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### **Consultation paper – reform of the controlled foreign company rules**

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide comments on the reform of the controlled foreign company rules consultation paper released by Treasury on 5 January 2010 (**Consultation Paper**).

The Taxation Institute's submissions on the proposed reforms as outlined in the Consultation Paper are set out in the attachment to this letter.

The Taxation Institute understands that Treasury is seeking brief submissions in relation to the proposed reforms rather than submissions which include detailed arguments justifying the submissions. Accordingly, the Taxation Institute's submissions only include a brief explanation of the reasons for our submissions where appropriate.

If you require any further information or assistance in respect of our submission, please contact David Williams on 02 9958 3332 or the Taxation Institute's Tax Counsel, Angie Ananda on 02 8223 0011

Yours faithfully

A handwritten signature in black ink that reads 'D Williams'.

David Williams  
President

## Attachment

### The Taxation Institute's comments in respect of foreign source income attribution rules Consultation paper

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#### Glossary:

Term	Meaning
<b>Board Review</b>	The Board of Taxation's Report on the Review of the Foreign Source Income Anti-Tax-Deferral Regimes (September 2008)
<b>Consultation Paper</b>	Treasury Consultation Paper concerning the controlled foreign company rules released on 5 January 2010
<b>June Submission</b>	The Taxation Institute of Australia's submission dated 9 June 2009 in relation to the Treasury Discussion Paper concerning the foreign source income attribution rules released on 12 May 2009
<b>Tax Act</b>	The <i>Income Tax Assessment Act 1936</i> and the <i>Income Tax Assessment Act 1997</i> (as appropriate)
<b>HM Treasury Discussion Document</b>	Her Majesty's Treasury 'Proposals for controlled foreign companies (CFC) reform: discussion document' (January 2010)

## 1. Targeted income module

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### 1.1 Commercial income stream

#### Consultation question 1

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

#### Summary of Submissions

- The inclusion of a specific list of passive income is to be welcomed. However, consideration should be given to narrowing and clarifying the list of items included as prima facie passive income.

Subject to the comments below, broadly stated, the rules target the kind of income which should be subject to attribution.

The description of 'prima facie passive income' in Rule 1-1 casts a wide net effectively capturing all types of income that would typically be viewed as 'passive income' as well as many that would otherwise not (particularly as the income is derived through an active business). Amounts of prima facie passive income that will not be subject to attribution are then determined by way of the exceptions contained in Rules 1-2 and 1-3. Whether or not the rules target the kind of income that should be subject to attribution is therefore very much a function of the correct operation of these latter rules which are discussed below.

The Taxation Institute observes generally that the list of items in the definition of 'prima facie passive income' is heavily reliant on Tax Act-defined terms. Notably, it requires cross reference to the definitions of 'equity interest', 'debt interest', 'financial arrangement' and 'CGT event'. The Board Review considered the manner in which passive income should be defined in paragraphs

3.35 to 3.44. Relevantly, it proposed basing amendments on ‘existing well-understood concepts’ as a means of providing greater certainty (see para.3.38 and 3.39).

As a starting point, the Taxation Institute does not consider it appropriate that tax concepts are used to determine whether a CFC has prima facie passive income. From a compliance perspective, it would be significantly easier if a taxpayer first determines whether, based on the accounts and other records, the CFC has earned what would ordinarily constitute passive income (eg. interest, dividends in the ordinary sense). If the CFC has derived no such income, then no further inquiries would be required. However, if the CFC has prima facie passive income which is adjusted tainted income, then at this point, Australian tax concepts would be applied to determine the CFC’s notional assessable income. Adopting this approach would be consistent with the methodology reflected in the current CFC rules.

In contrast, under the current proposed wording, a taxpayer would have to apply Australian tax concepts much earlier in the process – namely, at the first step in determining whether it has prima facie passive income (eg a debt interest, a “financial arrangement”). As mentioned above, this will increase the compliance burden for taxpayers.

Secondly, while the Taxation Institute acknowledges that terms defined in the Tax Act may be said to be ‘existing’, they are not necessarily ‘well understood’. In particular, the definitions of ‘debt interest’ and ‘equity interest’ raise a host of technical issues and it is unclear whether the term ‘financial arrangement’ is intended to take its Div.230 or its Div.974 meaning. If it is the case that the Div.230 definition should apply, its relative newness will inevitably cause ‘teething problems’. If it is meant to be the Div.974 definition, the Taxation Institute reiterates the significant issues associated with applying the debt/equity rules. In all cases, it is difficult to apply these tax concepts in the domestic context and will be even more difficult to apply them in the foreign context.

The Taxation Institute proposed in its June submission that the categories of passive income that constitute the basis for working out attributable income should be clearly defined and should focus on passive income that provides the greatest incentive for inappropriate deferral outcomes. While the rules, in particular Rule 1-1, do provide a definitive list of items of ‘prima facie passive income’, which is welcomed, the list may go too far, in particular in relation to its general inclusion of profits from CGT events. This is on the basis that CGT assets encompass all assets – whether on ‘revenue’ or ‘capital account’. Therefore, any profits realised on realisation of revenue assets are technically prima facie passive income, with taxpayers having to rely on the ‘active business exemption’ to ensure such profits are not attributable income. Consideration ought to be provided for limiting the scope of CGT assets to those which give rise to gains or profits of a *capital nature*. This would be consistent with the approach that has been adopted in relation to ‘designated concession income’ in the *Income Tax Regulations 1936* (see in particular, the definition of ‘capital gains’ in Regulation 152A(3)).

