

# Treasury Discussion Paper

## Foreign source income attribution rules

### NOTE TO PARTICIPANTS

The purpose of this consultation paper is to provide interested parties with an opportunity to comment on the proposed redesign of Australia's foreign source income attribution rules as outlined below.

The contents of this document are the preliminary views of the Treasury and do not represent the final views of the Government or the Treasury.

### 1 Introduction

On 10 October 2006, the former government announced a review of Australia's attribution rules. These rules include the controlled foreign company (CFC) rules, the foreign investment fund (FIF) rules, the transferor trust rules and the deemed present entitlement rules.

The review was conducted by the Board of Taxation. The review's terms of reference were to examine ways to reduce the complexity and compliance costs associated with the regimes, including whether the current regimes could be collapsed into a single regime; and whether the regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

To assist the consultation process, the Board of Taxation also released a discussion paper, a position paper, and an issues paper (covering five topics) to help identify the high-level principles which should apply in the future design of the rules. Following an extensive consultation process the Board's final report, which included ten recommendations, was provided to the Government in September 2008. These papers can be accessed from the Board of Taxation at [www.taxboard.gov.au](http://www.taxboard.gov.au).

The Government's response to the Board of Taxation's report was announced as part of the 2009-10 Budget. In summary, the Government announced that it had agreed to implement all of the recommendations other than the listed public company exemption (recommendation 2).

In this regard, the key announcement by the Government that provides the framework for the redesign of the attribution rules is that the CFC rules will be retained and rewritten into the *Income Tax Assessment Act 1997* (ITAA 1997). Relevant to this decision is the announcement that the CFC rules will also apply to closely held trusts and that the FIF and deemed present entitlement rules are to be repealed. A full list of the recommendations is set out in the attachment.

## 2 Purpose

This discussion paper provides a framework for comment on the redesign of the CFC attribution rules consistent with the Government's announcement. In particular, the discussion paper seeks comment from interested parties on the legislative design approaches suggested as a means of codifying the policy objectives.

The paper does not cover the design of the specific anti-roll-up rule (recommendation 9). The Board envisaged that this rule would be narrowly defined and target the most abusive non-control cases. Implementation of the rule will depend on identifying those arrangements to be targeted. Similarly, the paper does not address the Government's decisions in relation to the transferor trust regime (recommendation 10). These issues, together with issues such as the treatment of non-common-law entities, will be considered in more detail during the development of the enabling legislation.

## 3 Background

### 3.1 Operation of existing law

In general, residents of Australia are taxable on their worldwide income, from both labour and capital. To ensure residents cannot accumulate income offshore and thereby defer, or even avoid, Australian tax, attribution rules apply to tax residents on an accruals basis on their share of certain income accumulating offshore in foreign entities. As well as protecting the Australian revenue, this ensures offshore investments via foreign entities are not favoured over directly held investments for taxation reasons.

Australia's attribution regimes include the CFC, FIF, transferor trust, and deemed present entitlement rules. In summary:

- Foreign companies controlled by Australian residents are subject to the CFC rules. Branch-equivalent calculations are required to be performed to calculate attributable income. If the CFC fails the active income test, its tainted income (that is, passive income and base company income) is generally attributed. There is an exemption for comparably taxed income.
- Foreign companies not controlled by Australian residents and widely held fixed foreign trusts are subject to the FIF rules. If the foreign entity is not eligible for any of the FIF exemptions, calculations are required to be performed in respect of attributable income. The FIF rules contain an active business exemption but it is restricted to foreign companies. A limited comparable tax exemption also exists for certain investments in the United States.
- Closely held foreign trusts are subject to the deemed present entitlement rules. Ordinarily, all of the foreign trust's income including active and comparably taxed income is attributed to Australian resident beneficiaries (according to their present and future entitlement) on a branch-equivalent basis.

- Foreign discretionary trusts are subject to the transferor trust rules. The income attributed to the transferor is based on branch-equivalent calculations. If a transferor cannot perform branch-equivalent calculations, a notional interest rate applies to the value of the transferred property or services. Although there is no active income exemption under the transferor trust rules, a comparable tax exemption based on the CFC rules applies.

