Greenwoods & Freehills

Tax Brief

15 January 2010

CFC review

On 5 January 2010 Treasury took a further step in the long-running process to reform the anti-tax-deferral regimes that relate to foreign source income by issuing a consultation paper directed at the high-level design of the new controlled foreign company (**CFC**) rules. The proposals in the consultation paper are further developed than in the past and so provide further insight into the likely shape of important aspects of the new rules. However, the paper has been released for consultation purposes only so is not definitive and leaves a number of questions unanswered.

Background

The former Government originally announced that the Board of Taxation would undertake a review of the foreign source income anti-tax-deferral rules back in October 2006. The Board published a number of issues and position papers as part of its consultation process and gave its final report to Government in September 2008. The Government then publicly released the Board's final report on Budget night 2009 (12 May 2009) together with an announcement that it would adopt most of the recommendations and a Treasury discussion paper for consultation purposes.

The main features of the Government's Budget announcement were that:

- the foreign investment fund (**FIF**) rules would be repealed;
- a 'specific, narrowly-defined anti avoidance rule' would be introduced to replace the FIF rules – this rule has become known as the 'anti-roll up rule';
- the deemed present entitlement (**DPE**) rules, which deem investors in foreign trusts to be presently entitled to a share of the trust's income so that tax would be payable, would be repealed;
- the CFC rules would be removed from the 1936 Act and entirely rewritten in the 1997 Act; and
- the transferor trust rules would be amended.

More detail of the Budget announcement is available in our previous Tax Brief: http://www.gf.com.au/Tax_Brief_Federal_Budget_2009.pdf.

The new paper is the result of Treasury's consultation following the Budget announcements and concentrates on the high-level design of the new CFC rules.

In addition, the Government released an exposure draft of legislation to repeal the FIF and DPE rules on 18 December 2009.

Overview of the consultation paper

The consultation paper is quite short (15 pages) and really only summarises the design principles that will make up the new CFC rules and replacement for the current s 23AJ. It does not attempt to delve into the intricacies of the new CFC rules in any detail.

The design principles discussed can be broken into four categories:

- identification of CFCs;
- attribution of attributable income;
- identification of attributable income; and
- treatment of distributions by foreign companies.

Identification of CFCs

Main points:

- *A foreign company will require a single controller (including associates) to be a CFC, except in specific cases of 'joint control'.*
- *There is no mention of trusts being treated as CFCs.*

Control test

The consultation paper proposes to significantly narrow the control test that determines when a foreign company will be a CFC.

Currently a foreign company will be a CFC where up to five unrelated Australian residents control the company. That means that a shareholder with a small minority interest could be subject to attribution despite not having any ability to control. Indeed, that shareholder might not even realise that the foreign company is a CFC if it does not make extensive inquiries of the other shareholders' circumstances.

Treasury has recognised these problems and, subject to the exception discussed below, suggests a test that requires the foreign company to be controlled by one entity, which could be either Australian or foreign, together with its associates. This move is to be welcomed and is consistent with the broader policy rationale for repealing the FIF rules which was that non-controlling investors in foreign companies should not be subject to attribution.

The one exception to the above rule is that Treasury has introduced a concept of 'joint control' which seems to be aimed at situations where, due to some relationship between a number of shareholders they jointly control the foreign company even though none of them do individually. Normally the relationship would be contractual and Treasury seems to have in mind joint venture companies; a presumption that 50/50 owned companies are jointly controlled will be introduced.

The consultation paper indicates that 'control' will take its ordinary meaning. That is in line with the current 'de-facto control' test but it does away with the presumption that control exists with a 40% shareholding.

Relevant entities

Both the Board's final report and Treasury's May 2009 discussion paper proposed to include foreign trusts within the CFC rules. Hence those documents talked about 'controlled foreign entity' or 'CFE' rules. The suggestion was confusing because the Treasury discussion paper also suggested that the current trust rules should apply to foreign trusts to the extent possible. It was therefore not clear in what circumstances, and how, the CFE rules would apply to a foreign trust.

