

## CFC and foreign income changes – Second Consultation paper issued by Treasury

### More consultation announced – no detailed law and silence on the operative date

On 16 July 2010, the Federal Government released an updated Consultation Paper relating to the modernisation of the Controlled Foreign Company (CFC) regime and the taxation treatment of certain foreign income. The Consultation Paper follows on from a previous paper issued in January 2010 and contains updated and expanded rules and additional detail regarding the proposed changes to the law.

The Government intends to release a draft enabling legislation only after receiving submissions regarding this latest Consultation Paper. The Consultation Paper is silent about the proposed effective date for the new rules. However, it now seems very unlikely that the previously announced 1 July 2010 start date will occur and this issue will be decided after the Federal Election.

The release of a second Consultation Paper (as well as the promulgation last week of the modernised Foreign Investment Fund and Deemed Present Entitlement Rules) demonstrates that some progress has been made in reforming Australia's rules for taxing foreign income. However, some may question the need for another round of consultation in the absence of detailed draft legislation and an accompanying explanatory memorandum. Since the former Government commissioned the Board of Taxation to review the anti-tax-deferral regimes in October 2006, the Board of Taxation has reported three times and Treasury has now issued three discussion papers on this topic.

The closing date for submissions on the Consultation Paper is 31 August 2010. PricewaterhouseCoopers will be lodging a submission to Treasury and welcomes comments from clients affected by the proposals.

The main features of the Consultation Paper are summarised below.

### What is a CFC?

- A foreign company will be a CFC only where an Australian resident "controls" the company. It is intended that 'control' will be based on the Australian Accounting Standards (in particular AASB 127 and AASB 131) and will include 'joint control'.

### What income is attributable?

- Only certain 'passive income' should be subject to tax on an accruals basis and a list of 'prima facie passive income' has been provided.
- Both 'tainted sales' and 'tainted services' income of a CFC – which were previously subject to attribution under the CFC rules – are proposed to be excluded.

### Will all passive income be attributed?

- No. There are proposed to be five principal exemptions to the attribution of passive income, as follows:

#### 1. Active business exemption

- A new 'active business exemption' is proposed to apply to prevent the attribution of otherwise passive income where the income 'arises in the ordinary course of the active conduct of a trade or business'.
- This exemption reflects one key objective of the reforms to modernise and update the CFC rules to reflect the broader scope of legitimate commercial activity now undertaken by Australian-controlled businesses offshore.



- This test is proposed to be applied on an item-by-item of income basis.
- To demonstrate active conduct of a trade or business, there must be evidence of ‘competitive participation’ involving ‘human activity’.
- The Consultation Paper contains 21 examples (and seven guiding principles) to assist in determining when a particular item of income will be considered to arise in the ordinary course of an active business of the CFC. This perhaps suggests that identifying active transactions may not be a simple task and the Consultation Paper explains that taxpayers will be able to apply to the ATO for a ruling in respect of the application of the active business income exemption for cases where it is difficult to discern its precise application.
- Notwithstanding the above, royalty income will remain subject to attribution if the underlying intellectual property has been transferred to the CFC (directly or indirectly) from Australia (unless the CFC has substantially developed, altered or improved the IP).

## 2. Group income exemption

- Passive income derived by a CFC from fellow-group CFCs or the Australian controller of the CFC is proposed to be excluded from attribution. For the purposes of this test, the accounting concept of a group company would be used.

## 3. AFI subsidiary exemption

- The Australian Financial Institution (AFI) subsidiary exemption remains. However, details about this rule are scant and will be developed in consultation with industry.

## 4. EDCI exemption (listed country CFCs only)

- CFC’s that are tax resident in a ‘listed country’ (currently US, UK, Canada, France, Germany, Japan & New Zealand) are to remain subject to attribution

only in respect of passive income that is listed in the regulations as being concessionally taxed (so called, eligible designated concession income or EDCI).

## 5. De minimis exemption (old five per cent rule)

- A de minimis test is to be retained (similar to the current active income test) to exclude passive income from attribution where, based on the financial accounts, it represents less than five per cent of the total income of the CFC.