### 3.2 Policy objectives

The principal policy objective which underpins the foreign source income attribution rules is to ensure that passive investment decisions of Australian residents are not distorted by tax considerations. This objective is achieved by preventing Australian residents from obtaining an Australian tax advantage by having passive income earned by controlled foreign entities in which they have substantial ownership interests, thereby protecting the Australian tax revenue. However, in achieving this objective the rules should minimise compliance and administrative costs.

The policy objective is effected by ensuring that passive income earned in foreign entities is subject to accruals taxation in the hands of Australian residents (to the extent of their interest in the foreign entity).

## 4 Legislative design of proposal

### 4.1 Operative principle

The new CFC provisions will begin with the main operative principle which will then be followed by a number of explanatory and facilitating provisions.

The operative principle that follows is broad and so requires some exceptions. These are set out below.

#### Operative principle

An Australian resident which holds a substantial ownership interest in a controlled foreign entity in an income year, includes in its assessable income its share of the passive income derived by the foreign entity.

The core concepts that provide this principle with its efficacy are the following terms and phrases:

- Australian resident
- Holds a substantial ownership interest
- Controlled foreign entity
- Income year
- Assessable income
- Share
- Passive income

Some of these terms like ‘Australian resident’, ‘assessable income’ and ‘income year’ are concepts that are generally well understood or defined under the tax laws and as a consequence need no further elaboration (other than that already provided under the tax laws).

Consistent with the ‘Australian resident’ concept, a trust that is a resident trust estate in accordance with section 95<sup>1</sup> could have an amount included in its assessable income (in calculating its net income). So too could a corporate unit trust or a public trading trust. Further a partnership with one or more Australian partners could have an amount included in its net income.

Other terms and phrases like ‘substantial ownership interest’, ‘controlled foreign entity’, ‘share’ and ‘passive income’ are concepts that are not well understood or cannot borrow from existing definitions in the tax laws (other than those provided under the existing CFC rules). In these cases it is necessary to unfold these concepts and their underlying principles to allow the new CFC provisions to become operative.

These concepts and a discussion about how they might be codified are set out below.

### 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?

#### 4.1.1 Excluded entities

Certain entities, where the risk or scale of deferral is low, are not required to include anything in their assessable income under this principle. A complying superannuation fund does not include anything in its assessable income under this principle. However, it will not extend to situations in which the superannuation fund holds an indirect interest in a controlled foreign entity through a resident company. There is also an exemption for those with relatively small investments in controlled foreign entities (the de minimis exemption). This exemption would replace the existing exemption for smaller amounts otherwise attributable from a CFC in a listed country (section 385).

A dual Australian resident/resident of a treaty partner country that is taken to be a resident of that other country for the purposes of the treaty will not include anything in its assessable income under the operative principle. This ensures that Australia will not attempt to impose tax inconsistently with its treaty obligations. This outcome could be achieved by incorporating an earlier Board recommendation to treat such an entity as a foreign resident for domestic income tax purposes.<sup>2</sup> For like reasons, temporary residents of Australia will not include anything in their assessable income under the operative principle.

---

1 Unless otherwise stated, all references are to the *Income Tax Assessment Act 1936* (ITAA 1936).

2 Recommendation 3.13. See Board of Taxation, ‘International Taxation: Report to the Treasurer’, vol. 1, AGPS, Canberra, p 110.

## 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?

## 4.2 Substantial ownership interest test

A core concept within the operative provision is the notion of an Australian resident entity 'holding a substantial ownership interest'. This concept is intended to ensure two things: first, that the rules are well targeted and only affect taxpayers that have the capacity to orchestrate inappropriate deferral outcomes through significant influence over investment decisions of the foreign entity (see also 'control'); and, second, that only those Australian resident entities holding interests of a kind that confer ownership or control rights (as distinct from those of a creditor or supplier) should come within the scope of the foreign source income attribution rules and are eligible for the section 23AJ dividend exemption.

### Design principle

A substantial ownership interest will exist where an Australian resident (or resident trust estate or a partnership with at least one Australian partner) has a total direct and indirect ownership interest, alone or together with the ownership interests of its associates, of not less than 10 per cent of all direct ownership interests in the foreign entity.

Consistent with the approach under the current CFC rules (section 361), such an Australian resident could be referred to as an 'attributable taxpayer' in relation to that foreign entity.

A foreign resident trust or a partnership with only foreign partners will not include an amount in its net income under the redesigned CFC rules.

