Australia releases exposure draft legislation on reform of foreign-source income deferral rules

Australia’s Assistant Treasurer released draft legislation on 17 February 2011 to implement the reform of the controlled foreign company (CFC) rules and introduce the foreign accumulation fund (FAF) rules. The proposed changes are part of a broader package of reforms announced in the 2009/2010 Budget and mark the next stage of what has been several years of consideration by the Board of Taxation and Treasury, and consultation with business and the tax profession, to modernize these rules.

Key changes to the CFC rules

As compared to the consultation papers issued in 2010, the draft legislation eliminates certain compliance obligations, but also waters down the active income exemption from what was previously proposed. The key changes are as follows:

Active CFC test exemption – Previously referred to as the “de minimis passive income” exemption, the active CFC test still provides an exemption from attribution if less than 5% of the income of the relevant CFC has a passive character but now is tested by reference to the “financial accounts” of the CFC, instead of “audited financial accounts.” This change removes the compliance burden where CFCs are not required to prepare audited financial statements.

Active business income exemption – This exemption has been revised to take into account the concerns raised about the uncertainty of the circumstances in which the exemption would apply. A new definition of what will constitute “income of an active character” has been introduced, together with a new concept of “disconnected income,” which must be satisfied before the active business income exemption will apply. Broadly, where a CFC derives prima facie passive income and the source of the income, the market and use of labor does not have a substantial connection with the country in which the CFC has a permanent establishment (PE), such income will be attributable. This represents a substantial watering down of this exemption compared to what was previously proposed by Treasury.

“Integrity rule” – An “integrity rule” still applies and includes an amount of prima facie passive income in the attributable income of a receiving CFC to the extent the prima facie passive income has given rise to an Australian tax benefit (i.e. a deduction, change in the cost base of a capital gains tax asset or a tax offset) for the attributable taxpayer for the CFC or an associate of the attributable taxpayer for the CFC. The integrity rule was previously expressed as denying a tax benefit to the payer. Following submissions by the business community, Treasury has acknowledged that this outcome was inappropriate as a gross deduction was being denied to the provider instead of including an amount of income net of expenses in the attributable income of the receiving CFC.

CFC grouping relief – The draft legislation still provides that prima facie passive income that is referable to a financial benefit received from a member of the same CFC group is not attributable. However, grouping relief will only apply where the financial benefit has not given rise to a deduction in calculating the attributable income for the CFC that provided the benefit. Otherwise, the relevant prima facie passive income is required to be included in the attributable income of the CFC in receipt of the financial benefit.

Exclusion from attribution for rent from real property – The new rules exclude specifically rent from real property.

CFC rules

The CFC rules are intended to prevent the deferral of Australian tax on the derivation of passive income by foreign companies. The draft legislation will introduce a new set of rules intended to target more precisely Australian resident taxpayers that control (as determined according to accounting standards) foreign companies that derive certain passive income and capital gains.

Specifically, where an Australian resident (or associate of an Australian resident) controls a foreign company at the end of the company’s statutory accounting period, the company will be a CFC and the Australian resident will be taxed on an accruals basis in respect of certain passive income (“attributable income”) of the CFC unless an exemption applies.

The CFC rules will not apply if:
• For financial accounts purposes, the passive income of the foreign company is less than 5% of the gross income of the foreign company (active CFC test);
• The Australian resident that controls the CFC (directly or indirectly through partnerships or trusts) is a lightly taxed entity (i.e. complying superannuation entity or life insurance company); or
• The CFC is resident in a comparable tax (listed) country at the end of the CFC’s statutory accounting period and the income is considered to be comparably taxed.

Definition of CFC – Very broadly, a CFC will be a foreign company that is controlled by (or is controlled by an associate of) an Australian resident. If two or more Australian residents jointly control a foreign company, each will be treated as controlling the company. If two entities each hold 50% of the “equity interests” (as defined for tax purposes) in a foreign company, the entities are treated as jointly controlling the company.