More specifically, to the extent that ‘financial arrangement’ is meant to take its Div.230 meaning then the Taxation Institute remains of the view, expressed in our June submission, that taxpayers should be given the choice as to whether to apply Division 230 to their interests in a CFC and in calculating the attributable income of a CFC. Put another way, the CFC rules should only apply to Div.230 financial arrangements on an elective basis. Inclusion of financial arrangements in the definition of prima facie passive income will effectively impose the burden of a taxation of financial arrangements style inquiry in relation to all transactions entered into by a CFC. Such an inquiry would entail considerable compliance costs and would be particularly complicated in the foreign context. ‘Financial arrangements’ are therefore inappropriately included in the definition in Rule 1-1.

Further, clear guidance will need to be provided in relation to the meanings of some categories of income. For example, it should be made clear what exactly a ‘return on a debt interest’ includes. In practice, this wide description could include, for example, many fees which would ordinarily be viewed as active income. Similarly, would a ‘return on a debt interest’ include a capital return on a debt interest? If capital returns on debt interest are included, would the definition also be broad enough to catch foreign exchange gains and losses on such returns?

The Consultation Paper did not address the Taxation Institute's concerns in relation to the retention and modernisation of the 'AFI subsidiary exemption' and the related meaning of 'financial intermediary business'. The proper operation of this exemption is critical in that it ensures that income from banking almost all of which would be, by definition, 'passive income' is exempted from attribution.

The Taxation Institute welcomes the retention of the 'EDCI' and 'listed country' approach and reasserts its view that the list of 'listed countries' should be updated to include other countries which have a comparable effective tax rate such as China and Korea.

As an alternative (or perhaps as an addition) to expanding the list of 'safe' jurisdictions, it may be useful to develop a test or list of factors that would permit taxpayers to identify other similarly tax jurisdictions in which subsidiary operations would not, prima facie, attract attribution. The Taxation Institute notes that this approach is currently under consideration by the Treasury of the United Kingdom. Specifically, the HM Treasury Discussion Document<sup>1</sup> proposes that subsidiaries operating in jurisdictions where they would be taxed comparably to the UK will be prima facie excluded from the CFC regime. Rather than creating a 'white list' of comparably taxed jurisdictions, the UK Government is exploring whether a short list of factors could be compiled that would act as proxies for an UK type tax base.<sup>2</sup> This approach has considerable appeal and its progress in the UK should be monitored.

The Taxation Institute welcomes the introduction of the intra-group income exception contained in Rule 1-3.

## Consultation question 2

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

## Summary of Submissions

- The inclusion of the active business test is to be welcomed. However, further consideration should be given to the precise wording of the exemption to provide greater certainty in relation to its application in practice, particularly where the CFC is a special purpose company which is conducting limited activities (as part of a wider group).

The Taxation Institute notes that the 'active business test' included in rule 1-2 represents a significant paradigm shift from the existing 'active income test' insofar as it tests the foreign entity's business not the income it derives. Consequently, it permits taxpayers to derive inherently passive income within their active business operations without attribution. This change appropriately reflects the practical reality of foreign active business operations in which considerable passive income is derived in the course of business without any deferral intent.

Notwithstanding this significant improvement to the model, the Taxation Institute observes that the active business test will present considerable practical and interpretive dilemmas.

From an interpretive standpoint, questions will arise as to the meaning of key terms required to apply the test, such as:

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<sup>1</sup> Her Majesty's Treasury in the United Kingdom released a discussion document in January of this year entitled 'Proposals for controlled foreign companies (CFC) reform' ('**HM Treasury Discussion Document**') which canvassed many similar issues to those set out in the various reviews, discussion papers and consultation papers published by the Australian Tax Review Board and Treasury.

<sup>2</sup> HM Treasury Discussion Document at para. 2.9.

- what will constitute income that arises in the ‘ordinary course’ of the active conduct of a trade or business? Can a one-off investment or undertaking ever be taken to give rise to income that arises in the ordinary course of an active business?
- what is ‘competitive participation’? Against who must you compete? How can the human activity through a PE of another entity evidence the ‘competitive participation’ by the CFC in a given undertaking? what happens when the human activity (either by an employee of the CFC itself or by another individual) does not occur through the relevant permanent establishment?
- to what extent must a nexus between the human activities performed by or on behalf of the CFC with the income it derives, be established?

Some of these issues may be overcome by providing definitions or exceptions clarifying what will or will not put an entity or income from its activities within/outside the scope of the active business test

The Taxation Institute notes that the active business test is focused on a particular CFC. It is the case that many CFCs, particularly special purpose vehicles (**SPVs**), operate within the context of a larger overall active business. The Taxation Institute submits that the active business test should incorporate sufficient flexibility to address the activities of a broader group rather than focusing on the activities of a single member within that group. At present, it is not sufficiently clear that the active business exemption will apply to SPVs which are conducting activities as part of the operations of a wider group of which the CFC is a member.

For example, on a practical level, although the existence of a ‘permanent establishment’ is not the primary condition for determining whether an item of income is passive or active, it is still fundamental to the finding of an active conduct of a trade or business. Many businesses use SPVs in their foreign operations and to avoid the complications of having PEs in multiple jurisdictions will use employment entities to service those SPVs. In some cases, the human activity (negotiating contracts, etc) will occur before the SPV entity is even created. Absent a physical PE and on-going human activity in relation to the SPV’s business, the passive income of an SPV may be inappropriately outside of active business exception notwithstanding the active nature of its business.

In addition, confusion may arise due to differences in tax treaty and domestic law definitions of PE. For example, many tax treaties exclude ‘preparatory or auxiliary activities’ from giving rise to a PE. Will these operations be sufficient to give rise to a PE under the definition of PE in s.6(1) of the Tax Act so as to permit CFCs with such operations to avail themselves of the exception?