This definition of substantial ownership is slightly narrower (that is, it excludes associated interests) from the way in which a non-portfolio interest is defined in section 960-195 of the ITAA 1997 for the purposes of the foreign resident capital gains tax rules.<sup>3</sup> It is also different from the concept implicitly used in section 23AJ for the dividend exemption and in Subdivision 768-G of ITAA 1997 for the CGT participation exemption. An objective of the new provisions will be to consolidate these similar concepts by using the same terms to describe them wherever possible. For example, it may be possible to use the same requirement for identifying an attributable taxpayer as well as for the eligibility condition to the section 23AJ exemption. It may also be possible to make the requirements more consistent as to when they are to be satisfied (for example, by aligning them to be more like the timing requirement in Subdivision 768-G).

The concept of an Australian 1 per cent entity in the existing law will not be retained because it is an unnecessary complication in most cases.

---

<sup>3</sup> Division 855 of ITAA 1997.

## 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?

### 4.2.1 Direct ownership interests

The next task is to define what is meant by a direct ownership interest. Throughout the law several different ways of tackling this have been adopted, including the approach based around the rights of shareholders and entitlements to acquire those rights in the existing CFC provisions. The concept of a membership interest encapsulates most of that approach but does not include the idea of entitlements to acquire those rights. The concept of an 'equity interest' in Division 974 of the ITAA 1997 brings some of these together and broadens them to encompass other interests that should be treated in the same way.

#### Design principle

Because of its comprehensiveness, an entity's direct ownership interest in another entity will consist of its equity interest in that other entity in these new rules. The same meaning could also be used as the basis for the section 23AJ dividend exemption and, to the extent it is relevant and possible, for the CGT participation exemption and the thin capitalisation provisions.

## 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?

### 4.2.2 Indirect ownership interests

Indirect ownership interests could be calculated in the same way as under the existing law (sections 352 to 355). Consistent with those provisions, indirect interests would only be counted where the intermediate entity (or each intermediate entity) is a controlled foreign entity, to avoid including them when held through another Australian entity (for example, an associate) or through foreign entities that are not Australian-controlled. The existing case

of a controlled foreign trust where there is an eligible transferor would also continue to be used to identify controlled foreign trusts for tracing purposes. A concept of a controlled foreign partnership will still be needed for tracing indirect interests.

The other existing special rules about indirect control interests (for example, that it will be 100 per cent in some cases) will be retained.

#### 4.2.3 Attribution percentage

##### Design principle

The operative principle (section 4.1 above) explains that a share of the foreign entity's passive income may be included in the attributable taxpayer's assessable income. That share is the attributable taxpayer's total direct and indirect ownership interest (as a percentage or fraction) in the foreign entity. This is what is currently called the taxpayer's attribution percentage (section 362).

As with the existing law, this does not include any proportionate interest held in the foreign entity by the taxpayer's associates. If they are Australian residents they too may be attributable taxpayers and their attribution percentage will be their own total ownership interest in the foreign entity.

#### 4.3 Controlled foreign entities

The current approach in the CFC rules to defining a CFC is to stipulate two specific circumstances of control (paragraphs 340(a) and (b)) in conjunction with a broad economic notion of control (paragraph 340(c)).

To allow these rules to be expressed more simply it is proposed that the principle of paragraph 340(c) should become the basis for the primary rule for determining whether a foreign company or trust is a controlled foreign entity (CFE).

##### Design principle

A foreign resident company or trust would be a CFE at a particular time only if the foreign company or trust is controlled by a group of five or fewer Australian residents at that time, either alone or together with associates.

This approach to defining control could rely on the meaning of control in the Corporations Law<sup>4</sup> as a basis for drafting but would not be restricted by the focus of that law on a single controller.

It is not expected that this approach will result in more taxpayers coming within the attribution rules net.

---

4 See section 50AA of *Corporations Act 2001*.

## 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?

### 4.3.1 Which foreign entities?

To be a CFE a foreign resident must be a company, a corporate limited partnership (CLP) or a trust<sup>5</sup>. A dual resident company (or trust) that, under a tax treaty, is treated as a resident of the other country and not as a resident of Australia, may also be a CFE.

A foreign company or CLP that is treated as a partnership for Australian tax purposes under Division 830 of the ITAA 1997 cannot be a CFE from which an amount might be attributed under the operative principle.