The current consultation paper does not make a definitive comment on this issue either way. However, the language does seem to have moved away from CFEs back to CFCs implying that the new rules may only apply to foreign companies, and possibly to some non-common law entities (**NCLEs**).

Attribution of attributable income

Main points:

- *Each Australian controller of a CFC and each Australian associate of a controller will be an attributable taxpayer if it has a participation interest in the CFC greater than zero.*
- *Participation interests will be measured by the investor's right to distributions of profits on equity interests (using the tax debt/equity rules).*
- *Complying superannuation funds will be exempt.*
- *The consultation paper raises the possibility of a de minimis exemption.*

Attribution process

Once a CFC's attributable income has been calculated, the attribution process will be similar to the current process. That is, each attributable taxpayer will simply multiply the CFC's attributable income by its participation interest and include the resulting amount in its assessable income.

An Australian controller that causes the foreign company to be a CFC and each associate of a controller (including Australian associates of a foreign controller) will be attributable taxpayers unless, of course, that taxpayer does not itself have any participation interest in the CFC.

The May 2009 Treasury discussion paper raised the question of when the attribution process should occur and whether any allowance should be made where a taxpayer becomes an attributable taxpayer part way through the year. Despite raising that question, the current consultation paper suggests retaining the current rule that attribution is applied at the end of the CFC's statutory accounting period and each attributable taxpayer at that time is attributed a share of the attributable income for the full year, even though it might have only held its interest for part of the year (indeed, the company might only have been a CFC for part of the year).

Participation interests

The consultation paper suggests two important changes to the identification of participation interests:

- the test will only look at the right to receive distributions of profits (as opposed to the greater of votes, paid-up capital, distributions of capital and distributions of profits); and
- the test will look at equity interests as defined under the tax debt/equity rules rather than legal form shares.

In particular, the shift in focus to equity interests rather than legal form shares will mean that investors will not be subject to attribution by virtue of, for example, redeemable preference shares that are debt interests – however, the quid pro quo is that the s 23AJ exemption will also not be available for distributions on those shares. On the other hand, investors could be subject to attribution on legal form debt that is classified as equity for tax purposes. That situation in particular will require care in determining each investor's percentage interest in the CFC's 'profits'; eg because the debt might entitle the investor to a fixed return rather than a proportion of profits. For this reason, the percentage of rights to profit (and hence the level of attribution) could fluctuate from year to year, and could be quite different to the percentage of shares (if any) held.

Exemptions

As previously indicated by Treasury, an exemption from the CFC rules will be introduced for complying superannuation funds. That exemption currently exists in the FIF rules but not the CFC rules. Unfortunately, the consultation paper does not explicitly mention other entities that are also currently exempt from the FIF rules such as pooled superannuation trusts, approved deposit funds and life insurance companies (where the investment is held as a complying superannuation/FHSA asset). We would hope that the exemption will cover those entities.

The consultation paper suggests that a de minimis exemption might apply but says nothing more.

