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Discussion Paper - Foreign source income attribution rules

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide comments on the foreign source income attribution rules discussion paper released by Treasury on 12 May 2009 (**Discussion Paper**).

The Taxation Institute's submissions on the proposed reforms as outlined in the Discussion Paper are set out in the attachment to this letter. These submissions were prepared by the Taxation Institute's International Subcommittee, chaired by Jane Michie FTIA.

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. Further, where appropriate, we have summarised our submissions in a bullet point format.

If you require any further information or assistance in respect of our submission, please contact at first instance the Taxation Institute's Senior Tax Counsel, Dr Michael Dirkis, on 02 8223 0011.

Yours faithfully

Joan Roberts
President

Attachment

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

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Glossary:

Term	Meaning
Board Position Paper	The Board of Taxation's Position Paper on the Review of the Foreign Source Income Anti-Tax-Deferral Regimes (January 2008)
Board Review	The Board of Taxation's Report on the Review of the Foreign Source Income Anti-Tax-Deferral Regimes (September 2008)
MIT Review	The Board of Taxation's review into the taxation of Managed Investment Trusts
Tax Act	The *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997* (as appropriate)
Treasury Paper	Treasury Discussion Paper concerning the foreign source income attribution rules released on 12 May 2009

1. Operative principle

Consultation question

- Is the operative principle an appropriate legislative expression, having regard to the policy objectives that it is intended to meet and the need to express the operative rules as principles?

Summary of Submissions

- The "operative principle" should be the operative *provision* of the new CFC rules.
- The new CFC rules should be clear as to which residency definition applies to trusts, and when a trust is required to include attributable income in its net income.

The "operative principle" should be the operative *provision* of the new CFC rules. For the sake of simplicity and ease of application, the operative provision should be at the beginning of the new CFC rules (this is to be contrasted with the current approach, where the operative provision, s.446, arises some 139 sections into the CFC rules in Part X of the Tax Act).

Simply having the "operative principle" as a statement of "objectives" in the new CFC rules rather than as the operative provision would not be sufficient.

In relation to "Australian resident" and trusts, there are currently two provisions in the Tax Act regarding residency:

- "resident trust for CGT purposes" (s.995-1(1)); and
- "resident trust estate" (s.95(2)).

The differences between the two definitions mainly relate to "unit trusts". Further, the definition of "net income" in s.95(1) requires an assumption to be made that the trustee is a "resident" taxpayer.

The new CFC rules should be clear as to which definition applies, and when a trust is required to include attributable income in its net income. The drafting of the new CFC rules should also

consider any changes resulting from the MIT Review (and, in particular, the current difficulties arising for non-residents and the ATO's view in ATO ID 2005/200).

2. Exemptions

Consultation questions

- Should approved deposit funds, pooled superannuation trusts and Retirement Savings Accounts be exempt in the same way as complying superannuation funds?
- If the rules better target passive income in the manner proposed, is a de minimis exemption warranted? If so, what cases should qualify for the de minimis exemption?
- The earlier Board recommendation concerning dual residents dealt with companies only. Is there good reason not to extend that recommendation to other entities?

Summary of Submissions

- Approved deposit funds, pooled superannuation trusts and RSAs should also be exempt from the new CFC rules.
- A de minimis exemption is both warranted and necessary.
- Managed investment trusts that are widely held and publicly offered should be exempt from the new CFC rules.
- The recommendation concerning dual residents should be extended to other entities.

2.1 Superannuation exemption

Approved deposit funds, pooled superannuation trusts and Retirement Savings Accounts (**RSA**) should also be exempt from the new CFC rules. This is consistent with the current FIF exemption in s.519B(2) which applies to "complying superannuation entities" (which includes complying superannuation funds, complying approved deposit funds, and complying superannuation funds), and that RSAs are generally taxed at 15% in respect of RSA income.

Further, consistent with the current FIF exemption in s.519B(1) regarding "complying superannuation / FHSA assets" and "exempt assets" (as defined in s.470 and s.320-170(6)), an equivalent exemption should apply for life insurance companies for their "VPST" and "SEA" assets.

The Taxation Institute notes the following statement in the Board Report:

> *3.68 The Board also noted that the current* [FIF] *exemption is narrowly cast and needed to be updated to reflect emerging business practices. A particular concern was the inflexible nature of the exemption that prevented superannuation funds accessing pooling arrangements in order to gain critical mass for on-investment into worldwide markets.*

The superannuation exemption should exist regardless of whether a superannuation entity holds an interest in a CFC directly or indirectly (with other investors). That is, if a superannuation fund that is eligible for the exemption invests in an Australian trust that in turn is an attributable taxpayer in respect of a CFC, then any attributable income to which the superannuation fund is subject to assessment by virtue of s.97 of the Tax Act should be exempt for the superannuation fund.

An exemption from the new CFC rules should also exist for entities who are predominantly owned (such as 90%) by superannuation entities who are themselves exempt from the new CFC rules. This would reduce compliance costs, and ensure that appropriate pooling arrangements used by

superannuation funds are not adversely affected by the new CFC rules. Such an exemption would also need to consider the MIT Review in the context of pooling arrangements that use trusts.

2.2 De minimis exemptions

A de minimis exemption is both warranted and necessary for the effective operation of the new CFC rules.