Ultimately, in circumstances where taxpayers are legitimately streamlining their foreign operations so as to minimise their costs and tax burden in certain jurisdictions where they operate, the imposition of the PE test will impose an unnecessary compliance burden for the purpose of seeking legitimate relief from attribution.

### Consultation question 3

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

### Summary of Submissions

- Consideration should be given to including additional exemptions, for example, a ‘motive’ test similar to that proposed by the UK Treasury.

Some of the concerns addressed above could be addressed, as noted, by way of definition or exception.

Additionally, exceptions from the CFC regime such as those proposed in the HM Treasury Discussion Document could be incorporated into the Australian reforms. In particular, HM Treasury is proposing an exemption system, whereby subsidiaries satisfying a 'trading business' test or with de minimis profits will be exempted from the regime. Flexibility in the system has been proposed to address circumstances where exemption requirements are narrowly missed or where one-off commercial transactions result in a test being failed. Additionally, HM Treasury is considering the inclusion of a 'motive test' for circumstances where exemptions are not available:

The [motive] test would provide an opportunity for such an overseas subsidiary to demonstrate the non-tax related commercial rationale for any specified transaction and/or its role or purpose as a member of the group as a whole.<sup>3</sup>

#### **Consultation question 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?

#### **Summary of Submissions**

- Accounting standards relating are an appropriate basis upon which to determine group entities. However, it would be more appropriate to define group entities according to equity accounting concepts as set out in AASB 128 than according to the consolidation rules in AASB 127.

As noted in the June submission, the Taxation Institute supports the use of accounting standards as the means by which a 'group' is determined, which is consistent with the Board Review (paragraph 3.48). However, the Taxation Institute notes that Treasury has elected to apply the rules pertaining to consolidation for determining 'group entities' rather than the broader concept of group entities espoused in the equity accounting rules in AASB 128. In the circumstances, the Taxation Institute is of the view that it is more appropriate to adopt the broadest possible definition of 'group entity' and thus AASB 128 should be adopted as the basis for identifying group entities.

### **1.2 Tax law income stream**

#### **Consultation question 5**

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

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<sup>3</sup> HM Treasury Discussion Document at para. 2.17.



## Summary of Submissions

- In computing a CFC's attributable income, it is appropriate that in applying Australian tax rules, a variety of exclusions apply.

The Taxation Institute's June submission proposed listing taxing provisions that should apply to arrive at a CFC's attributable income. The Taxation Institute notes in this regard that the rules set out in the Consultation Paper reflect the adoption (or continuation of) an exclusion approach similar to that which applies under the current CFC regime.

To the extent that Treasury intends to proceed using an exclusion approach, the Taxation Institute reiterates the need for excluding a number of tax measures which were listed in the Board of Taxation Issues Paper (May 2008) in section 5.19. Further to our June submission the Taxation Institute reiterates that:

- TOFA should apply only on an elective basis;
- the foreign exchange rules in Subdivision 960-C and Division 775 should not apply;
- Attributable taxpayers should be able to make functional currency elections in relation to a CFC for the current year in which the CFC interest is first acquired; and
- Division 820 should not apply, nor should there be a quasi-thin cap rule for CFCs.

## Consultation question 6

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

## Summary of Submissions

- The change of residence provision in Rule 2-1 needs to be revised to ensure that only the component of a capital gain in relation to an asset that can be attributed to a time period where the CFC was resident in an unlisted jurisdiction is subject to attribution.

As it is currently conceived, the change of residence provision set out in Rule 2-1 is overly broad and will have unintended consequences.

Firstly, the Taxation Institute notes that the rule is drafted broadly enough to capture any change of residence to a listed country. It should not be the case that a change of residence from a listed country to a listed country should give rise to attribution on gains. In this respect, the Taxation Institute notes that Rule 2-1(3) proposes that carve outs are to be determined. The Taxation Institute submits that one such carve out should be for listed country to listed country residence changes.

Secondly, the Taxation Institute observes that, as currently drafted, Rule 2-1 will capture all of a capital gain on an asset from the time of acquisition to the time of disposal regardless of the holding time in the listed country. This is an inappropriate result and results in the taxation of gains beyond what is currently contemplated in s.457.

Section 457 creates a deemed disposition of CGT assets at the time of a change of residence and any gains resulting from the deemed disposition are attributed under the CFC rules at the time of the deemed disposal. Section 457 has been criticised in that it creates a timing issue for attributable taxpayers by taxing such gains without an actual disposition. In this respect, Rule 2-1

improves on s.457 by moving the taxing point to the time of actual disposition. However, Rule 2-1 takes the taxing right further by also asserting a right to tax increases in value accumulating during the residence in the listed country, including where the capital gain is not EDCI.

In order to address the issues inherent in s.457 and in Rule 2-1, the Taxation Institute proposes that the rule be drafted in such a way as to create a deemed disposition of the asset at market value at the time of the change of residence. However, attribution of the gain from the disposition of the asset should be deferred until such time as the asset is actually disposed of.

### Consultation question 7

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

### Summary of Submissions

- Capital losses (to the extent they are realised on the disposal of a passive asset) should be available to be carried forward and used to offset gains realised in later years.

The Taxation Institute supports the approach reflected in Rule 2-3(d) that only those capital losses that arise from essentially passive assets should be available to offset capital gains realised on the disposal of other passive assets.

It should be the case that any unutilised capital losses (which are realised on the disposal of passive assets) should at the very least be available to be carried forward by the CFC to future years to offset capital gains realised in subsequent years (subject to the usual restrictions).

## 2. Attributable taxpayer module

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### 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?