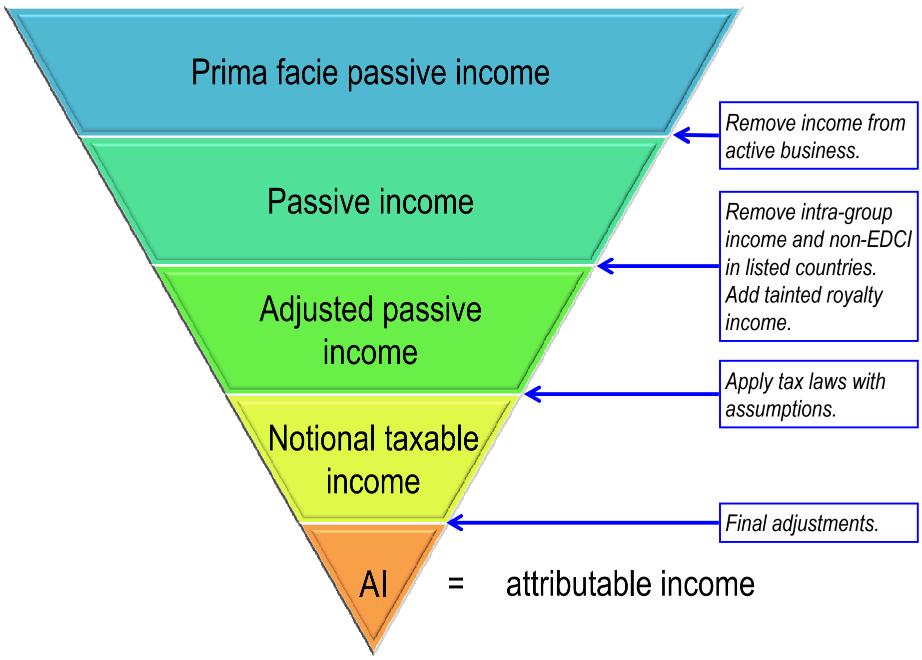
Identification of attributable income

Main points:

- *Most income from an active trade or business will escape attribution.*
- *Most intra-group income will escape attribution.*

Conceptual overview

The consultation paper suggests significant changes not only to the way attributable income of a CFC is identified but also to the process of identifying that income. The concept can be represented as follows:



The process begins with *prima facie passive income* and filters down through four steps to leave the *attributable income*. At each step in the filtration process the income from the previous step is narrowed (with two exceptions).

Income category	Description
Prima facie passive income	Includes all: • returns on debt and equity interests (eg interest and dividends); • rent; • annuities; • royalties; • a profit from a financial arrangement; and • a profit from a CGT event happening to an asset.
Passive income	Any *prima facie passive income* that arises in the ordinary course of the active conduct of a trade or business is removed. Also removed are profits from financial arrangements and CGT events where the relevant arrangement or asset was used in that trade or business. This important step has the potential to improve on the current law by recognising that some types of otherwise passive income can be derived by an active business and should not be attributable; eg interest derived by a finance company or rent derived by a company in the business of renting real property or hiring goods. Nevertheless, the determination of 'active conduct' is unlikely to be a bright-line test and will therefore require interpretational judgment.
Adjusted passive income	Two categories of *passive income* are removed at this step: • amounts that are not eligible designated concession income (**EDCI**) where the CFC is a resident of a listed country (Canada, France, Germany, Japan, New Zealand, United Kingdom and United States of America) – this is the same as the current rule and recognises that most income derived in a listed country will be subject to comparable tax rates so there is no incentive for deferral; and • intra-group income – this is a new exemption.

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Income category	Description
	The exemption for intra-group income recognises that interest etc paid between members of the group should not be attributed. Otherwise, as is currently the case, active income derived from external sources by one CFC can effectively be attributed if it is then paid as passive income to another CFC in the group; eg as interest to a group finance company. Effectively this means that the income will only be tested at the point it enters the group and not also when it is paid between members of the group. There is, however, one exception to this rule. If the payer of an amount of *passive income* gets an Australian tax deduction (including under the CFC rules, if applicable) for the payment, then it will be *adjusted passive income* for the recipient. The consultation paper is not definitive on how the group will be defined for this purpose. However, it suggests using the tests in AASB 127 (which is about consolidated financial statements and basically requires control) as one possibility. The Board of Taxation originally suggested a wider group, which would have included equity-accounted affiliates. However, the Board's proposal was that the grouping relief would apply only for the purposes of the de minimis active income test. Accordingly, whilst the group definition might be narrower than proposed by the Board, the actual relief will be much more powerful. This step also involves adding back certain categories of income. The consultation paper takes the view that there is some income that might have escaped attribution thus far but for which 'the risk of inappropriate deferral is higher'. So far only 'tainted royalty income' is identified as being in that category.
Notional taxable income	The Australian tax laws are applied to the *adjusted passive income* with a number of assumptions and modifications to determine the *notional taxable income*. The assumptions are similar to those currently made, of which the most important is that the CFC is an Australian resident. The modifications to be made are not listed in any detail other than to say that income assessed in Australia and franked dividends are excluded and that if the CFC has a trust or partnership interest the modifications must also be taken into account in working out that entity's net income.