Value of interests in foreign entities

Similar to the current FIF exemption in s.515, where the total value of a taxpayer's interests in controlled foreign entities is less than a prescribed amount, that taxpayer should be exempt from the new CFC rules. The de minimis exemption should *exclude* interests that would currently constitute FIF interests (on the basis that they will no longer be subject to anti-deferral measures with the repeal of the FIF regime). The exemption should be available for all taxpayers, rather than just individuals as is currently the case in s.515. It should also be increased, as the $50,000 exemption in s.515 has not been adjusted since its introduction in 1992. In this regard, the Board Position Paper observed at paragraph 4.42:

> ***The Board considers that a $200,000 threshold should be applied to the total value of interests in foreign entities*** *(that is, modelled on the current FIF approach). Such a level will 'future proof' the threshold for a significant period since it more than accounts for the effect of inflation since 1990. This will allow taxpayers with both high and low levels of information about their foreign investment access to the exemption. Applying the threshold to the value of income along the lines of the current CFC approach would prove difficult for taxpayers with low levels of information about their foreign investment to satisfy.* (emphasis added)

A $200,000 threshold (at a minimum) would be appropriate for all entities.

Amount of passive income of the CFC

A similar exemption as is currently contained in s.385(4) for listed countries should be incorporated into the new CFC rules for both listed *and unlisted* countries. Where the amount of passive income (that is intended to be captured by the new CFC rules) of a CFC is less than a prescribed threshold (which should be increased from its current level of $50,000), no further attribution should be required.

In addition, consideration should be given to an exemption based on the accounting income of a CFC.

Balanced Portfolio exemption

A "balanced portfolio" exemption should apply to the new CFC rules similar to the current exemption to the thin capitalisation rules where the "90% Australian assets threshold" in s.820-37 is satisfied. Where an Australian taxpayer satisfies a similar 90% Australian assets test, the new CFC rules should not apply (regardless of whether the taxpayer is an attributable taxpayer in respect of a CFC).

2.3 MITs

Managed investment trusts that are widely held and publicly offered should be exempt from the new CFC rules (this would be in addition to an exemption for pooling arrangements involving superannuation funds discussed in section 2.1 above). Such an exemption would greatly reduce compliance costs and assist in the competiveness of Australia's fund management industry.

2.4 Dual residents

The recommendation concerning dual residents should be extended to other entities.

3. Substantial ownership interests

Consultation questions

- Is it appropriate in the definition of an attributable taxpayer to count direct and indirect ownership interests as well as those of associates?
- What changes to the definition of an associate are required in order to encompass those who share common interests in relation to the foreign entity, having regard to the various uses for which this definition is used in the law?
- Would the proposed notion of a non-portfolio ownership interest contained in this definition work in other areas of the law where the same or similar ideas are used: section 23AJ, and Subdivision 768-G, Division 855 and Division 820 of the ITAA 1997?

Summary of Submissions

- Only taxpayers who form part of the "controlling group" of a CFC should be attributable taxpayers in respect of that CFC. Further, an attributable taxpayer's attribution percentage should *exclude* their associate's direct and indirect interest in the CFC.
- The current definition of associate in s.318 needs to be revisited, with legislative guidance provided as to what is meant by "sufficiently influenced". Tracing of an Australian resident taxpayer's direct and indirect interests should be limited to it and its Australian resident associates.
- The concept of non-portfolio interest for s.23AJ should be expanded to include interests of associates and indirect interests.

3.1 Attributable taxpayer

Only taxpayers who form part of the "controlling group" of a CFC should be attributable taxpayers in respect of that CFC under the new CFC rules. That is, only those entities which are taken to "control" the CFC under the equivalent to s.340 should be capable of being an attributable taxpayer.

> ***Example***
> *Taxpayer A (an Australian resident company) owns 50% of a foreign company (**ForCo**)*
> *Taxpayer B (an Australian resident company who is unrelated to Taxpayer A) owns 10% of ForCo.*
> *Only Taxpayer A controls ForCo and should be an attributable taxpayer in respect of ForCo.*
> *Taxpayer B should not be an attributable taxpayer, and should not be subject to attribution.*

The exclusion of Taxpayer B in the above example from being an attributable taxpayer in respect of ForCo (and therefore not subject to attribution) is consistent with the repeal of the FIF provisions – that is, entities with minority / non-controlling interests in overseas entities should *not* be subject to the new CFC rules given that they will no longer be subject to the FIF rules.

As is the case under the current CFC rules, an attributable taxpayer's attribution percentage should *exclude* their associate's direct and indirect interest in the CFC.

3.2 Associates

Definition

The current definition of associate in s.318 needs to be revisited, with legislative guidance provided as to what is meant by "sufficiently influenced". Further, a taxpayer should not be an associate of a trust by simply being able to benefit under the trust (s.318(3)(a)) or be an associate of a partnership by simply being a partner (s.318(4)(a)) without having accompanying control or influence over the trust / partnership (as is the case for a "public unit trust entity").

The new definition of associates should be included in s.995-1(1).

Whether an entity is a CFE?