### Summary of Submissions

- If the concept of control is the sole ground that will be used in determining whether a foreign company is a CFC, then a sufficient degree of certainty should be provided as to what this concept actually means. Under current law, there is no 'ordinary meaning' of the concept of control.

Greater certainty in the meaning of 'joint control' would be preferred to permitting the term to take its 'ordinary meaning'. In the circumstances, the Taxation Institute submits that the definition of 'joint control' in AASB 131 focuses too narrowly on what amounts to control over operations (what would be taken to be the 'central management and control' in a residency inquiry) rather than on control over distributions of profits. Specifically, AASB 131 defines 'joint control' as:

Joint control is the contractually agreed sharing of control over an economic activity and exists only when the **strategic financial and operating decisions** relating to the activity require the unanimous consent of the parties sharing control (the venturers). [Our emphasis.]



In the CFC context, the inquiry into control as well as 'joint control' should be concerned with whether or not a party or group of parties control the manner in which profits will be distributed since such decisions ultimately determine when and whether deferral occurs. This policy is reflected in the rules relating to control and indirect control of companies and trusts in sections 350-355 of the Tax Act. The definition of 'joint control' should require unanimous consent of parties sharing control over distribution policies of the CFC.

The concept of control is central to the operation of the CFC rules. Its proper definition is therefore critical. The Consultation Paper suggests that 'control' is a term which can easily adopt its 'ordinary meaning'. However, it is clear that the case law concerning the meaning of 'control' provides little in the way of guidance as it is largely dictated by the context in which the term appears. For example – does it mean control at the shareholder or director level, does it mean control over all operations and affairs of the company or only specific ones (eg. distribution policy), does it require that actual control has to be exercised or is it sufficient that the Australian taxpayer has the ability to control certain decisions (eg. by having a veto right in relation to particular decisions)?

The 'ordinary meaning' of control is therefore not as clear as would be suggested by the Consultation Paper and the Taxation Institute reiterates its view expressed in the June submission that the de facto control test now contained in s.340(c) should be removed and replaced with a test of economic control/contribution. Where such a test is not feasible, then what exactly is meant by 'control' should be spelled out in the new rules and not left to its 'ordinary meaning'.

In addition, the Taxation Institution is concerned with the breadth of the definition of 'joint control' in Rule 3-2, particularly in relation to the concept of two or more entities jointly controlling a CFC. In theory, based on this definition and absent further criteria it would appear possible to have a group of independent owners who only each have a very small actual percentage of ownership being taken to 'jointly control' the subsidiary, on the basis that collectively they control the company for example merely by signing a shareholders agreement (even though they are not acting in concert). Furthermore, additional clarification will be required to determine what kinds interests or contractual obligations can give rise to control or joint control. For example, while it seems clear that where there are two shareholders (49% / 51% interests) who sign a shareholders agreement requiring unanimous agreement as to the key decisions of the company (including the declaration of a dividend), this would give rise to joint control, the relevant analysis in circumstances where there are a group of (say) 8 shareholders who sign a shareholders agreement or there are tag along or drag along rights, is considerably less clear.

### **3. Attribution of attributable income module**

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#### **Consultation question 9**

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

#### **Summary of Submissions**

- It is to be welcomed that the 'testing time' for CFCs will be one-off at the end of the CFC's statutory accounting period. However, apportionment should be applied where a purchaser acquires a CFC part-way through the CFC's statutory accounting period.
- If the 'associate' definition is not going to be amended significantly as part of the rewrite of the CFC rules, then a narrower version of the definition should be applied for the CFC rules.

#### Testing time

It is to be welcomed that the 'testing time' for CFCs will (as is the case with current law) be the end of the statutory accounting period of the CFC and that only those Australian taxpayers who have an interest in a CFC at this time have to include any attributable income in their assessable income.

However, The Taxation Institute reiterates the point made in its June submission that apportionment should be applied where a purchaser acquires an interest in a CFC part-way through the CFC's statutory accounting period.

### Participation interests

The Taxation Institute's primary concern with the rules governing the calculation of an attributable taxpayer's share of the CFC's attributable income relate to the problems inherent in the definition of 'participation interests'. Please see question 15 below for a full discussion of this issue.

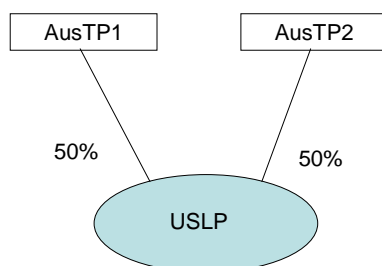
### Associate test

In addition, the Taxation Institute would like to reiterate its on-going concerns with the retention of the definition of associate in s.318 for the purposes of the CFC rules.

The breadth of the definition of associate results in inappropriate parties being taken to be associates for the purposes of the CFC rules.

By way of example, consider the following:

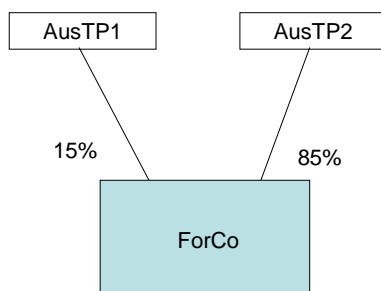
Transaction 1



AusTP1 and AusTP2, two otherwise unrelated parties acting at arm's length enter into Transaction 1. They each subscribe for 50% of the interests in a US limited partnership which is treated as a foreign hybrid in Australia. As a result of Transaction 1, AusTP1 and Aus TP2 are 'associates' within the meaning assigned by s.318(2)(a) as they are partners.

