Australian Government

Reform of the controlled foreign company rules

Consultation Paper
January 2010

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CONSULTATION PROCESS

Request for feedback and comments

The Government is seeking your feedback and comments on the rewrite of the taxation laws that are designed to modernise the controlled foreign company rules. The rewrite was announced in the 2009-10 Budget as part of wider reforms to the Australia's foreign source income anti-tax-deferral rules.

While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in-confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: 1 March 2010

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FOREWORD

I am very pleased to release this consultation paper on the design of the taxation laws that will modernise the controlled foreign company (CFC) rules.

In the 2009-10 Budget, the Rudd Government announced that the CFC rules would be reformed as part of wider reforms to Australia's foreign source income anti-tax-deferral rules.

The CFC rules are designed to address integrity risks to the Australian tax base. However, this must be balanced against other policy objectives such as equity, efficiency, simplicity and low compliance costs. These objectives are fundamental to ensuring Australian businesses remain competitive within an increasingly globalised world economy.

These reforms to the CFC rules will improve the competitiveness of Australian businesses with offshore operations by modernising and simplifying the rules to better target areas at risk of inappropriate tax deferral, while reducing compliance costs for businesses.

The proposed changes will significantly assist in this regard and we look forward to receiving the community's views.

Senator The Hon Nick Sherry
Assistant Treasurer

BACKGROUND

The reform of the CFC rules was announced in the 2009-10 Budget as part of wider reforms to Australia's foreign source income anti-tax-deferral (attribution) rules.

In summary, the Government announced that the CFC and transferor trust rules would be retained and modernised, while the foreign investment fund (FIF) and deemed present entitlement (DPE) rules would be repealed. Draft legislation repealing the FIF and DPE rules was released for comment on 18 December 2009.

Details surrounding the transferor trust changes and the anti-roll-up rule are still being developed. Legislation to give effect to these changes will be released for further comment before the legislation is finalised.

This consultation paper has been prepared to elicit comment on the high-level design of the taxation laws that will reform the CFC rules. The paper also sets out the re-design of the section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936) dividend exemption which provides Australian resident companies with an exemption from tax for certain dividends received from a foreign company.

The comments received will be used to facilitate ongoing discussions between Treasury and industry which, ultimately, will inform Government on the legislative approach to take forward.

Importantly, the rules set out below do not at this stage represent the final view of the Government, and therefore may contain certain design features that are subject to final approval. Furthermore, the final design of the rules will need to be fiscally responsible and balanced against other pressing needs within the Australian budget.

Against this backdrop, the Government invites your comments on the rules set out below, including on issues mentioned in the specific consultation questions. You may also like to raise other matters that will assist in the final design of the law.

POLICY DRIVERS

POLICY BENCHMARKS

There are legitimate commercial reasons why residents invest capital in foreign active businesses. The policy setting for foreign active investment is that capital imported into a foreign jurisdiction should be treated the same as other investments in that jurisdiction, and that foreign investment should therefore be taxed at the same competitive level (capital import neutrality).

However, foreign passive investment should not be favoured over domestic passive investment. Foreign passive investment will continue to be treated the same as capital that is invested in Australia, and the benefit of deferral should be eliminated to remove any potential bias in favour of capital exported (capital export neutrality).

POLICY OBJECTIVES

The policy objective of the CFC rules is to ensure that passive investment decisions of Australian resident taxpayers are not distorted by tax considerations, thereby protecting the Australian tax revenue. In achieving this objective the rules should also minimise compliance and administrative costs.

The policy means giving effect to this objective is to tax resident taxpayers on an accruals basis on their share of the passive income accumulating in a foreign entity that they hold an interest in.

PROPOSED DESIGN

The legislative design proposal set out below has been assembled against the following core concepts:

- commercial income concept of passive income;
- tax law concept of passive income;
- attributable taxpayers and CFCs;
- attribution of attributable income; and
- statutory accounting periods.

The diagram below sets out the legislative scheme.

The consultation paper provides a brief description of what the core concept is intended to achieve followed by a statement of the rule itself. Focusing questions are then posed at the end of each module which are intended to elicit comment on the appropriateness of the concept as encapsulated by the rule.