Income category	Description
	Presumably the legislation will include much more extensive modifications, as is currently the case.
Attributable income	Finally, there are some minor adjustments to reach *attributable income*. The only adjustment currently listed is to add back in an amount in certain circumstances where the CFC has escaped attribution of non-EDCI when changing residence. The consultation paper indicates that there could be further carve outs at this step but does not identify them.

Treatment of distributions by foreign companies

An equivalent of s 23AJ, which makes non-portfolio dividends from foreign companies non-assessable non-exempt income, will be included in the new rules. However, the consultation paper suggests a number of important changes:

- Only returns on equity interests will qualify for the exemption. As noted above that means, for example, dividends paid on redeemable preference shares that are debt interests will not qualify.
- The requisite threshold interest will still be that the Australian corporate holds at least a 10% interest in the foreign company. The interests in the foreign company must be participation interests (see below), rather than voting interests as is currently the case.
- In addition, all attributable corporate taxpayers in relation to a CFC will be eligible for the exemption. That may mean that, on occasions, corporate taxpayers with less than a 10% interest in a CFC will qualify for s 23AJ treatment.
- A participation interest in the foreign company for these purposes will be the same as for CFCs and, as noted above, will be determined by reference to the right to receive distributions of profits on equity interests.
- The exemption will be available through partnerships and trusts. That overturns the ATO's controversial decision that s 23AJ is not available for dividends received through those entities.

Repeal of FIF and DPE rules

The exposure draft legislation released on 18 December 2009 provides the mechanics to repeal the FIF and DPE but does not specify any effective date for the repeal.

In addition, the exposure draft proposes one clarifying change to the current CFC and FIF rules. Both the FIF and the CFC regimes currently provide for relief where an interest in a CFC or FIF is sold and there has been prior attribution of income but no distribution of that income. In that case, the amount of the attributed but not distributed income is subtracted from the capital proceeds used to determine the capital gain or loss realised on sale. However, changes made in 2006 created uncertainty as to whether that relief is available where the interest is held on revenue, rather than capital, account. The exposure draft clarifies that the relief is available for both capital and revenue account assets. That change is scheduled to apply to the 2006-07 income year and later years and will presumably have a 'short life' in light of the FIF repeal/CFC rewrite.

Finally, the exposure draft proposes to maintain the s 23AK mechanism of exempting distributions from previously attributed FIF income from tax. That will be a transitional provision to deal with the balance of FIF attribution accounts at the time the FIF rules are repealed and it is proposed that a sunset date will apply but that date has not yet been specified.

Where to from here?

While the process of reforming the anti-deferral rules has already taken over three years, it is clear that there is still much work to be done. Submissions on the current consultation paper are due by 1 March 2010. Considerable further drafting will be required, which will not be an easy task – the CFC rules are incredibly complicated and there is a large amount of detail that the consultation paper does not get into. Moreover, there are also a large number of consequential amendments that will need to be made; eg s 23AH, CGT participation exemption, thin capitalisation.

There also seems to have been little progress in relation to two of the other broad elements of the review: the anti-roll up rule and the amendments to the transferor trust rules. Treasury has said that legislation for those elements will be released before the CFC legislation is finalised.

Treasury has previously said that it was aiming for the new rules to operate for income years beginning 1 July 2010 and later. While that target date seems ambitious Treasury has not said anything that suggests the target has been delayed.

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These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

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