AusTP1 and AusTP2 then enter into Transaction 2 which is an investment in ForCo. AusTP1 has a 15% interest and AusTP2 has a 85% interest in ForCo. AusTP1 and AusTP2 are still unrelated and acting at arm's length. Transaction 2 is a new transaction, completely separate and independent of Transaction 1.

Transaction 2



Because AusTP1 and AusTP2 are associates within the meaning assigned by s.318 as a consequence of Transaction 1, they will also be associates for the purposes of Transaction 2. As a result, under Rule 3-1(b)(ii), AusTP1 will be taken to be an attributable taxpayer in relation to ForCo notwithstanding: (a) its minimal, non-controlling interest in ForCo and (b) the nature of its relationship with AusTP2 in the circumstances of both Transaction 1 and Transaction 2.

Retaining the existing definition of 'associate' for the purposes of the revised CFC rules will have the effect of causing entities to be attributable taxpayers in inappropriate circumstances. Moreover, it creates a significant compliance concern insofar as it requires parties to ascertain the nature of the investments of all parties with whom they have associate relationships with to determine whether their associate status in one transaction has CFC consequences for others.

#### Exemption for complying superannuation funds

Rule 4-1(3)(a) exempts complying superannuation funds from including attributable income in their assessable income for an income year. As discussed in greater detail in the June submission and again in the 'Additional Issues' section below, the Taxation Institute submits that this exemption should be extended to all complying superannuation entities.

Furthermore, the Taxation Institute observes that as Rule 4-1(3)(a) is currently drafted, the exemption will only be available where the superannuation fund is an attributable taxpayer. This means the exemption would only apply where the superannuation fund invests directly in a CFC. The exemption will not be available in circumstances where, say, the superannuation fund invests in an onshore trust which invests in a CFC. Because the interposed onshore trust will be the attributable taxpayer, the superannuation fund will not benefit from the exemption provided in Rule 4-1(3)(a). From a policy perspective, it should not matter whether an interest in a CFC is held by a superannuation fund directly or through an interposed trust. Consequently, it is submitted that the rules be drafted so as to address this fact pattern.

#### **Consultation question 10**

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

#### **Summary of Submissions**

- A de minimis exception is required.

Clearly, a de minimis exemption in Rule 4-1 would have compliance cost benefits. However, the compliance cost benefits would be greater if the regime were to include 'threshold' de minimis rules. A threshold de minimis test/s would serve to exempt an entity at the outset of the CFC inquiry rather than at the end stage of attribution process. The Consultation Paper does not address this proposal.

The Taxation Institute proposed three types of threshold de minimis exceptions that should be included in the new CFC regime in its June submission:

1. a value of interest in foreign entities exemption;
2. an amount of passive income of the CFC exemption; and
3. a balanced portfolio exemption.

Details concerning these proposals are set out in the June submission.

An further threshold *de minimis* test featured in the UK CFC regime (and which the HM Treasury Discussion Paper proposes retaining and increasing) which the Taxation Institute proposes for consideration by Treasury looks to the profits of the CFC.<sup>4</sup>

The policy objectives of the Australian CFC reform align in many respects with those of the UK. In particular, both reforms are concerned with minimising compliance costs and protecting their respective country's tax revenue. Incorporating one or all of the above-noted threshold *de minimis* tests to exclude certain foreign subsidiaries from the CFC regime will constitute a significant step toward minimising compliance costs without putting any meaningful amount of Australian tax revenue at risk.

The Taxation Institute appreciates that the active business test approach taken in the rules set out in the Consultation Paper implicitly provides a *de minimis* test. In theory, the active business test should ensure that a small amount of passive income earned in the context of an otherwise active business will not be subject to attribution. However, relying on the active business test as the primary means of excluding income from the CFC regime will still require CFC analysis to be performed on entities where the risk of deferral is low. Hence, the potential compliance cost benefits associated with the above-proposed exemptions are such that they should be taken into serious consideration by Treasury.

#### 4. Distributions to Australia Module

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##### Consultation question 11

- Do the rules appropriately apply to determine a taxpayers' entitlement to the non-portfolio dividend exemption?

##### Summary of Submissions

- The use of equity concepts to determine a taxpayer's interest in a foreign company for the purposes of applying the dividend exemption is fraught with difficulty.
- One alternative would be for the ownership level to be based on legal form shares such that, once the requisite threshold (10%) is satisfied, all returns on equity interests can qualify for the exemption.
- It should be expressly stated that the dividend exemption is capable of applying to Div 5A limited partnerships that are deemed to be companies for all purposes of the Tax Acts.
- The timing aspects of when the necessary requirements (eg. 10% ownership threshold) have to be satisfied should be clarified, particularly to deal with buy-backs and redemptions.

As discussed below, the Taxation Institute is of the view that the definition of 'participation interest' is problematic. Given that the entitlement to the non-portfolio dividend exemption turns on the quantum of a receiving company's 'total participation interest' in the distributing company, it too is plagued with uncertainty.

##### The Equity Interest Approach – the primary mechanism

In particular, the Taxation Institute is of the view that it is inappropriate in the context of the non-portfolio dividend exemption to look to equity interests within the meaning of Division 974 in determining nature and quantum of a dividend recipient's interest in a foreign entity (the **Equity**

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<sup>4</sup> Companies with profits beneath £50,000 are currently exempt from the UK CFC regime.

**Interest Approach).** Equity interests are relevant for determining a taxpayer's 'total participation interest' (Rules 7-1 and 7-2) under the 'primary mechanism' in Rule 7-2(1). 'Total participation interest' in turn is relevant for Rule 6-1 which makes certain distributions non-assessable non-exempt income.