<table>
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<th>Control and Joint Control</th>
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<td>The concept of control is defined by reference to the Australian Accounting Standards AASB 127: Consolidated and Separate Financial Statements. Under AASB 127, control is defined as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.”</td>
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For the purposes of AASB 127, there is a rebuttable presumption that control exists where an entity owns (directly or indirectly) more than half of the voting power of another entity. If the entity has half or less of the voting power, control also exists if the entity has power:

• Over more than half of the voting rights by virtue of an agreement with other investors;
• To govern the financial and operating policies;
• To appoint or remove the majority of the members of the board of directors;
• To cast the majority of votes at general meetings.

The concept of joint control is adopted from AASB 131: Interests in Joint Ventures. That standard defines joint control as 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.”

Active CFC test – Previously referred to as the “de minimis passive income” exemption, the active CFC test exemption still provides an exemption from attribution if less than 5% of the income of the relevant CFC has a passive character but now is tested by reference to “financial accounts” instead of “audited financial accounts.” This change removes the compliance burden where CFCs are not required to prepare audited financial statements.

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| Active CFC test ratio = \[
\frac{\text{Passive financial account income}}{\text{Financial account income}}
\] |

The test is passed if the ratio is less than 5% (i.e. there is total exemption from attribution).

Definitions

Financial account income – CFC’s gross income recognized in its financial accounts for the period

Passive financial account income – Financial account income for the period to the extent it is referable to prima facie passive income

Financial accounts

The CFC must prepare financial reports that:

• Are prepared in accordance with commercially accepted accounting principles; and
• Give a true and fair view of the financial position of the company.
Active business income exemption/"income of an active character" – The active business income exemption is a principal feature of the proposed new rules. The draft legislation refers to income covered by this exemption as “income of an active character.” Where a CFC satisfies this exemption in relation to an amount of prima facie passive income, that income will not be attributable. The exemption will be satisfied if the prima facie passive income:

- Is attributable to a PE of the entity (in Australia or elsewhere);
- Arises from the entity competing in a market (not country specific); and
- Arises substantially from the ongoing use of labor by the entity.

Broadly, a PE is a fixed place of business through which the business of an enterprise is wholly or partly carried on. In addition, the source of the prima facie passive income, the market and the use of labor must have a “substantial connection” with the country in which the PE of the CFC is located.

The principle outlined above is a significant departure from the active business income exemption that was contained in the 2010 consultation papers and represents a substantial winding back of the exemption. No examples of the operation of the proposed provision have been provided as there was no explanatory material accompanying the draft legislation.

The Australian Financial Institution (AFI) subsidiary exemption contained in the current CFC rules has been broadly retained. Details of this exemption remain subject to consultation with industry.

An integrity rule will apply where a CFC has an amount of prima facie passive income that has not been included in adjusted passive income and the attributable taxpayer or an associate has obtained a tax benefit (i.e. a deduction, a change in the cost base of a capital gains tax (CGT) asset or a tax offset) referable to that income. In that case, the CFC is required to include that prima facie passive income in its adjusted passive income. This integrity rule overrides the active business income exemption and the AFI subsidiary exemption and will only apply to listed country CFCs where the income is not comparably taxed in the CFC’s country of residence.

CFCs resident in listed countries – Passive income of CFCs resident in listed countries generally will be excluded from attribution unless the income is not comparably taxed in the listed country. The exposure draft legislation does not provide complete details of this exemption as the legislation refers to the need to specify the relevant income or profits in regulations, which have not been released. Further, the legislation seems to be introducing a requirement that the income be “subject to tax” in the listed country. Currently, the only countries that are classified as listed countries for the purposes of the CFC provisions are Canada, France, Germany, Japan, New Zealand, U.K. and U.S. There is no indication that there will be any changes to this list.

Attributable income – The attributable income of a CFC is determined by first calculating the “CFC taxable income.”

