may exercise this option on lodgement of their income tax return.

INCOME YEARS PRIOR TO THE START DATE FOR PARTNERSHIP TREATMENT

As significant and genuine uncertainty has existed around the application of the CFC rules (and to a lesser extent the FIF rules) to taxpayers with interests in foreign hybrids, additional legislation will deal with income years prior to the start date for the new rules.

This legislation will apply for any years for which a taxpayer may apply to the Commissioner for an amendment to an assessment. Generally, this is within four years from the date of an assessment. The retrospective changes will result in the need for some taxpayers to lodge amended assessments for prior years.

Taxpayers that have returned income in accordance with the approach adopted in the ATO's interpretation in TD 2001/D14 will have the option of amending prior year returns, but will not be required to do so. This will minimise compliance costs for these taxpayers. These retrospective changes will also be available for taxpayers that have not yet lodged income tax returns for the years prior to the start date for the new rules.

Under the retrospective changes a foreign hybrid will **continue to be treated as a company** for Australian tax purposes. It will be a resident of the country in which it was formed. For example, a US LLC 'checking the box' under the Internal Revenue Code to be treated as a partnership or 'disregarded entity' will be resident of the US for CFC purposes.

Included in these changes are amendments to sections 393 and 573 of the ITAA 1936 so as to avoid potential for double taxation. The amendments will recognise the foreign tax paid by the foreign hybrid partners/members in relation to the notional assessable income of the hybrid CFC or FIF.

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APPENDIX 1:

The limited partner's financial exposure to the loss is calculated as follows:

Step 1. Work out the sum of the amounts that the limited partner has contributed to the foreign hybrid.

Step 2. Subtract the sum of:

- all amounts (if any) of the limited partner's contribution that are repaid to the partner; and
- capital losses and or unapplied foreign hybrid capital losses from a CGT event in relation to the foreign hybrid or one of its CGT assets used to reduce any capital gains not related to the foreign hybrid in previous years; and
- partnership loss deductions and 'outstanding amounts' allowed in previous years; and
- the amount of any debt interests issued by the partner or on the partner's authority, to the extent that they are secured by the partner's interest in the foreign hybrid (for example, through non-recourse financing, guarantees, stop-loss agreements etc).

Example 1

A limited partner contributes \$100,000 to a foreign hybrid. The partner partly finances the contribution with a loan of \$80,000. The loan contract provides the lender with limited recourse against the partner of \$10,000 should the loan be in default.

Partner's contribution	\$100,000
Less:	
Contributions repaid	NIL
Reductions/deductions allowed for previous capital/partnership losses	NIL
Amount protected against loss	<u>\$70,000</u>
Partner's financial exposure to any loss	\$30,000

The limited partner's share in the foreign hybrid's loss for the 2003-04 year of income is \$40,000 (the loss is purely a domestic loss). The deduction allowable to the partner is reduced to the partner's financial exposure to the loss, \$30,000.

From the above example, the partner has an 'outstanding loss amount' of \$10,000. Because the loss limitation rules apply at the partner level not the partnership level, the outstanding loss amount is carried over **by the limited partner**. A deduction will be allowable in later years where the limited partner places additional capital amounts at 'risk' into the foreign hybrid.

Example 2 – carries on from example 1

In the 2004-05 year of income the limited partner's share of the foreign hybrid's loss incurred for that year is \$5,000 (again the loss is purely a domestic loss). During that year the limited partner contributed further capital of \$20,000 which was financed from the partner's funds and has been held at risk for greater than 180 days. There has been no change in the amount of the debt or the value of the security provided.

The deductible amount is:

Partner's contribution	\$120,000
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Less:

Contributions repaid	NIL
Reductions/deductions allowed for previous capital/partnership losses	\$30,000
Amount protected against loss	\$70,000

Partner's financial exposure to any loss	\$20,000
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Subtract:

outstanding loss amount	\$10,000
partner's share of partnership loss	
for the 2004/05 year	\$5,000

As the amount calculated as available for offset is greater than the combined 'outstanding loss amount' and current year loss, the amount of the deduction allowable to the partner is \$15,000.