## Consultation question

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

## 4.4 Timing

### Design principle

Satisfaction of the conditions set out above, concerning attributable taxpayers, their attribution percentages and whether a foreign company or trust is a CFE, could be determined at the end of the foreign entity's accounting year, as in the existing law. The continued use of these timing tests may depend on what is decided in relation to other relevant areas such as section 23AJ and Subdivision 768-G.

A once-a-year test has the benefit of reducing compliance costs but can be arbitrary in its outcomes and is open to manipulation. The justification for it has been that if the attributable taxpayer disposes of its interest in the CFC during the relevant period, it may be subject to CGT which will indirectly deal with current-period earnings of the CFC, and so attribution is not necessary. On the other hand, the existing FIF rules take account of how much of the accounting period the attributable taxpayer has held the interest in working out the attributable amount (and provided the interest is held at year end). The tax law treatment of partnerships and trusts contains elements of both approaches.

---

<sup>5</sup> See section 4.5.3 for discussion on the interaction between attribution rules and trusts.

## 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?

### 4.5 Attributable income

#### Design principle

The component of the year's profit of the foreign entity, a share of which may be included in the assessable income of an attributable taxpayer, is the profit made from certain types of passive income and other amounts derived by the foreign entity through its participation in trusts and partnerships (attributable income).

Attributable income does not include passive income<sup>6</sup> of the CFE in a year in which the foreign entity passes the active income test.

The Board recommended applying the active income test on a group basis. A way of doing this would be where the foreign entities that are part of the same consolidated accounting group are located within the same jurisdiction. For these entities, only passive income derived from outside that group would count for the purposes of applying the active income test. The potential revenue effect of adopting this group approach will have a bearing on its final acceptability and design. Accounting information is to be used when applying the active income test. The foreign entity or jurisdictional group passes the active income test if it carries on business (but not a business of generating passive income) outside Australia through a permanent establishment and its passive income for the year according to satisfactory accounting records is less than 5 per cent of its total turnover.

There is also the question of if and how the income of a partnership or trust in which the CFE has an interest is included in the CFE's active income test. If it were to be included, there would be more justification for the conclusion that if the CFE passed the active income test nothing would be attributed (disregarding amounts that are always attributable regardless of the result of the active income test – paragraphs 384(2)(b) to (d), for example). On the other hand, it may be more appropriate in some cases to treat the income from these interests as passive.

Amounts of income that are subject to comparable tax in a listed country at an appropriate time will be excluded from the active income test and from attributable income in the same circumstances as under the existing law (see for example sections 385 and 436). No changes to the list of amounts that are not comparably taxed or to the list of seven comparable-tax countries are presently proposed.

#### 4.5.1 Passive income

The concept of passive income is relevant to both the active income test and the calculation of attributable income. In both cases, what is being targeted is the income or gains from certain types of assets, investments or transactions where little else other than the investment

---

<sup>6</sup> What is 'passive income' is explained in section 4.5.1.

of capital is involved. The current law (section 446) lists what is traditionally regarded as passive income. The Board recommended that this approach be retained but modernised.

One of the Board's specific suggestions was to exclude amounts derived in carrying on an active business. While that might be done in different ways depending on the type of income, one common requirement for such an exclusion could be that the income is attributable to a permanent establishment through which the CFE carries on business. Because it is a primary requirement for passing the active income test that the CFE carries on business through a permanent establishment in its country of residence, it is likely that this requirement would be satisfied in most cases. Even if the CFE fails the active income test for other reasons, the permanent establishment condition would still be relevant for determining what income would be attributed.

A further necessary element for the active business exclusion could be to exclude income derived from a transaction directly related to the active conduct of a trade or business (see, for example, the definition of interest income in section 6). The existing law already contains this idea, for example, in dealing with commodity investments and exchange rate gains and losses. The exclusion could cover interest earned in the course of a business of lending money and interest earned on trade receivables.<sup>7</sup> It is not targeted at interest that is incidental to the carrying-on of a business (such as from short-term investment of excess cash): the 5 per cent threshold in the active income test allows for incidental passive income. It could also be applied to the other existing categories of passive income (such as rents and royalties). It would be expected that because of this, rent from the leasing of moveable property will generally be treated as active income.

The Board also reasoned that income from related party transactions should not as a general rule be treated as passive income. As mentioned above, the active income test may be performed on a limited, jurisdictional basis and amounts that are excluded from the active income test under a grouping approach may not be attributable as passive income if the CFE (or the relevant group) fails the active income test.