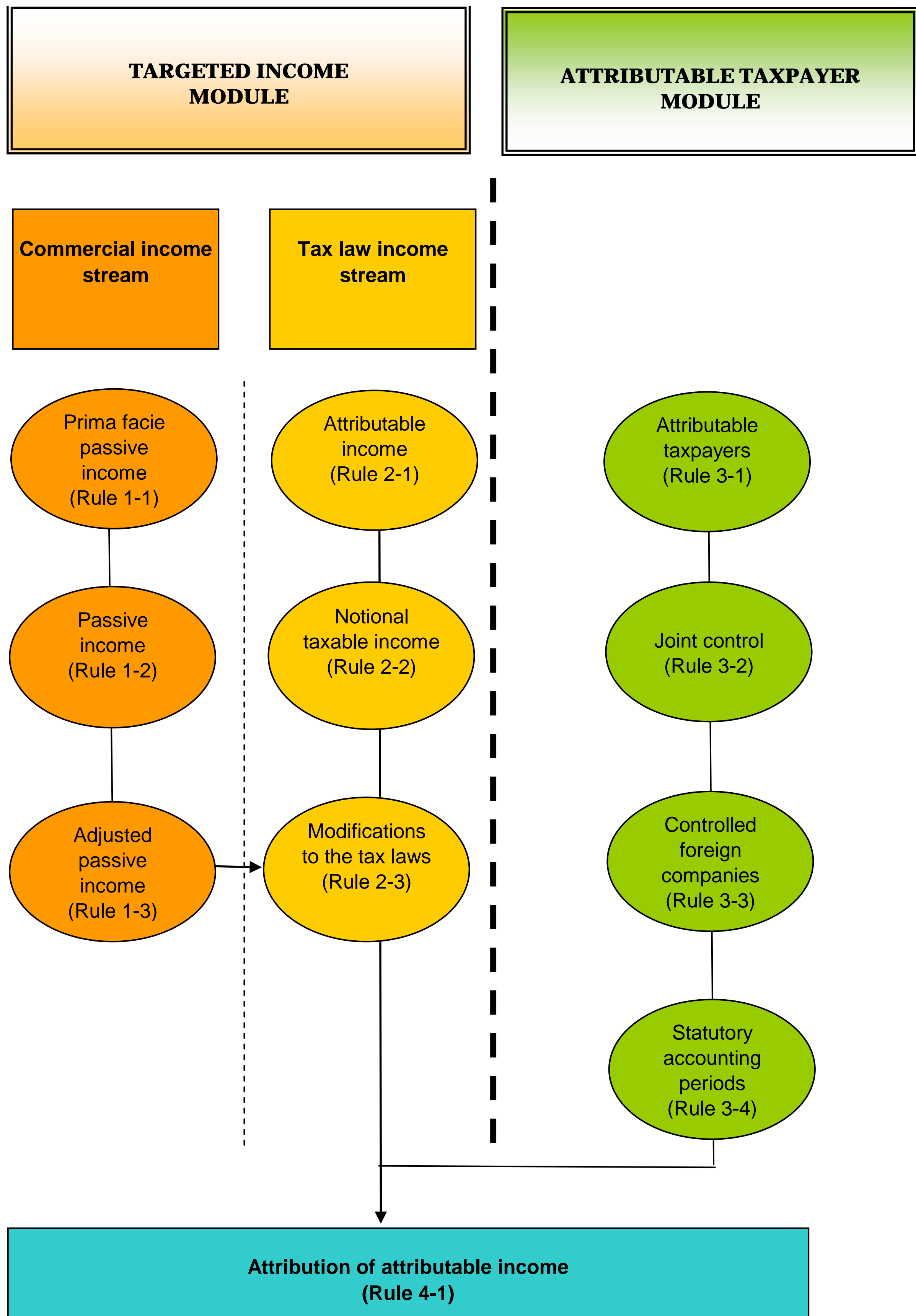
While the Government is particularly interested in your view in respect of the questions posed, it would also like to hear from you about any other matters that will assist in the final design of the law. In particular, you may have comments about the general structure of the rules, the nature of any additional or ancillary rules that might be required, and the appropriateness of a rule after having 'road-tested' it against your particular circumstances.

Two further concepts are also separately dealt with below:

- the income tax exemption for non-portfolio dividends paid by companies; and
- ownership or participation interests.

The Government also invites comments on these concepts in the same manner.