The current test of determining whether an entity is a CFC by reference to a taxpayer and its associates produces anomalous results where non-resident associate interests are included. This was recognised in part and an amendment was made to the definition of "commencing day" in s.406(1) in 2005 (although this anomalous result was only fixed in relation to certain CGT consequences, rather than the underlying problem being fixed). The explanatory memorandum to the *New International Tax Arrangements (Foreign-owned Branches and Other Measures) Act 2005* which amended s.406(1) observed:

> *2.17 There are times, however, when a company becomes a controlled foreign company but the company is not in Australia's tax net. This can arise when Australian residents have foreign associates through which they are taken to be able to exert control upon a foreign company, but do not have any direct or indirect interest in the foreign company.*
>
> ***Example 2.1***
>
> *ForCo Ltd, a non-resident company wholly-owned by non-residents, has two subsidiaries - AusCo Pty Ltd, an Australian resident company, and CFC Ltd, a non-resident company. Because ForCo Ltd is an associate of AusCo Pty Ltd, CFC Ltd is a controlled foreign company because AusCo Pty Ltd is taken to be able to control it through its relationship with ForCo Ltd. This is despite AusCo Pty Ltd (or any other Australian resident) having no attribution percentage in relation to CFC Ltd, and therefore no possibility of any income being attributable in respect of CFC Ltd's activities.*

The situation as outlined in example 2.1 should *not* result, under the new CFC rules, in CFC Ltd being a CFE (or a CFC) where no Australian resident either controls or has a direct or indirect interest in the foreign entity.

One solution would be to limit tracing of an Australian resident taxpayer's direct and indirect interests to it and its Australian resident associates. This would ensure that situations as outlined in the above example would not arise, as For Co Ltd would not be an Australian resident associate of AusCo Pty Ltd, nor a controlled foreign entity of AusCo Pty Ltd.

Other provisions

Any amendment to the definition of associates will require detailed consideration of its impact on other provisions in the Tax Act and will require further consultation as well as whether other modifications to the associate definition are required (for example, the definition of associate is modified for the purposes of the interest withholding tax in s.128F(9)).

3.3 Non-portfolio interests

In relation to s.23AJ, the Taxation Institute supports expanding the concept of non-portfolio interest to include interests of associates and indirect interests in determining whether an Australian taxpayer has a non-portfolio interest in the foreign company.

In respect of other areas of the Tax Act (such as Subdivision 768-G and Division 855), this will require further consideration to ensure that any changes do not give rise to unintended outcomes.

4. Direct ownership interests

Consultation questions

- Does the existing concept of an 'equity interest' represent an appropriate balance for the various provisions in which it is proposed to be used, in terms of achieving their policy objectives?
- On what basis would an alternative definition be preferred and what would that alternative be? Would it apply in the other areas mentioned? How should the total of all direct ownership interests be measured?
- What is required to give the flexibility to deal with the variety of ownership interests encountered throughout the world?
- Should there be any change to the use of membership interest and non-portfolio interest in Division 855 in defining an indirect Australian real property interest held by a foreign resident?

Summary of Submissions

- It is inappropriate for an "equity interest" to be the basis of what is a "direct ownership interest" under the new CFC rules.
- An alternative approach that builds on existing concepts of economic control (interest in paid-up share capital and rights to distributions of capital or profits) should be utilised.
- It is likely to be too difficult to provide for non-common law entities in the general definition of "direct ownership interest", without complicating the general application to "standard entities" and causing unintended outcomes.

4.1 Equity interests

The focus of the CFC rules is whether an Australian resident taxpayer controls a non-resident entity – that is why the current definition of "direct ownership interest" in s.350 focuses on the interest in paid-up share capital; rights of shareholders to vote and rights to distributions of capital or profits.

In contrast, the stated aim of the debt / equity provisions in Division 974 is to tax interests in companies in accordance with their economic substance (refer paragraphs 1.4-1.9 of the *New Business Tax System (Debt and Equity) Act 2001*). Accordingly, the legislative aims of the debt / equity rules in Division 974 make it inappropriate for an "equity interest" to be the basis of what is a "direct ownership interest" under the new CFC rules. For example, if legal form debt which is an equity interest (eg. because the term is for more than 10 years and the interest is subject to a contingency, for example, available cash) was counted as a direct ownership interest, then the level of that interest could vary from year to year (making compliance with the CFC rules difficult).

Further, the debt / equity rules in Division 974 are difficult provisions to apply to Australian interests, and will likely be even more difficult to apply to interests in foreign entities.

4.2 Alternative approach

An alternative approach that builds on existing concepts of economic control (interest in paid-up share capital and rights to distributions of capital or profits) should be utilised. The current approach in s.350 of referring to voting rights could be disregarded such that if an Australian entity only holds voting rights in the non-resident entity (rather than any economic rights), this of itself should not result in the non-resident entity being a CFC.

Further, the concept of "membership interest" in s.960-130 and s.960-135 (as discussed in the Board Position Paper) could form the basis of what is a direct control interest.

If the concept of control was limited to economic interests, then the concept of "entitlement to acquire" could be removed, as an Australian taxpayer will have no economic interest in the foreign entity until it has an actual interest in the entity.

4.3 Non-common law entities

It is likely to be too difficult to provide for non-common law entities in the general definition of "direct ownership interest", without complicating the general application to "standard entities" and causing unintended outcomes.

One approach is to "deem" certain non-common law entities to be treated as companies or trusts for the purposes of the new CFC rules, with interests in such entities to be treated as direct or indirect ownership interests (as the case may be). The deeming would also be used to determine the attribution percentage interest in the non-common law entity, and whether that entity should be subject to the CFC rules, the transferor trust rules or other provisions of the Tax Act.

Such an approach could be achieved via regulations to the Tax Act in a manner similar to the current EDCI and listed country approach, and would provide certainty to the ATO and taxpayers as to the treatment of such entities under the new CFC rules.