## Dividends

### Design principle

It is proposed that non-portfolio dividends (however 'non-portfolio' is ultimately defined for section 23AJ purposes) not be passive income.

These dividends are a distribution of profits from a substantial ownership investment in another company, not a passive investment. To the extent this other company is engaged in earning passive income, that passive income may be directly attributed to the attributable taxpayers. An exception might be needed for non-portfolio dividends paid by an Australian company that is subject to little or no Australian withholding tax (unless it is fully franked). All portfolio dividends would be passive income, subject to the above general exclusions.

One of the considerations in redefining passive income will be to ensure that there is a good fit with the concept of active foreign business asset in Subdivision 768-G. That may mean some consequential changes to that concept and some of the ideas in section 768-540 may be used in defining passive income.

---

<sup>7</sup> This may mean that the AFI subsidiary exemption is no longer required.

### 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?

#### 4.5.2 Other attributable amounts

When it comes to the CFE's interests in partnerships or trusts, the main principle to be followed is that there should be no difference in what is assessable or deductible from what occurs if the Australian resident attributable taxpayer held those interests directly rather than via the CFE.

#### Design principle

Therefore, amounts that would be included in the assessable income of the foreign entity for the year if it were an Australian resident company, under Divisions 5 (partnerships), 6 (trusts) and 6AAA (transferor trusts) of Part III, are also included in attributable income.

As for the CFE's interests in other foreign companies, if the other foreign company is a CFE then inclusion of any of its passive income will depend on whether the Australian resident is also an attributable taxpayer in relation to that second foreign company.

### Consultation question

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

#### 4.5.3 Calculating attributable income

As part of a principles-based approach to the redesign of the CFC rules, it is desirable that branch-equivalent calculations proceed on the basis that there should be few exceptions in applying the Australian tax in respect of the calculations. A consequence of this is that it may no longer be appropriate to disregard Division 974 (the debt/equity rules) or the new Division 230 (gains and losses from financial arrangements). The proposed changes that better target passive income will mitigate the extent to which the inclusion of these rules increases compliance costs.

Nevertheless, in applying the Australian income tax law a number of modifications will be made and these will be based on the current list of tax law modifications. An effort will be made to simplify these as much as possible (for example, the provisions dealing with sometimes exempt income) and possibly by removing some (for example, the special deduction for interim dividends). The interim dividends deduction could be removed to simplify the provisions because the dividends will not be otherwise taxable in many cases, if the requirements for the dividend exemption are made the same as for being an attributable taxpayer as suggested above.

## Design principle

The attributable income of a foreign entity is calculated by determining what the taxable income/net income of the entity would be if it were an Australian resident and its only income or gains were those listed above, with appropriate modifications to the Australian income tax law. Alternative, simpler means of determining the attributable amount are outlined in section 4.5.4 below.

Despite the Australian residence assumption, double tax treaties between Australia and other countries should be ignored in calculating attributable income. Also, similar to current arrangements, the following provisions of the Australian income tax law will not apply: sections 23AI, 23AK, 128D, 136AF(1A) and Division 15 of Part III (other than subsection 148(1)) of the ITAA 1936; and section 25-90, Part 3-6 and Division 820 (and these new attribution provisions) of the ITAA 1997. In place of Division 820 (the thin capitalisation rules) a simpler limit on debt deductions might be applicable (for example, debt deductions are limited to a stipulated percentage of passive income) if necessary to improve integrity.

In the case of a controlled foreign trust (CFT), the net income of the trust will already be calculated on the same residence assumption when determining amounts on which beneficiaries with fixed entitlements will be taxed. The attributable income would be the part of that net income that arises from the trust's passive income and the other amounts described in section 4.5.2 above. The amounts on which Australian resident beneficiaries are assessed under Division 6 may include a share of the attributable income of the trust because it will be included in net income. Only if there were amounts of trust income to which the beneficiaries were not presently entitled would these attribution rules have any application, and only then if the foreign trust were a CFT and one or more Australian resident beneficiaries were an attributable taxpayer. Some way to prevent double counting of the attributable income component of net income will have to be developed in consultation.