## Are the above exemptions limited?

- The Consultation Paper outlines a previously unannounced integrity rule that is intended to protect the Australian revenue base from the impact of the above exemptions by denying a tax deduction for an Australian attributable taxpayer (or CFC of such taxpayer) for payments of passive income made to the CFC which are exempt from attribution.

- The intended application of this integrity rule is not clear from the Consultation Paper. In particular, it seems that this rule is intended to only be activated where the passive income of a CFC is protected from attribution by the active business, group income and/or the AFI exemption (cf the De minimis and EDCI exemptions). However, the Consultation Paper and associated draft outline of the rules does not make this clear. This will no doubt be a topic to address in the consultation process.

## How is the CFC’s attributable income calculated?

- The current approach to calculating the attributable income of a CFC will be broadly retained with some modification – i.e. each CFC must calculate its notional taxable income under Australian concepts on a stand-alone basis, on the assumption that it is an Australian resident.



- In calculating the attributable income of a CFC (in addition to the existing modifications to the income tax law) it is proposed that:
  - Division 974 (debt and equity) and Division 230 (TOFA) will now apply
  - section 23AH (foreign branch exemption) is now included, and
  - the CFC will not be subject to the thin capitalisation rules (and therefore will not be entitled to access a deduction under section 25-90)
- The draft operative rules contemplate an attributable taxpayer being taxed on the attributable income of a CFC multiplied by its ‘total participation interest’ in the CFC. However, an alternative method has also been proposed for discussion. Under this alternative ‘subtractive approach’ the Australian controller would be taxed on 100 per cent of the attributable income of the CFC, with a tax offset or credit provided for distributions that are made (or reasonably anticipated to be made) to non-controlling, non-associated Australian investors in the CFC or to associated foreign investors.

### A revised foreign dividend exemption

- The current exemption for non-portfolio dividends under section 23AJ will no longer apply to dividends paid on Division 974 ‘debt interests’ but will be extended to apply to distributions made on Division 974 ‘equity interests’ where the recipient of the distribution has at least a ten per cent participation interest in the foreign company (or is otherwise an attributable taxpayer in relation to that CFC).
- A participation interest is measured as the percentage right of a holder to returns on equity interests of the CFC to its members that are a distributions of profits. Where this is impossible or impractical to determine, distributions of capital to members or relative market value may be used (in that order).

- This exemption will also be extended to apply to income derived through one or more interposed partnerships or trusts.

### Which taxpayers will this affect?

- The proposed legislation affects all Australian tax residents who hold interests in foreign corporate entities.
- Trustees of a complying superannuation entity should not be required to include any attributable income from CFCs in the entity’s assessable income (as complying superannuation funds will be exempt from attribution under the proposed rules).

### What should you be doing?

Affected taxpayers should consider the impact of the proposed changes on their business structure and operations. However, without detailed draft legislation and no guidance concerning operative dates, this may be difficult in practice.

To the extent that you wish to give feedback to Treasury, submissions on the Consultation Paper should be made by 31 August 2010.

Some immediate thoughts of areas to consider include:

- The change in the definition of a CFC to control (including ‘joint control’) could affect the entities that are and are not CFCs.
- The active business exemption is a step forward in terms of flexibility compared with the previous rule. However (as recognised in the Consultation Paper) it can present challenges for taxpayers in obtaining certainty as to whether a particular item of income will qualify or not. It remains to be seen if Treasury’s suggestion to obtain a private ruling from the ATO will be workable in practice.

- Amounts of income that were previously brought within the regime may no longer be subject to attribution. This could include tainted sales income and tainted services income and certain passive income (e.g. amounts received from a group company or received by an active CFC).
- The passive income ‘integrity rule’ may adversely impact current deductions being claimed in the Australian group or in existing CFCs. This area requires further careful consideration and focus in the consultation process.
- Whilst the section 23AJ exemption on dividends repatriated to Australia no longer applies to non-equity shares, its extension to equity interests may have an impact on current and future plans for funding offshore investment.



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