5. Definition of controlled foreign entities

Consultation questions

- Would the meaning given to control in the Corporations Act deal with indirect interests in the way that is described in section 4.2.2 above?
- Would the Corporations Act meaning be relevant for determining control in foreign trust cases or could it be adapted for this purpose?
- Should the controlling group have to consist of Australian resident entities only or should a foreign entity be a CFE if it is controlled by a group of five or fewer entities one or more of which is an Australian resident?
- What should be the required minimum number and connection between the foreign entity and Australia?

Summary of Submissions

- The current definition of a CFC as expressed in s.340(c) should not be the sole basis of determining whether an entity is a CFC.
- The meaning given to control in the Corporations Act is unlikely to provide clarity, and will make the application of the new CFC rules less certain.
- The controlling group should consist of a single Australian resident and its Australian resident associates.
- "Bare trusts" and "nominee" arrangements should not be subject to the new CFC rules where the underlying investments would not be subject to the new CFC rules if held directly rather than via a bare trust / nominee.

5.1 Control

The Taxation Institute does not agree with Treasury's proposal to have the current definition of a CFC as expressed in s.340(c) being the sole basis of determining whether an entity is a CFC. The concept of control is too wide and is difficult to apply in practice. For example case law in terms of the ability to control a company generally recognises that the control of a company can be considered from two perspectives:

- the control of a company, with such control generally residing with the shareholders of a company; and
- the control of the affairs or business operations of a company, which will usually rest with the board of directors, or those who exercise the day to day management over the business of the company.

Further, the definition of control in s.50AA of the *Corporations Act* refers to "capacity to determine the outcomes of decisions about an entity's financial and operating policies", having regard to practical influence, practices and pattern of behaviour. This is unlikely to provide clarity, and will make the application of the new CFC rules less certain.

Rather, the Taxation Institute considers that the test of determining whether an entity is a CFC and an Australian taxpayer's interest in the CFC should be determined by reference to its economic control/economic contribution as if there is no economic control/contribution by an Australian taxpayer, then the opportunity and impetus for deferral of taxation on income would seem negligible.

Moreover, in order to improve the certainty and operation of the new CFC rules:

- The existing "bright-line" tests in s.340(a) (50% or more) and s.340(b) (40% and no other controller) should be amended and form the basis of whether an entity is a CFC under the new CFC rules.
- The current de-facto control test in s.340(c) should be removed.
- If the concept of de facto control is retained (eg for the purposes of applying the 40%/no other controller test in s.340(b)), the concept of exactly what is meant by "control" (and what level, whether shareholder control or board control) should be spelt out in the new CFC rules.

In the view of the Taxation Institute, a foreign entity should only be classified as a CFC if there is "control" (as per the modified tests above) by a single Australian taxpayer (either on its own or with its Australian associates). For example, there is no reason why a non-resident entity owned 20% each by non-related Australian taxpayers should be classified as a CFC (and none of the Australian taxpayers should be an attributable taxpayer) *unless* it can be demonstrated that one or more of those Australian entities in fact "controls" the non-resident entity (applying the economic control tests outlined above), in which case only the controlling Australian entities should be an attributable taxpayer.

5.2 Controlling Group

As outlined above in section 3.2, the current operation of s.340 and the definition of "associates" in s.318 causes non-resident entities to be classified as a CFC for Australian tax purposes in inappropriate situations due to the wide scope of "associate inclusive control interests".

As outlined in the example in section 3.2, a non-resident entity can be a CFC under the existing rules even if Australian resident taxpayers have *no* direct or indirect interests in the non-resident entity – this should not be the case under the new CFC rules. Accordingly, the controlling group should consist of a single Australian resident and its Australian resident associates.

5.3 Closely held trusts

The Taxation Institute notes the proposal to incorporate closely held trusts into the new CFC rules.

"Bare trusts" and "nominee" arrangements should not be subject to the new CFC rules where the underlying investments would not be subject to the new CFC rules if held directly rather than via a bare trust / nominee. This is consistent with the current "look through" approach in s.484, and would ensure that a bare trust / nominee arrangement that is currently disregarded under the FIF provisions would not be subject to the new CFC rules.

Further, the current definition of "closely held trust" in Division 6D demonstrates that further thought is required as to what will be a closely held trust for the purposes of the new CFC rules (and, in particular, who would be an attributable taxpayer in the case of discretionary trust given the continued operation of the transferor trust rules). For example, the definition in s.102UC is difficult to apply:

- the current requirement to trace through to 20 individuals can be difficult to apply in practice; and
- a discretionary trust is currently defined to be any trust that is not a fixed trust (which is an extremely hard test to satisfy under current law without a ruling from the ATO).

Further, the types of trusts excluded from the definition also need to be considered (such as foreign superannuation funds and an equivalent to the s.519 exemption), as does the impact of the MIT Review.

Also the interaction of the CFC measures, the transferor trusts regime and Division 6 will have to be considered, particularly in relation to distributions out of income that have already been taxed, say, under the CFC measures).

6. Range of controlled foreign entities

Consultation question

- Are there other classes of foreign entities that should or should not be CFEs?

Summary of Submissions

- The new CFC rules should ensure that different outcomes do not arise between investing directly in a foreign entity and investing indirectly via another foreign entity.