## 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?

### 4.5.4 Alternative calculations of assessable amounts

Providing taxpayers with a choice of attribution methods was initially advocated by the Board in the context of the attribution rules applying universally to both controlling and non-controlling interests. While the Board noted that there was arguably less need to provide for choice with the rules now focusing only on controlling interests, it maintained its initial position given the concerns about the complexity and higher compliance costs associated with the branch-equivalent calculation.

### **Design principle**

An attributable taxpayer may choose either the deemed rate of return method or the market value method to calculate the amount to be included in its assessable income as an alternative to the method set out in sections 4.2.3 and 4.5.3 (above).

These alternatives are provided to reduce compliance costs. However, by their nature neither of them focuses on passive income of the CFE nor on whether any of the income or profits of the CFE have been subject to comparable tax in a listed country. They also raise questions concerning the impact of the choices on the integrity of the rules and the transition between the various methods from year to year.

One circumstance where an attributable taxpayer may be locked into using the same attribution method from one year to the next is where it seeks to recoup a loss resulting from application of any of the methods in a prior period. This ensures the same underlying income base that was used to determine the amount of the loss is also used in calculating the income to recoup that loss. This assumes that, as under the existing law, a negative amount of attributable income (that is, a loss) will not be immediately deductible by the attributable taxpayer but instead will be carried forward by the attributable taxpayer in relation to that CFE.

### **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?

#### **4.5.4.1 The deemed rate of return method**

### **Design principle**

The amount included in the attributable taxpayer's assessable income under this method is determined by applying the deemed rate of return to the adjusted opening value of its equity interest in the CFE, taking account of the previous history of attribution and distribution and the period during that year that the interest was held.

The current FIF provisions (Subdivision C of Division 18 of Part XI) provide a model for this method.

The deemed rate of return is to be limited to the prevailing 'base interest rate'. Where the relevant accounting period of the CFE relates to more than one period for which a base rate is specified, a weighted average of the relevant 'base interest rates' is to be used.

Where either the branch-equivalent calculation method (section 4.5.3 above) or market value method (section 4.5.4.2) is used in the prior period (if this is permitted), the opening value for the purposes of applying the deemed rate of return method would be determined consistent with current arrangements.

Where for whatever reason nothing is attributed to the taxpayer for the preceding period, the attributable taxpayer will be required to reset the opening value of its interests upon application of this method for the later period.<sup>8</sup>

### 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?

#### 4.5.4.2 The market value method

##### Design principle

To work out the amount to include in assessable income using this method it is necessary to determine, for the relevant period, the change in the value of the equity interest that the attributable taxpayer holds in the CFE.

In calculating the change in value for the period, the market value of the interest is based on the value quoted on an approved stock exchange on the relevant day. Where stock market information is not available, publicly available information in relation to buy-backs, redemptions and purchase price that is offered to all entities holding interest might be used as the basis for determining the market value, although there may be concerns for the integrity of such valuations in controlling situations. The market value on the last day of the period is adjusted to take account of relevant transactions occurring during that period.

The current FIF market value methodology provides a model to achieve this outcome. However, unlike the existing FIF rules, any loss resulting from the application of this method would not flow through to the attributable taxpayer. Consistent with existing CFC policy, losses would be quarantined within the CFEs to be offset against any future attributable income.

---

<sup>8</sup> Under the current arrangements, if the market value method is used in the prior period, the deemed rate of return (DRR) would be applied to the closing market value of that prior period. If both (i) the branch equivalent calculation method was used in the prior period, and (ii) a quoted market value was available at the end of the prior period, the DRR would also be applied to the closing market value of the prior period. Otherwise, the deemed rate of return would need to be applied to the sum of: (a) the original value of the interest when acquired; and (b) the notional compounded DRR returns since the interest was acquired; less (c) distributions received (see existing sections 552 and 553).

## 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?

### 4.5.5 Double accruals taxation

The CFE may be subject to foreign income tax on some or all of the income or gains that are included in its attributable income under the accruals tax regime of third countries.

When using the branch-equivalent calculation method to determine attributable income under the current law, the attributable income of a foreign entity for Australian purposes is reduced if a part or the whole of that amount has been or will be subject to accruals tax in a listed country (section 456A).

The amount by which it is reduced takes account of the attributable taxpayer's indirect interest in the foreign entity that is held through an interest in another CFE in that listed country. It also takes account of the amount that is subject to accruals tax in the listed country and how much of that amount has been included in the attributable income.