LEGISLATIVE SCHEME — CFC RULES



TARGETED INCOME MODULE

COMMERCIAL INCOME STREAM

Rule 1-1: Prima facie passive income

The starting point for identifying the range of income that may potentially be subject to attribution is to rely on ordinary commercial concepts of passive income that should be familiar to business and readily accessible. This is referred to below as 'prima facie passive income'.

> ***Rule 1-1: Prima facie passive income***
>
> An entity's **prima facie passive income** is any of the following:
>
> a) a return on an equity interest;
>
> b) a return on a debt interest;
>
> c) a payment of rent;
>
> d) an annuity payment;
>
> e) a royalty;
>
> f) a profit from a financial arrangement (other than an amount mentioned in paragraphs (a) to (e));
>
> g) a profit from a CGT event that happens in relation to an asset.

Rule 1-2: Passive income

The 'prima facie passive income' concept is then adjusted by excluding amounts that arise in the ordinary course of the active conduct of a trade or business or which are profits from assets or financial arrangements that were held for the predominant purpose of producing 'active' income. This concept is referred to as 'passive income'.

> ***Rule 1-2: Passive income***
>
> 1) The **passive income** of an entity is its prima facie passive income, except to the extent that:
>
>   a) the prima facie passive income arises in the ordinary course of the "active conduct of a trade or business" by the entity; or
>
>   b) the prima facie passive income is a profit mentioned in paragraph 1-1(f) or (g), if:
>
>   i) the profit is not covered by paragraph (a); and

ii) the asset or financial arrangement was held for the predominant purpose of producing an amount or amounts which either are covered by paragraph (a) or are not covered by Rule 1-1.

Active business test

2) The active conduct of a trade or business by an entity means the competitive participation by the entity in industrial, commercial or financial undertakings, evidenced by human activity through a permanent establishment.

3) To avoid doubt, for the purposes of subrule (2):

a) the human activity may be by any individual (whether or not employed by the entity);

b) the permanent establishment may be of the entity or of any other entity.

Rule 1-3 Adjusted passive income

Adjusted passive income is a concept that adjusts the scope of the CFC regime's targeted income by excluding certain amounts that are a low risk (such as comparably taxed income and intra-group income) and adding amounts where the risk of inappropriate deferral is higher.

Rule 1-3: Adjusted passive income

1) An entity's **adjusted passive income** is its passive income, other than the following:

a) for an entity resident in a listed country—amounts that are not eligible designated concession income

b) if the entity is a member of a CFC group—an amount referable to a financial benefit provided by another entity that is also a member of the group, if:

i) the other entity is not entitled to a tax benefit (ie. a deduction) under the Income Tax Assessment Acts in respect of the financial benefit; and

ii) in a case where the other entity is a CFC for the statutory accounting period in which the payment is made — in calculating its attributable income for that statutory accounting period, the other entity is not entitled to a tax benefit under the Income Tax Assessment Acts in respect of the financial benefit.

2) However, its **adjusted passive income** also includes the following:

a) its tainted royalty income

Consultation questions

1. Do the rules appropriately target the kind of income which should be subject to attribution?

2. Does the active business test work appropriately having regard to the policy settings?

3. What kind of additional detail or subsidiary rules are required to provide greater clarity?

4. How should a group entity be defined for the purposes of the CFC rules? Can the accounting standards (see AASB 127) be relied upon to provide an adequate definition of the term?

TAX LAW INCOME STREAM

Rule 2-1 Attributable income

The attributable income of a CFC for a period is its notional taxable income (see Rule 2-2) adjusted by the effect of Rule 2-1. Rule 2-1 includes certain gains that might arise after a CFC has changed its residency.

Rule 2-1: Attributable income

1) The **attributable income** of a CFC for a period (the current period) is its notional taxable income for the current period, after including the add-ons in subrule (2) and subtracting the carve-outs in subrule (3).

2) The add-ons are as follows:

   a) if:

      i) the CFC has changed residence at a time; and

      ii) the time was before the start of the current period; and

      iii) the CFC held an asset covered by paragraph 1-1(f) or (g) at the time; and

      iv) a CGT event happens in relation to the asset in the current period; and

      v) the CGT event gave rise to a profit for the CFC that was not reflected in its notional taxable income for the current period because of paragraph 1-3(1)(a) (non-eligible designated concession income);

   add the amount that would have been reflected in its notional taxable income for the current period in respect of the gain (disregarding paragraph 1-3(1)(a).