The Equity Interest Approach imposes the application of the notoriously challenging debt/equity rules onto foreign entities. In order to determine whether amounts received on an interest in a foreign entity will be entitled to the benefits of the exemption, the taxpayer will first have to determine whether or not its interests are 'equity interests' within the meaning assigned by Division 974. This will present unique challenges in that it will require consideration of foreign legal documents and laws which may not be available in English. In many cases, foreign concepts will require explanation by foreign advisors.

The Equity Interest Approach will also require the taxpayer to consider the debt/equity characterisations of all other potential equity interests on issue by the foreign entity (with the related information issues noted above) to determine the total number of equity interests on issue to work out whether it meets the 10% threshold. This assumes that the Australian taxpayer is in a position to access the information and documentation pertinent to such an inquiry. Whilst in the CFC context, the ability to access to such information may be easier<sup>5</sup>, in the non-portfolio dividend exemption context the affected taxpayer is not necessarily in a controlling position. The Taxation Institute notes that it is conceivable that even an entity holding 50% or more of the 'equity interests' in a foreign entity would not have the degree of control necessary to access information where those interests do not have equity governance entitlements in the local jurisdiction.

In addition, levels of relevant interests in the foreign entity could fluctuate significantly between years (and even between distributions) and the holder of the interest may have little control over such fluctuations.

Use of the Equity Interest Approach in this context will provide further challenges when it comes to ascertaining which equity interests will give rise to 'distributions of profits' under the primary method of determining a taxpayer's 'total participation interest'. Although in Australia, for the time being, dividends must be paid out of profits, such is not the case in all foreign jurisdictions where, for example, directors may declare a dividend provided they are satisfied of the solvency of the company. Moreover, it may be the case that many equity interests on issue by a particular CFC will in fact be legal form debt in relation to which the 'distributions' (ie. interest) would typically be seen as an expense which reduces profits (rather than a distribution of profits). Rather than adopting the Equity Interest Approach, the Taxation Institute suggests retaining a threshold ownership test that is based on legal form shares. Once this threshold is passed, the exemption itself could then be applied to returns on *equity interests* held by the Australian taxpayer.

The Taxation Institute notes as well that the inclusion of the Equity Interest Approach in Rules 7-1 and 7-2 does not impact exclusively on the non-portfolio dividend exemption. It will also have a considerable impact on the operation of the CFC rules more broadly in 'total participation interests' are also relevant for working out how much of a CFC's attributable income relates to a particular Australian taxpayer.

#### The other default mechanisms

The inclusion in Rule 7-2 of the two additional 'default' mechanisms where the primary rule in Rule 7-2(1) for working out an entity's 'direct participation interest' is impossible/impracticable is broadly welcomed. However, it is not clear what will amount to circumstances that make it 'impossible/impracticable' to use a particular mechanism. Moreover, these two mechanisms do not

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<sup>5</sup> There may still be practical difficulties in the CFC context for Australian taxpayers to obtain sufficient information to undertake a debt/equity analysis. This would typically be where the Australian taxpayer has only a minority interest in the CFC (the foreign company being a CFC due to the interests of its associates). Due to the breadth of the definition of 'associate' (refer Consultation Question 8 above), it may be the case that the associates of the Australian attributable taxpayer are unrelated third parties.

appear to depart sufficiently from the equity interest approach espoused in the primary mechanism which, as set out above, is plagued with difficulties in its practical application.

The secondary mechanism (Rule 7-2(4)) refers to distributions of capital to 'members'. Should this be taken to suggest that it applies to holders of legal form shares or more broadly to holders of equity interests? To the extent that this mechanism is meant to capture holders of equity interests broadly, it suffers from the same issues as the primary mechanism.

The application of the third mechanism (Rule 7-2(6)) specifically references "direct equity interests' in the other entity (measured by market value)". Again, this appears to require taxpayers to undertake inquiries into all of the CFC's outstanding interests to determine its 'equity interests'. Additionally, it requires a determination of the market value of those interests. While this may not pose considerable difficulties in the case of some listed companies where such information can be ascertained based on trading prices, in the majority of cases, this requirement will impose a considerable compliance burden and one which must be undertaken every time a distribution is paid (in relation to the dividend exemption) or annually (in relation to the testing of 'attributable percentage' for CFC purposes).

#### Clarification of application to limited partnerships

In the view of the Taxation Institute, the rules should expressly provide that they are capable of applying where the payer of the distribution is a limited partnership that is deemed to be a company under Division 5A of the Tax Act. This is to address the issue in a recent ATOID (ATOID 2010/8) which states that s.23AJ is incapable of applying where the payer is a corporate limited partnership. The Taxation Institute does not agree with the views expressed in that ATOID.

#### Timing aspects

Currently, s.23AJ is unclear as to when the corporate taxpayer has to hold the requisite voting interest – whether immediately before, during or after the dividend payment. This raises uncertainty where the dividend (or deemed dividend) is paid as part of the termination of the taxpayer's interest in the foreign company eg. on a cancellation or buy-back of the shares. In the view of the Taxation Institute, the dividend exemption ought to apply to any dividends (for tax purposes) arising on a buy-back or redemption of shares.

The proposed dividend exemption (Rule 6-1) is drafted in a similar manner to current s.23AJ. It provides that the necessary requirements have to be satisfied *at the time the distribution is made*. This does not resolve the uncertainty outlined above.

#### **Consultation question 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?

#### **Summary of Submissions**

- The addition of 'attributable taxpayer' in the context of a reformed s.23AJ is to be welcomed.

Yes. The addition of the 'attributable taxpayer' rule in the context of a reformed s.23AJ aligns these rules with the CFC rules.

#### **Consultation question 13**

- Does the exemption flow through partnerships and trusts appropriately?