Alternatively, this could be treated as another case for double tax relief. Foreign accruals tax, whether levied by a listed country or not, would just be another foreign tax imposed on the attributable income (even if not paid by the same entity).

## 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?

### 4.6 The double taxation relief principle

#### Design principle

To relieve double taxation where foreign or Australian income tax has been paid on the attributable income, it is proposed that the attributable taxpayer may claim a deduction for its share of the amount of foreign income tax or Australian tax that is properly referable to its share of the attributable income of the foreign entity.

The attributable taxpayer would be subject to Australian tax on its share of the passive income of the foreign entity, net of any foreign or Australian income tax that is also imposed on the amounts included in that attributable income.

This would represent a change of the existing policy because of the greater concentration on, and narrowing of, passive income that can be attributed. It is not in Australia's economic interest to treat passive income derived by foreign entities and subject to foreign tax as being

of equal value to passive income derived directly by Australian resident entities.<sup>9</sup> Passive investments by CFEs that generate a return, after foreign tax, which is less than the before-tax return from alternative directly held investments should be discouraged. Such a policy would be consistent with the policy objective of the regime as stated in section 3.2 above. This approach would mean that a foreign income tax offset would no longer be allowed to Australian companies that are attributable taxpayers.

This would only apply when using the branch-equivalent calculation method to determine attributable income, because the alternative methods indirectly do the same thing and any relevant amount of foreign income tax would not relate to what is attributed under those methods.

### 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?

## 4.7 The distribution principle

As a starting general principle, dividends or distributions paid by a CFC or trust to an Australian resident are assessable income.

---

<sup>9</sup> Taxing a resident investor on the passive income of CFEs on an accruals basis at the same domestic tax rate as domestic income, and with foreign tax treated as a deductible expense, encourages neutrality in residents' investment decisions between domestic (pre tax) and foreign (post foreign tax) investments, based on the gross return to Australia.

### **Design principle**

The existing exemption for dividends paid by a foreign company to an Australian resident company (section 23AJ) will apply to equity interests that are sufficient to make the Australian company an attributable taxpayer in a CFC. As part of the rewrite of these provisions and to implement Board recommendation 8, this exception will not apply in respect of a return on a debt interest but it will apply to a non-share dividend (that is, a return on a non-share equity interest).

In this way, the ownership interests that are taken into account for the purposes of the attribution regime will be the same as those for which this dividend exemption is provided. Moreover, the test for the level of interest required under both sets of rules will be the same (see section 4.2 above). This exemption does not currently apply to dividends, paid to a partnership or a trust where an Australian resident company is a partner or beneficiary, nor to a corporate unit trust or public trading trust.

### **Design principle**

To avoid double Australian tax of the passive income of a CFC, there is also an exception for dividends or distributions to the extent they are paid out of the attribution surplus that an attributable taxpayer has in relation to the foreign entity that made the distribution (existing section 23AI).

In the case of partnerships or trusts that are attributable taxpayers, the exception does not generally apply at the entity level (in calculating the net income or partnership loss) but can apply in respect of the relevant partners or beneficiaries.

Financial benefits provided to an attributable taxpayer, or its associates, by a CFE out of its undistributed profits may also be treated as a dividend or distribution made by the foreign entity to the attributable taxpayer. The benefits and the circumstances in which their provision will be taken to be a dividend are as listed in section 47A.

## 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?

## 4.8 The disposal principle

When an attributable taxpayer disposes of an ownership interest in a CFC or trust, or another CGT event happens in relation to that interest, the gain or loss may be a capital gain or capital loss or it may be ordinary income or a loss. The gains, or net gains, may be included in assessable income and the losses may be allowable deductions. Any capital gain or loss may be reduced, even to zero, under Subdivision 768-G. Again, all of this is already in the law and may not need to be changed at all. Under existing law, the proceeds from the disposal may be reduced by any attribution surplus the taxpayer has in relation to that foreign entity in calculating the capital gain or loss made on disposal.

As with the distribution principle, this principle does not apply where a trust is the attributable taxpayer when it comes to calculating the net income of the trust. It is not relevant for partnerships, because net capital gains are not included in calculating the net income or loss of a partnership.