3) The carve-outs are as follows:

a) [to be determined, if any]

Rule 2-2 Notional taxable income

The notional taxable income of a CFC is the amount that would have been its taxable income had certain assumptions been applied. Losses are also taken into account under Rule 2-2A.

Rule 2-2: Notional taxable income

The **notional taxable income** of a CFC for a period is the amount that would have been its taxable income for the period on the following assumptions:

a) the CFC is an Australian resident for the entire period;

b) the period is an income year, and that income year is the financial year in which the period ends;

c) this Act is modified in accordance with rule 2-3.

Rule 2-2A: Notional tax loss

1) The **notional tax loss** of a CFC for a period is the amount that would be its tax loss for the period on the assumptions mentioned in Rule 2-2.

2) The **notional film loss** of a CFC for a period is the amount that would be its film loss for the period on the assumptions mentioned in Rule 2-2.

3) The **notional net capital loss** of a CFC for a period is the amount that would be its net capital loss for the period on the assumptions mentioned in Rule 2-2.

Rule 2-3 Modifications of the Tax Acts in determining notional taxable income

In applying the tax laws to determine the CFC's taxable income for a period, certain modifications to the Tax Acts are applied. These are contained in Rule 2-3.

Rule 2-3: Modifications to the Acts in determining notional taxable income

1) The modifications are as follows:

a) the only amounts of the CFC's notional assessable income for the period are as follows:

i) the CFC's ordinary income and statutory income for the period, to the extent that it is referable to its adjusted passive income for the period;

b) however, the CFC's notional assessable income does not include the following:

i) the CFC's income that is assessable in Australia;

ii) franked distributions paid to the CFC;

iii) [extra paragraphs identified]

c) in working out the CFC's notional deductions:

i) disregard a loss made by the CFC from a financial arrangement unless, if the loss had instead been a profit, an amount would have been included in the CFC's notional assessable income for the period; and

ii) disregard a loss made by the CFC from a CGT event in relation to an asset unless, if the loss had instead been a profit, an amount would have been included in the CFC's notional assessable income as ordinary income for the period.

d) in determining the net capital gain or net capital loss of the CFC for the period, disregard a capital loss made by the CFC from a CGT event in relation to an asset unless, if the capital loss had instead been a capital gain and no other capital losses or capital gains had been made by the CFC for the period, a net capital gain would have been included in the CFC's notional assessable income for the period

e) in determining the net income of a partnership or trust for the purposes of Divisions 5 and 6 of Part III of the *Income Tax Assessment Act 1936*, apply all the modifications in this Rule as if the references to the CFC in those modifications were instead references to the partnership or trust.

2) In this Part:

a) the CFC's assessable income for the period determined in accordance with those assumptions is known as its **notional assessable income** for the period; and

b) the CFC's exempt income for the period determined in accordance with those assumptions is known as its **notional exempt income** for the period; and

c) the CFC's non-assessable non-exempt income (NANE) for the period determined in accordance with those assumptions is known as its **notional NANE** for the period; and

d) the CFC's deductions for the period determined in accordance with those assumptions are known as its **notional deductions** for the period.

Consultation questions

5. Do the rules appropriately apply the tax laws to arrive at the CFC's attributable income?

6. Does the change of residence provision set out above in Rule 2-1 provide a suitable outcome?

7.	How should capital losses arising from previous years be dealt with?

ATTRIBUTABLE TAXPAYER MODULE

Rule 3-1 Attributable taxpayers

The term ‘attributable taxpayer’ is a key concept of the CFC rules. Attributable taxpayers are resident taxpayers that control a foreign entity (or are an associate of a taxpayer that controls the foreign entity) and that hold an ownership interest in the foreign entity. The rule is expressed as follows:

> ***Rule 3-1: Attributable taxpayers***
>
> An entity (the **first entity**) is an **attributable taxpayer** for another entity (**the second entity**) at a time if, at that time:
>
> a) the first entity is an Australian resident; and
>
> b) the first entity:
>
> i) controls the second entity; or
>
> ii) is an associate of another entity that controls the second entity; and
>
> c) the first entity holds a total participation interest in the second entity of greater than zero.