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<th>Attributable Income</th>
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<tr>
<td>CFC taxable income = Adjusted passive income – “Notional” deductions</td>
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Calculating adjusted passive income

1. **Step 1 – Prima facie passive income (PFPI)**
   - Return on equity interest (as defined for Australian tax purposes)
   - Return on debt interest (as defined for Australian tax purposes)
   - Rent payment
   - Annuity payment
   - Royalty
   - Any other profit from a financial arrangement
   - A profit from a CGT event that happens to an asset if the asset gave rise (or could have given rise) to an amount listed above
## Attributable Income

### Step 2 – Passive income

Disregard the following PFPI:

- PFPI falling within the "income of an active character" exemption
- Profits from a CGT event that happens to an asset or from a financial arrangement where the asset or financial arrangement was held for the predominant purpose of producing income that falls within the "income of an active character" exemption or amounts that were not PFPI
- Intragroup amounts – PFPI referable to financial benefits (e.g. interest) provided from other CFC group members (financial benefit is not defined) and the financial benefit does not give rise to a deduction for the other CFC
- AFI exemption – PFPI referable to a banking business

### Step 3 – Adjusted passive income

- Royalty income connected with Australia (i.e. intellectual property is automatically included (subject to the listed country comparably taxed income exemption))
- Listed countries – only income not comparably taxed will be included
- Rent from real property is not included in adjusted passive income
- PFPI that is subject to the integrity rule will be included in adjusted passive income (subject to the listed country comparably taxed income exemption)

Consistent with previous consultation papers, the base company income rules (i.e. tainted sales income, tainted services income) have been removed.

In determining the CFC taxable income, the following principles apply:

- CFC taxable income is calculated as if the CFC were an Australian resident taxpayer for the entire income year.
- Amounts must be referable to adjusted passive income to be assessable or deductible in calculating CFC taxable income for the income year.
- An amount will not be assessable or deductible to the CFC if it was actually assessable or deductible in Australia to the CFC for the income year.
- In calculating the CFC taxable income, the taxation of financial arrangement provisions and the debt/equity provisions apply. The thin capitalization rules do not apply.
- A deduction will be allowed for foreign income tax or withholding tax paid in respect of amounts included in the CFC’s assessable income, although it is not clear from the exposure draft if and when this will give rise to a foreign income tax offset for that tax paid (in accordance with the current CFC rules).
- Where it is necessary to calculate the net income of a foreign partnership or trust for the purpose of calculating the CFC taxable income, the above principles apply.

**Grouping relief and associated “integrity rule”** – Financial benefits received by a CFC from a member of the same CFC group are exempt from attribution, provided the financial benefit has not given rise to a deduction for the CFC that provided the benefit (the term “financial benefit” is not defined in the draft legislation). Otherwise, the relevant *prima facie passive income* is required to be included in the adjusted passive income of the CFC in receipt of the financial benefit.

### CFC group

A CFC group consists of entities that throughout the statutory accounting period:

- Are CFCs of a single attributable taxpayer;
- Are controlled by that attributable taxpayer; and
- Are not controlled by any other attributable taxpayer.

**Amount attributed** – Taxpayers that are attributable taxpayers at the end of the CFC’s statutory accounting period are assessed on their share of the attributable income of the CFC. Unless the CFC passes the active CFC test or the taxpayer falls
within the lightly taxed entity exemption, the amount included in the attributable taxpayer’s assessable income is
determined by multiplying the attributable income by the taxpayer’s total participation interest in the CFC (i.e. the sum of its
direct and indirect participation interests in the CFC) at the end of the statutory accounting period.

To prevent double taxation, distributions from the CFC to the Australian shareholder will be non-assessable non-exempt
(NANE) income to the extent the distribution relates to amounts previously attributed. Capital proceeds on disposal of a CFC
will also be reduced to the extent of previously attributed, but undistributed, amounts.