## Summary of Submissions

- Clarification be provided in relation to tracing distributions and ownership (of interests of the distributing company) through interposed trusts and partnerships

The Taxation Institute welcomes the proposal for the dividend exemption to flow through trusts and partnerships. In relation to the particular proposed form of wording, the Taxation Institute considers that there requires to be clarification (preferably in the legislation itself, but otherwise in the Explanatory Memorandum) around the following points:

- how partnership/trust amounts are to be taken to be “referable” to the distribution made by the distributing company (Rule 6-1(2)(c))– this will be particularly relevant where there are a number of interposed trusts/partnerships in a “chain” with interposed entities incurring expenses (eg. interest expenses) and deriving other income;
- how the 10% threshold requirement will be traced through interposed partnerships/trusts.

## 5. Participation interests

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### Consultation question 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?

## Summary of Submissions

- A deeming may be appropriate. However, in any event, taxpayers should not be taxed in excess of their economic interest in the entity (or the profits of the entity) as otherwise this would give rise to inappropriate outcomes.

The Taxation Institute recognises that this rule is directed at non-common law entities where it may be difficult to determine the precise nature of the attributable taxpayer’s participation interest. However, in our view deeming a controller to have a 100% participation interest in such entities may result in vastly overstated attributable income.

The issue presented by such circumstances could be better addressed in one of two alternative manners:

- (1) the controller could be deemed to have a participation interest equal to its economic interest in the entity (or more specifically its interest in the distributable profits of the entity);  
or
- (2) the deeming provision could provide for an exception for circumstances where the controller can establish their participation interest is something less than 100%. In such circumstances, they may adopt that lower percentage as their participation interest in the subsidiary. the Taxation Institute notes that an allowance such as this is provided for in s.102AAZD(3)(c) in the transferor trust provisions which addresses a similar concern. However, the Taxation Institute submits that there be no requirement to lodge any



documentation with the Commissioner in relation to such an exception in the CFC rules (as is currently the case under the transferor trust rules).

### Consultation question 15

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

### Summary of Submissions

- The use of profits to determine an attributable taxpayer's attribution percentage is not appropriate, unless it is to be determined having regard to legal form shares only

Please see our comments in relation to the difficulties inherent in applying the Equity Interest Approach as it concerns, in particular, the calculation of the 'total participation interest' at Consultation Question 11 above.

In the view of the Taxation Institute, if the alternative approach outlined above for 'participation interests' is adopted (ie. based on legal form shares only), then in these circumstances it may be appropriate to use rights to participate in profit distributions as the basis for determining a taxpayer's attribution percentage. Under current law, an attributable taxpayer's attribution percentage is based on the highest of voting rights, capital distribution rights and profit participation rights. This can lead to inappropriate outcomes in situations whereby the attributable taxpayer has a small economic interest in the CFC, but can nonetheless have a high (say 100%) attribution interest due to its voting interest (albeit, that it has to exercise those voting rights in the interests of others). This situation can arise in relation to collective investment vehicles such as limited partnerships where an Australian taxpayer owns the general partner. If the right to participate in profit distributions is adopted as the sole ground for determining an Australian taxpayer's attribution percentage then this would, in most cases, result in an alignment between the tax treatment and economic position of the taxpayer.

### Consultation question 16

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

### Summary of Submissions

- If profits are to be used to determine an attributable taxpayer's attribution interest, it is not appropriate for such profits to be adjusted for any Australian tax concepts (whether Div 230 or otherwise).

Please see our commentary above in relation to the use of 'profits' being an inappropriate basis upon which to determine an entities total participation interest provided in the above commentary.

The Taxation Institute is not clear as regards what is meant by Division 230 notions of equity and debt in Consultation question 16 (eg. is this meant to be a reference to Division 974).

In any event even if (contrary to our views above), 'profits' is used as a basis for determining the attribution interest of an Australian taxpayer in a CFC, it should *not* be the case that the profits are adjusted for any Australian tax rules (whether Division 230 or otherwise). Adopting this approach (of adjusting profits for Australian tax rules) would raise difficult issues such as - what happens if

the Australian taxable income exceeds the actual/accounting profits (who would be treated as entitled to such profits as they would not actually be distributed to shareholders/equity holders)?

Also, there would be an additional compliance burden (at least in the context of non-wholly owned CFCs). An Australian taxpayer only has to apply the CFC rules to determine whether it has attributable income - which is essentially passive income, as determined by applying Australian tax rules, with some modifications. In other words, to determine a CFC's attributable income, it is *not* necessary to apply Australian tax rules to the entirety of the income/profits of the CFC (as mentioned above it is only necessary to apply Australian tax rules to passive income). Therefore, the compliance burden will be significantly increased (at least for non-wholly owned CFCs) if attributable taxpayers have to apply Australian tax rules to determine the profits of the CFC (which would include applying Australian tax rules to non-passive income), to enable them to determine their attributable interest in the CFC for the purposes of determining what proportion of the attributable income they are taxed on. This may be a significant burden, particularly in situations where the amount of passive income is a relatively small proportion of the other income/profits of the CFC.

Moreover, as a matter of policy, the objective of determining an Australian taxpayer's attribution interest in a CFC is to determine the Australian's taxpayer's *economic interest* in the CFC so that it can be taxed on its proportion of the passive income of the CFC. It seems more appropriate to determine this economic interest by reference to the actual/accounting profits rather than a notional concept of profits as adjusted for (some) Australian tax rules.

The additional complexity and uncertainty and compliance requirements would not seem to warrant adopting a concept other than actual/accounting profits.