Rule 3-2 Joint control

While it is intended that the term ‘control’ may adopt its ordinary meaning, but for special rules, joint controllers that are acting under a contractual arrangement may potentially be outside the scope of the CFC rules. For this reason Rule 3-2 has been specifically inserted to deal with this situation.

> ***Rule 3-2: Joint control***
>
> 1) In determining whether an entity controls a CFC for the purposes of Rule 3-1:
>
> a) if two or more entities jointly control a CFC, treat each of them as controlling the CFC; and
>
> b) determine whether 2 or more entities jointly control a CFC.
>
> (2) If 2 entities each hold 50% of the equity interests in a CFC, treat them for the purposes of subrule (1) as jointly controlling the CFC unless there are circumstances that prove that they do not jointly control the CFC.

Rule 3-3 Controlled foreign companies (CFCs)

Rule 3-3 is a machinery provision that is designed to serve as a reference point for the use of the term 'controlled foreign company (CFC)'. The rule is simply stated as follows:

> ***Rule 3-3: Controlled foreign companies (CFCs)***
>
> A company is a **controlled foreign company** (or **CFC**) [for a particular period] if:
>
> a) the company is not an Australian resident for the period; and
>
> b) there is at least one attributable taxpayer for the company for the period.

Consultation question

8. In defining 'joint control', can the term take its ordinary meaning (like 'control') or could the accounting concept of the term be relied upon to provide the right outcomes (see AASB 131)? What other alternatives would produce better outcomes?

ATTRIBUTION OF ATTRIBUTABLE INCOME MODULE

Rule 4-1 Attribution of attributable income

The rules in this part provide the mechanism for determining an attributable taxpayer's share of the CFC's attributable income. The process is similar to the operation of the current rules.

> ***Rule 4-1: Attribution of attributable income***
>
> 1) If a CFC has attributable income for a statutory accounting period, an Australian resident entity that is an attributable taxpayer for the CFC at the end of that period includes the amount mentioned in subrule (2) in its assessable income for the income year in which that period ends.
>
> 2) The amount is that attributable income multiplied by the percentage that is the entity's total participation interest in the CFC at the end of that statutory accounting period.
>
> 3) Subrule (1) does not apply if:
>
> a) the entity is a complying superannuation fund for the income year in which that statutory accounting period ends; or
>
> b) [a de minimis exception if required]

Rule 5-1 Statutory accounting periods

Certain machinery provisions are required in order for the CFC rules to become operational, including the specification of the relevant period for measurement purposes. In this regard it is intended that the existing notion of 'statutory accounting period' will be retained and substantially replicated for this purpose (see section 319 of the ITAA 1936).

Rule 5-1: Statutory accounting period

[This will be developed and reflect existing section 319 of the *Income Tax Assessment Act 1936*.]

Rule 5-2 Change of residence

A further machinery provision is set out in Rule 5-2 and covers the situation where a CFC becomes resident of another country. In these circumstances the relevant statutory accounting period is broken into two separate periods for the purposes of the CFC rules.

Rule 5-2: Change of residence

1) This Rule applies if at a time (the residence change time) in a statutory accounting period (the original statutory accounting period) of a CFC:

   a) the CFC stops being a resident of one country and becomes a resident of another country; and

   b) at least one of the countries is not an unlisted country.

2) Treat the original statutory accounting period as being instead two statutory accounting periods of the CFC, as follows:

   a) the first statutory accounting period starts when the original statutory accounting period starts, and ends just before the residence change time;

   b) the second statutory accounting period starts at the residence change time and ends at the time the original statutory accounting period ends.

3) To avoid doubt, the original statutory accounting period may be a statutory accounting period that exists because of a previous operation of this Rule.

Consultation questions

9. Do the rules appropriately apply to arrive at an attributable taxpayer's share of the CFC's attributable income?

10. What, if any, are the merits in providing a de minimis exemption in Rule 4-1?

DISTRIBUTIONS TO AUSTRALIA MODULE

Rule 6-1 Certain distributions on equity interests not assessable income and not exempt income

The rule in this module provides the legislative design for dealing with distributions that are paid by the foreign company to an Australian resident. The proposed structure reforms the operation of section 23AJ of the ITAA 1936 that treats certain dividends as not assessable

and not exempt income. The reforms outlined below would result in the exemption only being available in respect to:

- certain distributions received in respect of equity interests; or
- distributions where the receiving entity is an attributable taxpayer.