The new CFC rules should ensure that different outcomes do not arise between investing directly in a foreign entity and investing indirectly via another foreign entity (be it a company, partnership or

trust). So for example, the tracing rules for determining whether a foreign entity is a CFC, and (if so) an Australian taxpayer's attribution interest in the CFC should be the same and should be based on the Australian taxpayer's direct or indirect *economic* interest in the foreign entity (currently the "control tracing interest" and "attribution tracing interest" concepts are different).

7. Timing

Consultation question

- What would be a suitable balance of equity, efficiency and compliance costs in determining when all these requirements (control, residence, attributable taxpayer, attribution percentage) have to be met?

Summary of Submissions

- Whether a taxpayer is required to include any amount in respect of a CFC in their assessable income should be determined at the end of CFC's relevant period.
- The ATO should seek to rely on the general anti-avoidance rule in Part IVA of the Tax Act rather than a blanket approach being adopted in the new CFC rules to overcome any perceived "manipulation" risk.

Consistent with the current approach in Part X of the Tax Act, whether a taxpayer is required to include any amount in respect of a CFC in their assessable income should be determined at the end of CFC's relevant period.

If an Australian resident taxpayer does not have an interest in the CFC at the end of the relevant period, no amount should be included in the taxpayer's assessable income. Following disposal, nothing can be deferred and, subject to the participation exemption (which applies to "active businesses"), the taxpayer should trigger a taxing point in respect of their interest in the foreign entity on disposal. Further, any "deferred" income (including "deferred" income for the part income year prior to the sale/purchase) that has not been distributed will, in most cases, simply be reflected in the purchase price (and hence taxed, subject to the CGT participation exemption).

As noted in the Treasury Paper, such an approach reduces compliance costs. To the extent that "manipulation" does occur, the ATO should seek to rely on the general anti-avoidance rule in Part IVA of the Tax Act rather than a blanket approach being adopted in the new CFC rules to overcome any perceived "manipulation" risk. The current rule in s.319(6) regarding a CFC ceasing to exist should be maintained.

However, it is clear in the case of a purchaser of an interest in a CFC part-way during the CFC's relevant period that apportionment is required, as the purchaser will clearly not have deferred any income of the CFC prior to the purchase of their interest in the CFC.

8. Passive / active income

Consultation question

- Would the reliance on a direct active business connection and a permanent establishment condition provide sufficient certainty and flexibility in the determination of what is considered to be active income?

Summary of Submissions

- The better approach is to clearly define and focus on the types of income that should constitute passive income and be subject to attribution under the new CFC rules.

Targeting what passive income should be subject to attribution

The Taxation Institute considers that the better approach is to clearly define and focus on the types of income that should constitute passive income and be subject to attribution under the new CFC rules. Treasury should revisit the approach of using a "principles" based approach to target income that provides the greatest incentive to seek inappropriate deferral outcomes (see paragraphs 3.40 – 3.44 of the Board Report). As noted by the Board Report, such an approach would better target the deferral problem, and in the view of the Taxation Institute, significantly enhance the operation of the new CFC rules. The Taxation Institute would support severely cutting the current categories of "passive income" such that only those particular types of income that are most considered to be at risk of deferral would be considered to be passive income. This approach should also incorporate appropriate exemptions (such as retaining the active business exemption and an updated "AFI subsidiary exemption").

Under this approach, the "EDCI" and "listed county" approach should be retained but expanded and updated to better target the application of the new CFC rules (eg it should be expanded to include other countries which have a comparable effective tax rate/base eg. Korea, China). Also, if the list of "passive income" is shortened and restricted to particular types of income which are most risk of being subject to deferral, the list of "EDCI" should also be shortened (or dispensed with) as a result.

Alternatively if the list of passive income is not restricted in this manner:

- All income from related party transactions should *not* be treated as passive income. In other words, the grouping measures should *not* only apply to those CFCs resident in the same jurisdiction. Moreover, a grouping basis should apply not just to the active income test, but also to determining what is attributable income. The Taxation Institute supports using accounting consolidation as the means by which a "group" is determined, which is consistent with Board Report (see paragraph 3.48 which explicitly refers to group accounting), rather than on a jurisdiction basis.
- Any integrity rules adopted in conjunction with the repeal of the "base company income rules" should be narrow and target specific types of transactions and jurisdictions.
- The new CFC provisions should address the three areas identified in the Board Report concerning passive income (see paragraph 3.37 of the Board Report) to reflect modern commercial practices:
  1. Updating the definition of "financial intermediary business";
  2. Income derived from the management of real and other property; and
  3. Royalties.

In respect of the proposed "permanent establishment" (**PE**) condition, this should not be primary basis of determining what is active or passive income. Rather, if it is used, it should simply be a sub-set in that income (that would otherwise fall within prescribed categories of passive income) should be taken *not* to be passive income if it is related to an active business carried on by the permanent establishment and therefore not subject to attribution under the new CFC rules. Otherwise, this will result in the categories of passive income being expanded (if passive income would be *all* income that is not attributable to an active business).

If the PE concept is used as one basis for determining passive income, then the Taxation Institute submits that, in determining whether there is a nexus between income derived and the business carried on, the "directly related" concept (as per s.439) should not be used. This is overly restrictive and difficult to apply in practice. Instead, the Taxation Institute submits that the concept of income being "attributable" to the PE (which is carrying on the business) should be used (this being a familiar concept due to the business profits articles in Treaties).