**Returns on foreign investment** – Under the current rules, a non-portfolio dividend paid to a resident company by a
nonresident company is treated as NANE income. A non-portfolio dividend is a dividend paid to a company that has a
voting interest that amounts to at least 10% of the voting power in the company paying the dividend.

Under the changes, this dividend exemption will be restricted to distributions in respect of equity interests (as determined
under the debt/equity rules) where the receiving company either has a direct ordinary membership interest of at least 10%
or is an attributable taxpayer for the company paying the dividend (an attributable taxpayer will have access to the dividend
exemption regardless of their percentage equity interest in the CFC).

### Key changes

- Distributions on shares treated as debt interests (e.g. certain RPS and convertible notes) will no longer be eligible
  for the exemption;
- Dividends on certain non-share equity interests (e.g. perpetual notes) will now be eligible for the exemption; and
- Dividend distributions on equity interests received via trusts and partnerships will now be eligible for the exemption.

Further, the branch profits exemption has been rewritten. Effectively, the PE is treated as a CFC and the attributable income
rules apply. As such, certain branch profits derived by an Australian resident company from carrying on a business through a
PE in a foreign country will be treated as NANE. For these purposes, the new section appears to refer to the definition of PE
in the tax legislation rather than the approach under the current branch profits exemption, which applies a treaty definition
(where applicable). The exposure draft does not contain rules that would allow the branch profits exemption to apply where
the PE is held through interposed partnerships or trusts (as the current section does).

**Special rules for royalties** – Royalties can qualify for the “income of an active character” exemption and the intragroup
exemption. However, the “income of an active character” exemption and intragroup exemption will not be available for
“royalty income connected with Australia.” This refers to royalty income from intellectual property where:

- The CFC acquired the intellectual property (directly or indirectly) from a related Australian resident; and
- The CFC did not substantially develop, alter or improve the intellectual property while the CFC owned the property,
such that the market value of the intellectual property is not substantially enhanced.

This provision will not apply to comparably taxed royalty income of a CFC that is a resident of a listed country at the end of
a statutory accounting period.

It is not clear if the definition of royalty will be amended. The current definition includes equipment royalties.

**Special rules for rent** – Rent from real property is excluded from adjusted passive income. This is consistent with the
internationally accepted approach that the right to tax income from real property rests with the country where the real
property is located rather than the country where the investors are resident.

**Foreign Accumulation Funds (FAF) rules**

The FAF provisions seek to provide some limit on deferral of income in non-control situations following the repeal of the
foreign investment fund (FIF) regime in 2010.

An Australian resident individual, partnership or trust may fall within the scope of the FAF provisions where the entity in
which they invest constitutes a FAF. There are three requirements that must be met for an entity to constitute a FAF:
1. The entity must be either a nonresident company or a nonresident fixed trust;
2. The market value of debt interests (as defined for tax purposes) held by the entity must comprise 80% or more of the market value of the assets held by the entity; and
3. The entity must distribute 80% or less of its realized profits and gains and so much of its unrealized profits and gains held in entities it controls and is realized in those entities.

The new exposure draft significantly departs from last year’s version in that it no longer requires the Commissioner of Taxation to make a determination as to the investor’s purpose in making the investment, and so allows investors to self-assess. The rules also specify the percentage of profits that must be distributed by the FAF to prevent it falling within the scope of the FAF provisions rather than using the uncertain criteria of a “tax deferral benefit.”

Commencement date

The commencement date for the new measures is not specified. Although the CFC reforms were initially planned to apply from 1 July 2010, it is now unlikely that the rules would have a start date before 1 July 2011. It is possible that the government could provide an option for taxpayers to elect an earlier start date of 1 July 2010. The new FAF rules could apply from 1 July 2010 since the previous FIF provisions were repealed with effect from the 2010/11 income year.

Treasury has requested that submissions on the exposure draft legislation be made by 18 March 2011.

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