The rules as stated would also provide neutrality with the exemption currently available under section 23AH of the ITAA 1936 by maintaining the exemption where the distribution was received indirectly through a partnership or trust.

Rule 6-1: Certain distributions on equity interest not assessable and not exempt income

1) A distribution made by a company (the distributing company) to another company (the receiving company) in respect of an equity interest [in the distributing company] is not assessable income, and is not exempt income, of the receiving company if, at the time the distribution is made:

    a) the distributing company is not an Australian resident; and

    b) the receiving company is an Australian resident; and

    c) the receiving company does not receive the distribution in the capacity of a trustee; and

    d) any of the following requirements are satisfied:

        i) the receiving company holds a total participation interest in the distributing company of at least 10%;

        ii) the receiving company is an attributable taxpayer for the distributing company.

2) Subrule (3) applies if:

    a) disregarding that Subrule, an amount is included in the assessable income of a company (the receiving company) under Division 5 or 6 of Part III of the *Income Tax Assessment Act 1936* for an income year because the receiving company is a partner in a partnership or a beneficiary of a trust; and

    b) another company (the distributing company) made a distribution [(whether in that income year or in an earlier income year)] in respect of an equity interest [in the distributing company] to:

        i) the partnership or trust; or

        ii) if there are entities interposed between the partnership or trust and the distributing company, and all of the interposed entities are partnerships or trusts — one of the interposed entities; and

    c) the amount mentioned in paragraph (a) is referrable to the amount of the distribution; and

d) the requirements in paragraphs (1)(a), (b), (c) and (d) are met.

3) The amount mentioned in paragraph (2)(a) is not assessable income, and is not exempt income, of the receiving company.

4) For the purposes of paragraph (2)(d), in determining whether the requirement in subparagraph (1)(d)(i) is met, reduce the receiving company's total participation interest in the distributing company to the extent that the interest is not referable to the partnership or trust mentioned in paragraph (2)(a).

Consultation questions

11. Do the rules appropriately apply to determine a taxpayer's entitlement to the non-portfolio dividend exemption?

12. Does the addition of the 'attributable taxpayer' rule provide sufficient compliance cost savings to warrant its inclusion? Are there integrity issues associated with this rule?

13. Does the exemption flow through partnerships and trusts appropriately?

PARTICIPATION INTERESTS

Rule 7-1 Total participation interest

The CFC rules are designed to apply to taxpayers who hold ownership rights in the foreign entity. The rules set out below use the concept of 'equity interest' to identify the types of interests, such as ordinary shares. 'Equity interest' is defined in Division 974 of the *Income Tax Assessment Act 1997.*

Rule 7-1: Total participation interest

An entity's total participation interest at a particular time in another entity is the sum of:

a) the entity's direct participation interest in the other entity at that time; and

b) the entity's indirect participation interest in the other entity at that time.

Rule 7-2 Direct participation interest

Rule 7-2: Direct participation interest

1) An entity holds a direct participation interest at a particular time in another entity equal to the percentage that the entity holds at that time of the total rights to returns on equity interests in the other entity to its members (otherwise than on winding-up) that are "distributions of profits".

2) For the purposes of subrule (1), assume that all the profits of the other entity [for a particular period] were distributed to its members at that time.

3) Subrule (4) applies if it is impossible/impracticable to determine the entity's direct participation interest at that time in the other entity under subrule (1).

4) The entity holds a direct participation interest at that time in the other entity equal to the percentage that the entity holds at that time of the total rights to distributions of [capital] of the other entity to its members (otherwise than on winding-up).

5) Subrule (6) applies if it is impossible/impracticable to determine the entity's direct participation interest at that time in the other entity under subrules (1) and (4).

6) The entity holds a direct participation interest at that time in the other entity equal to the percentage that the entity holds at that time of the "direct equity interests" in the other entity (measured by market value).

Consultation questions

14. Where a controller does not have any direct or indirect participation interests in a CFC, would a rule deeming the controller to have a 100% interest result in any unintended or inequitable consequences? If so, what alternative rules are there to cover situations where a controller's total participation interest in a CFC does not align with the controller's level of control of the CFC?

15. Is the attributable taxpayer's attribution percentage based on rights to participate in distributions of profits appropriate?

16. Is it necessary for these profits to be adjusted to reflect Division 230 notions of equity and debt?