Better targeting what constitutes passive income would allow the "active income test" to operate by reference to whether a CFC derives a certain amount of passive income that should be subject to attribution, rather than whether income of the CFC is passive or active. If a CFC's total passive income subject to attribution is less than a certain percentage, then no further attribution should arise (i.e., satisfying the "active income" test should serve as a general exemption from the new CFC rules).

In addition, the new CFC rules should permit "grouping" between CFCs in relation to offsetting losses of one CFC against income of another CFC (ideally between CFCs in the same category of listed/unlisted countries and, at least, between CFCs resident in the same jurisdiction).

9. Other attributable amounts

Consultation question

- Should there be any restrictions on the amounts of trust or partnership net income that are included in attributable income?

Summary of Submissions

- Only passive income that would be attributable income if derived directly by the CFC should be attributable income of a CFC where derived via a partnership or a trust.

Only passive income that would be attributable income if derived directly by the CFC should be attributable income of a CFC where derived via a partnership or a trust. That is, only net income of a trust or partnership (which is currently the case for partnerships – s.384(2)(d)) that is itself passive income that is subject to attribution should be included in the attributable income of a CFC. For example, under the current rules, for CFCs resident in listed countries, the income that can be attributed where it is derived via a trust is different to the income that can be attributed if derived directly by the CFC (refer s.385(2)(d(iv)). This difference should be rectified.

We note that it may be difficult to obtain sufficient information from the trust or partnership in order to perform a branch equivalent calculation, and that consideration should be given to exempting income from trusts or partnerships where a small stake is held - this would be consistent (at least in the case of trusts) with the proposed repeal of the FIF rules.

10. Calculating attributable income

Consultation questions

- Which other provisions, if any, should be disregarded and if so why? Should any of the provisions listed above not be disregarded?
- What modifications are required when applying other parts of the law?
- What is the simplest and fairest way to overcome the potential double taxation of the passive income of a controlled foreign trust, under these attribution rules and under Division 6, without reducing what is included in the assessable income of Australian resident beneficiaries under Division 6?

Summary of Submissions

- If the scope of passive income that *should* be subject to attribution under the new CFC rules is appropriately narrowed, then this should reduce the provisions of the Tax Act that are required to be applied in order to undertake a branch equivalent calculation. This means that listing provisions that are to apply (rather than adopting the current exception basis) could be adopted.
- If an exception approach is retained, all of the provisions of the Tax Act which are not intended to apply to the branch equivalent calculation should be contained within the one provision.
- The recognition that double tax could arises supports limiting the application of the new CFC rules, and ensuring that appropriate de minimus rules are in place. Retaining a system similar to s.23AI is recommended for trusts (and companies).

10.1 General

If the scope of passive income that *should* be subject to attribution under the new CFC rules is appropriately narrowed, then this should reduce the provisions of the Tax Act that are required to be applied in order to undertake a branch equivalent calculation. This means that listing provisions that are to apply (rather than adopting the current exception basis) could be adopted.

If this approach is not adopted, then the Taxation Institute supports excluding those tax measures which are listed in the Board of Taxation Issues Paper (May 2008) in section 5.19 (although it is noted that the commercial debt forgiveness rules are already excluded).

In addition, the Taxation Institute submits that:

- Division 974 (debt/equity rules) should not apply in determining the attributable income of CFCs (unless s.23Aj is expanded to include equity interests – in which case, Division 974 should be applied for these purposes);
- Division 230 (TOFA) should apply but only on an elective basis (see section 17 below);
- Subdivision 960-C and Division 775 (forex rules) should not apply;
- in relation to attributable taxpayers, they should be able to make a functional currency election in relation to a CFC for the current year in which the CFC interest is first acquired (the “backdated start choice” rules in Item 4 of the table in s.960-65 are too restrictive);
- Division 820 should not be apply and there should not be a quasi-thin cap rule for CFCs – this would increase compliance costs, add an additional layer of complexity to CFC calculations and potentially duplicate such measures applying under other jurisdictions. Also, it could cause Australian taxpayers to be at a competitive disadvantage in the global

market, particularly in relation to the acquisition of an asset. For example, if an Australian taxpayer (or consortium) was competing with offshore parties in relation to the acquisition of an offshore asset, introducing a quasi-thin cap rule in the CFC measures could impose restrictions/costs on the funding arrangements which the (say) local purchaser would not be subject to. This would ensure that there is no possible double denial of debt deductions (in both the attributable income calculation, and for the attributable taxpayer in respect of its own thin capitalisation position).

10.2 Drafting principles

If an exception approach is retained, all of the provisions of the Tax Act which are not intended to apply to the branch equivalent calculation should be contained within the one provision. For example, the exclusion for the commercial debt forgiveness rules (s.245-100 of Schedule 2C) should be contained with all the other exclusions.

10.3 Double Taxation

The recognition that double tax could arises supports limiting the application of the new CFC rules, and ensuring that appropriate de minimus rules are in place.

The Taxation Institute recommends retaining a system similar to s.23AI for trusts (and companies).

11. Alternative calculations

Consultation questions

- In practice, how much impact on compliance costs is the availability of this choice likely to have?
- What are the advantages and disadvantages of making this choice irrevocable? If the choice is to be irrevocable, does that choice of method apply just to this CFE, just for this year or for all future years for this CFE; or does it apply to all CFEs in which the entity is or will be an attributable taxpayer? What exactly should an irrevocable choice mean in this context? Whether the choice is irrevocable or not, should attributable taxpayers who make the choice be able to apply the active income test?
- In what other circumstances should some restriction be placed on the ability to choose the method of calculating attributable income?