In relation to the specific question on Division 230, consistent with our response to Consultation Question 5 above, Division 230 should only apply to CFCs on an elective basis (not automatically). If profits are adjusted for Division 230 (whether notions of equity and debt or otherwise), then this would effectively 'back door' the application of Division 230 (at least where the CFC is not 100% wholly owned) as taxpayers would have to apply Division 230 in determining the income of a CFC which is attributed to them (by having to apply Division 230 in determining their attribution percentage) even if they did not elect to apply Division 230 in determining the attributable income of the CFC.

### ***Additional issues identified by the Taxation Institute***

#### **Additional issue #1 – summary of submissions**

- Consideration ought to be given as to whether the foreign hybrid measures should be amended to reflect the change in policy regarding the treatment of passive investors under the CFC rules.
- Rules should be included in the foreign hybrid measures to deal with the cost base of interests that an investor has in a foreign company when it ceases to be a foreign hybrid.

In addition to the above submissions, the Taxation Institute would like to take this opportunity to make some observations about the importance of Treasury taking into account interactions as between the CFC rules and Foreign Hybrid rules.

Under current law, whether or not an entity is a foreign hybrid turns on whether the entity is a CFC which requires a group of five or fewer Australian 1% entities the aggregate of whose associate-inclusive control interests in the company is not less than 50%. The fundamental changes to the definition of CFC proposed in Rule 3-3 will eliminate the 5 or fewer concept and, in the absence of changes to the foreign hybrid regime, this will inevitably lead to entities that were previously foreign hybrids losing their status. Currently, the foreign hybrid rules do not contain any measures that stipulate a taxpayer's cost base of its shares in a foreign company when it ceases to be a foreign

hybrid (the rules only contain measures for determining the cost base of assets which the foreign company holds when it ceases to be a foreign hybrid).

Consequently, it is essential that rules addressing issues of cost base on ceasing to be a foreign hybrid be included as part of the CFC reform package.

In addition, consideration should be given as to whether the foreign hybrid measures should be changed as a result of policy shifts in relation to the treatment of passive investors under the CFC measures.

Under current law, passive investors (holding 10% or more) who do not 'cause' a foreign company to be a CFC will still be an attributable taxpayer. Under the new CFC rules, passive investors will generally not be subject to the CFC rules. This is because only those investors who are controllers, either themselves or with associates, of a CFC will be an attributable taxpayer (new Rule 3-1).

The foreign hybrid rules operate in a manner similar to the current CFC rules. In particular, if a flow-through foreign entity is a CFC (with an attributable taxpayer) then (provided the other requirements in Division 830 are satisfied) the foreign entity will be treated as a partnership for Australian tax purposes for *all* investors, including passive investors. Consideration ought to be given as to whether, in light of the policy change underpinning the CFC rules in relation to the treatment of passive investors, a similar approach ought to be adopted for the foreign hybrid measures. If a similar policy was to be adopted in the foreign hybrid rules, then partnership treatment would only apply to those investors who would be attributable taxpayers (if the foreign entity was a CFC). Partnership treatment would not automatically apply to passive investors in the foreign entity – although they would have the ability to elect into partnership treatment consistent with (current) s.485AA.

#### **Additional issue #2 – timing**

- The CFC/dividend exemption rules should not have effect until *after* the date on which the new rules have been enacted. This is primarily on the basis that it is not correct to say that the CFC rules are an 'end of year' matter only.

In the Taxation Institute's view, taxpayers should be given an opportunity to consider the impact of the rewritten CFC and dividend imputation rules in a timely manner prior to such rules taking effect. For example, the Taxation Institute does not consider it appropriate that the rules are (say) contained in a Bill that is introduced into Parliament after the date from which such rules could potentially have application. In this respect, the Taxation Institute does not consider that it is correct to say that CFC rules are 'end of year'. This is because, if a foreign company is a CFC, then the attributable taxpayer is potentially taxed on all the passive income of the CFC derived during the income year. Unlike FIFs, it is generally not possible to 'bed and breakfast' a CFC.

Therefore, if (say) a CFC is proposing to undertake a restructure of its business, then it is inequitable that, at the time of undertaking the restructure, the attributable taxpayer does not know whether or not the restructure will give rise to passive income on which it is attributed. This situation would arise if the Bill to rewrite the CFC measures is only introduced after the beginning of the income year from which it will take effect.

#### **Additional issue #3 – exemption for superannuation funds and other complying entities**

- Approved deposit funds, pooled superannuation trusts and RSAs should be exempt from the CFC rules as should life insurance companies in relation to their VPST and SEA assets. The superannuation entity exemption should extend to direct and indirect interests in a CFC as well as to entities that are predominantly held by superannuation entities.

The Taxation Institute would like to take this opportunity to reiterate its view that approved deposit funds, pooled superannuation trusts and Retirement Savings Accounts (**RSA**) should be exempt from the CFC rules as set out in our June submission. As noted in the June submission, the exemption of such entities from the new CFC rules would be consistent with the current FIF exemption in s.519B(2) which applies to 'complying superannuation entities' (which includes complying superannuation funds and complying approved deposit funds), and that RSAs are generally taxed at 15% in respect of RSA income. In addition, and also consistent with the current FIF exemption in s.519B(1), exemptions should apply for life insurance companies in relation to their VPST and SEA assets.

As noted in response to Consultation Question 9 above, the superannuation exemption should apply regardless of whether a superannuation entity holds an interest in a CFC directly or indirectly (with other investors). Furthermore, the Taxation Institute reiterates its view set out in the June submission that it would be appropriate to include an exemption from the new CFC rules for entities that are predominantly owned (such as 90%) by superannuation entities that are themselves exempt. Such a provision would reduce compliance costs and ensure that appropriate pooling arrangements used by superannuation funds are not adversely affected by the new CFC rules.