### 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?

## 5 Interaction and consequential amendments

The recently introduced Division 230 concerning the tax treatment of gains and losses from financial arrangements is also an accruals system that can potentially apply to ownership interests in foreign entities. That raises questions of possible interaction or overlap between

the two regimes. That legislation currently excludes ownership interests in foreign companies or trusts from treatment under Division 230 pending the results of the review of the foreign income attribution regimes. Some amendment to that exclusion will now be required to give effect to the following.

### Design principle

Gains and losses from an ownership interest of an attributable taxpayer, including complying superannuation funds, would not be dealt with by Division 230. Gains and losses from other ownership interests in foreign entities (for example, less than 10 per cent interests in CFCs or equity interests in non-CFCs) would be dealt with by Division 230. The de minimis exemption and the exclusions from Division 230 on the basis of turnover, assets (see section 230-455) would operate independently of each other.

This would mean that in some cases the holder would be exempt from both regimes, and in other cases one or the other regime would apply. Where neither exemption applies, it would still be the case that only one or the other of the regimes would apply because of the above rules concerning different ownership interests.

### Consultation question

Does the proposed interaction between Division 230 and the rewritten CFC rules explained above provide an appropriate outcome?

## 6 Submissions

Interested parties are invited to lodge written submissions on the consultation questions set out in this paper.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law, which may be relevant to the design of this proposal.

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

The closing date for submissions is Tuesday, 9 June 2009. All information (**including name and address details**) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information **marked** as such in a separate attachment. A request made under the *Freedom of Information Act 1982* for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

**Written submissions should be addressed to:**

Manager  
Attribution Review Unit  
International Tax and Treaties Division  
Treasury  
Langton Crescent  
PARKES ACT 2600

**Fax:** (02) 6263 4352

**Email:** [fsiattribution@treasury.gov.au](mailto:fsiattribution@treasury.gov.au)

# ATTACHMENT

## Recommendation 1

Retain the CFC provisions as the primary set of rules designed to counter tax deferral arrangements.

- Rewrite the rules into the *Income Tax Assessment Act 1997*.
- Apply the rewritten CFC rules to closely held fixed trusts.
- Amend the rules to ensure that non-common law entities that confer ownership rights cannot avoid the operation of the CFC rules.
- Repeal the FIF and deemed present entitlement regimes.

## Recommendation 2

Exempt Australian-listed public companies from the rewritten CFC rules provided they satisfy at least one of the following eligibility criteria:

- Comparable worldwide effective tax rate rule.
- Sufficient distributions rule.
- Maximum worldwide passive income rule.

## Recommendation 3

Retain and modernise the existing legal-based definitions of passive income by addressing the constraints of the eligibility criteria as set out in paragraphs 3.37 to 3.39 (of the Board's report).<sup>10</sup>

Facilitate a group approach to determine eligibility for the CFC active income exemption.

## Recommendation 4

Remove the base company income rules.

Develop express integrity rules only where they are clearly needed and justified.

## Recommendation 5

Exempt complying superannuation funds from the CFC rules.

---

<sup>10</sup> See Board of Taxation, 'Review of the foreign source income anti-tax-deferral regimes: A Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs', pp 24-25.

## Recommendation 6

Allow taxpayers to choose from the branch-equivalent, market value or deemed rate of return attribution methods.

## Recommendation 7

Retain the tax laws approach for the CFC branch-equivalent calculations.

## Recommendation 8

Repeal section 404 of the *Income Tax Assessment Act 1936* and its attendant list.

Amend the non-portfolio dividend exemption in section 23AJ of the *Income Tax Assessment Act 1936* by:

- allowing other equity-like features to be taken into account to demonstrate ownership (including rights to dividends, capital and returns upon winding up); and
- precluding all debt-like interests.

## Recommendation 9

Replace the current FIF rules with a specific anti-roll-up fund measure, with the broad design features of the measure being modelled on the principles set out in paragraph 3.90 (of the Board's report).<sup>11</sup>

## Recommendation 10

Remove the control requirement for pre-commencement and pre-resident transferor trusts.

For foreign entities with multiple resident transferors, base the amount of income attributed to each transferor on the respective value of the property or services they transfer to the foreign entity and that, where it is not possible to determine this value, the transferor is deemed to hold a 100 per cent interest in the foreign entity.

Consider further technical issues with the transferor trust rules as part of consultation on any draft legislation.

---

<sup>11</sup> *ibid*, pp 37-38.