Summary of Submissions

- The potential compliance cost savings warrants the availability of alternatives to the branch equivalent calculation.
- It is not appropriate to make the election irrevocable.

11.1 Compliance costs

The potential compliance cost savings warrants the availability of alternatives to the branch equivalent calculation. Importantly, if either the deemed rate of return or market value method is elected with respect to a “first tier” CFC, then the new CFC rules should not apply with respect to any underlying CFCs – this is consistent with the current approach in the FIF rules (as the value of the underlying CFCs should be reflected in the value of the first tier CFC in respect of which the deemed rate of return or market value method is applied).

11.2 Irrevocable

As was discussed in the Board Position Paper (at paragraph 5.14), any restrictions need to be commensurate with the risk to the revenue. As it has not been demonstrated that there is a risk to revenue, it is not appropriate to make the election irrevocable.

If the choice is irrevocable:

- it should only apply for a set period (subject to a change in circumstances);
- it should only apply on an entity by entity basis (as some interests may be listed, whereas others may not be); and
- the "active income" test should continue to apply as a threshold question prior to applying an alternative calculation – the point of the alternatives is that they are an alternative to the branch equivalent calculation, not whether it is appropriate that the CFC have any attributable income.

12. Deemed rate of return

Consultation questions

- Are there any modifications to the approach adopted in the current FIF rules that would improve the operation of the deemed rate of return method? What is the best way of stipulating the deemed rate of return?
- Is a market value approach the best option for determining the opening value of an existing interest where there was no attribution in the preceding period?

Summary of Submission

- The "base interest rate" should contain its own definition within the new CFC rules.
- An adjustment should be made to the opening value where, for example, there is a return of capital that does not result in the interests in the CFC coming to an end.
- In respect of the calculation of the opening value where there has been no previous attribution, the new CFC rules should not follow the current approach in s.552(3).

For the sake of simplicity, the "base interest rate" should contain its own definition within the new CFC rules without referring to the *Taxation Administration Act 1953*.

In respect of determining the opening value generally, an adjustment should be made to the opening value where, for example, there is a return of capital that does not result in the interests in the CFC coming to an end (currently, s.551 in the FIF rules does not cater for this situation).

In respect of the calculation of the opening value where there has been no previous attribution, the new CFC rules should not follow the current approach in s.552(3) whereby a notional calculation is required from the date of acquisition, as this is difficult to apply. Further, consideration will need to be given to how the market value of a CFC is to be determined, given the current limitations on the availability of the market value method in the FIF rules (discussed in more detail below in section 13).

13. Market value method

Consultation questions

- Are any modifications required to the principles underlying the approach adopted in the current FIF rules that would improve the operation of the market value method?
- Are any further modifications required where existing interests were previously not of sufficient magnitude to be subject to the CFC rules?

Summary of Submissions

- The market value method should be available on a broader basis than is currently the case under the FIF rules.

The market value method should be available on a broader basis than is currently the case under the FIF rules – that is, it should be expanded beyond stock market listed entities and entities that regularly publish buy-back / redemption prices, as these are likely to be of limited application to CFCs.

Any proposal to determine market value needs to ensure that the stated aim of reducing compliance costs is not undone by requiring detailed (and costly) valuations to be undertaken on a regular basis.

14. Double accruals

Consultation question

- Would a deduction for foreign accruals tax levied by any foreign country be a simpler but still fair way of relieving this double taxation?

Summary of Submission

- A preferable method would be to rely on the transfer pricing rules.

The Taxation Institute believes that s.456A is overly restrictive and cumbersome and that a preferable method would be to rely on the transfer pricing rules in the overseas jurisdiction such that, if these rules apply (possibly subject to some restrictions), then the income should not be subject to tax under the Australian CFC rules.

15. Double Taxation Relief

Consultation question

- If the attribution rules are better targeted in the manner proposed, will this allow relieving double taxation by way of a deduction for foreign tax instead of allowing some attributable taxpayers an offset for the foreign tax?

Summary of Submissions

- This proposal should be rejected and the existing foreign income tax offset regime should be retained.

The Taxation Institute rejects this proposal, and considers that the existing foreign income tax offset regime should be retained. This is not part of the Board's recommendations and is not appropriate for such a change to be made.

The provisions were enacted in 2007 in Division 770, and there is simply no reason to revisit the current approach.

16. Distribution principle

Consultation questions

- Should the exemption for non-portfolio dividends extend to returns on equity interests held indirectly by resident companies through resident trusts or partnerships? Should the exemption also apply to corporate unit or public trading trusts?
- Since controlled foreign trusts are to be subject to the attribution regime, should there be a similar exemption for distributions paid directly by them on non-portfolio equity interests so that there is neutrality in the tax treatment of different business vehicles? How would such an exemption fit within Division 6 as it applies to these foreign trusts?
- Are the benefits of the current section 23AI exemption in terms of relief from double taxation sufficient to warrant the additional complexity in the law and additional compliance costs, in view of the reduced likelihood of attribution? If so, is there some way that the exemption for distributions paid out of attribution surplus to an Australian partnership or an Australian resident trust can be applied at the partnership or trust level rather than at the partner or beneficiary level, taking into account that generally it is only Australian resident partners or beneficiaries that are taxed on the attributable income?
- With the repeal of the FIF provisions, there will be no long-term need for the section 23AK exemption for amounts paid out of the attribution surplus in relation to FIFs. How long before this provision should be repealed?

Summary of Submission

- The s.23AJ exemption should apply to returns on equity interests held indirectly by resident companies through resident trusts, partnerships, and for entities that are effectively taxed as companies, such as corporate unit trusts and public trading trusts.
- Section 23AJ should apply to all non-share dividends received on equity interests.
- Section 23AI (or an equivalent system) should be retained.
- The section 23AK exemption should be not be repealed.

16.1 Section 23AJ

- The s.23AJ exemption should apply to returns on equity interests held indirectly by resident companies through resident trusts, partnerships, and for entities that are effectively taxed as companies, such as corporate unit trusts and public trading trusts (regardless of whether

such a trust is the head company of a tax consolidated group). There is no sound policy reason for not extending the s.23AJ exemption in this manner, and would ensure that the s.23AJ exemption is available for companies regardless of whether they hold interests directly or indirectly, and when an entity is treated as a company for the purposes of the Tax Act.

- Section 23AJ should apply to all non-share dividends received on equity interests.
- The timing as to when a non-portfolio ownership interest needs to be held should be clarified (for example, where a redemption occurs).
- The current requirement in s.334A(1)(b) regarding arrangements that can affect rights should be removed. This requirement is unnecessary and can result in the denial of s.23AJ in situations where there is no policy reason for such denial (eg. where a shareholders agreement provides for "drag along" rights or where the shares are subject to forfeiture if partly paid and a call is made which is not paid).
- In some jurisdictions, it is impossible to meet the 10% voting power test as under the laws of the offshore jurisdiction, it is not permissible for a non-resident shareholder (eg an Australian taxpayer) to hold a voting interest in the relevant company.
- If debt interests are to be excluded from the scope of s.23AJ, then the current exclusion for "eligible finance shares" should no longer apply (as it will not be required).

16.2 Section 23AI exemption

Section 23AI (or an equivalent system) should be retained as an effective method of preventing double taxation.

16.3 Section 23AK exemption

The section 23AK exemption should be not be repealed, or alternatively, a deduction should be available for any existing attribution surplus or an adjustment should be made to the cost base of the relevant interest. Otherwise, if s.23AK is repealed (and nothing is enacted in its place), this will result in double taxation for those interests that are currently subject to the FIF regime (and which give rise to FIF income) and in respect of which distributions are not (and will not) be within s.23AJ.

17. Disposal principle

Consultation question

- Should this disposal principle be retained and why?
- If it is thought that some form of relief is cost-effective is the current mechanism (reducing the sale proceeds) the best way of providing that relief?

Summary of Submissions

- The disposal principle should be retained.

The disposal principle should be retained to ensure that any gain or loss is reduced (that is not otherwise disregarded) where the taxpayer has previously been attributed income that has not been distributed.

The sale proceeds should be reduced both where a capital gain / loss arises *and* where a revenue gain / loss arises.

17. Interactive and Consequential Amendments – other submissions

Summary of Submissions

- Taxpayers should be given the choice as to whether to apply TOFA to their interests in a CFC, and in calculating the attributable income of a CFC.
- The principles of the new CFC rules need to be incorporated into s.23AH.
- Rather than enacting a specific anti-roll-up rule, the general anti-avoidance rules (however modified) should be used to counter any "abuse" arising from tax payers achieving tax-deferral in non-control situations.

17.1 TOFA

Taxpayers should be given the choice as to whether to apply TOFA to their interests in a CFC, and in calculating the attributable income of a CFC.

17.2 Section 23AH

The principles of the new CFC rules need to be incorporated into s.23AH to ensure that there is tax neutrality between investing offshore via a branch and an offshore entity.

17.3 FIF repeal and anti-roll-up measures

Timing

The FIF provisions should be repealed with effect from 1 July 2010, regardless of the whether the new CFC rules are ready / enacted. There is no policy reason why the start date needs to be delayed if the Bill to give effect to changes to the CFC (and other) measures cannot be introduced into Parliament within this time-frame (although ideally, changes to the CFC (and other measures) and the repeal of the FIF regime should all be made before 1 July 2010).

Anti-roll-up

As a starting point, we note that Federal Government announced in the 2009-10 Federal Budget that a review will be undertaken to "*consolidate, streamline and improve the operation of provisions designed to counter tax avoidance*". In the Taxation Institute's view, rather than enacting a specific anti-roll-up rule, the general anti-avoidance rules (however modified) should be used to counter any "abuse" arising from tax payers achieving tax-deferral in non-control situations. Therefore, at the very least, consideration of whether a specific anti-roll-up measure is required should be delayed until (and undertaken as part of) this review.

If an anti-roll-up rule is enacted, then at a minimum, the following exemptions should be incorporated:

- A de minimis exemption should apply.
- The exemption for superannuation funds (discussed in section 2.1) should equally apply to the anti-roll-up measure.
- An equivalent exemption as in s.519 (for interest in employer-sponsored superannuation fund) should be adopted.
- Exclude all interests in entities resident in "listed countries".

Further, the Commissioner should be precluded from being able to apply Part IVA where the anti-roll-up rule does not apply.

17.4 Listed public company exemption

The Taxation Institute believes that the listed public company exemption (recommendation 2 of the Board Report) should be revisited by the Government once economic conditions normalise.