



**Australian Government**

# Reform of the controlled foreign company rules

Consultation Paper  
July 2010

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## **CONSULTATION PROCESS**

### **Request for feedback and comments**

The Government is seeking your feedback and comments on the rewrite of the taxation laws that are designed to modernise the controlled foreign company rules. The rewrite was announced in the 2009-10 Budget as part of wider reforms to the Australia's foreign source income anti-tax-deferral rules.

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

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* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

### **Closing date for submissions: 31 August 2010**

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## FOREWORD

I am very pleased to release this consultation paper on the design of the taxation laws that will modernise the controlled foreign company (CFC) rules.

The exposure legislation set out in this paper builds upon the CFC consultation paper that I released earlier this year and has been shaped to take into account the comments and submissions received during that process.

Given the scale, complexity and importance of these rules, however, it is desirable that a further round of consultation occur in respect of the development of the enabling legislation before it is introduced into Parliament. This will ensure that tax practitioners and industry have very high levels of input into the ultimate design of the CFC legislation.

These reforms to the CFC rules will improve the competitiveness of Australian businesses with offshore operations by modernising and simplifying the rules to better target areas at risk of inappropriate tax deferral, while reducing compliance costs for businesses.

The proposed changes will significantly assist in this regard and we look forward to receiving the community's views.

## SIGNED

Senator The Hon Nick Sherry  
**Assistant Treasurer**

## BACKGROUND

Earlier this year the Assistant Treasurer released a consultation paper<sup>1</sup> setting out the high level design of the proposed taxation laws to modernise the CFC rules.

The consultation paper followed on from the Government's announcement in the 2009-10 Budget to modernise the CFC rules as part of wider reforms to Australia's foreign source income anti-tax-deferral (attribution) rules.<sup>2</sup>

As part of these reforms, the Government introduced measures that were recently passed by the Parliament to repeal the foreign investment fund (FIF) and deemed present entitlement rules<sup>3</sup> as well as released exposure draft legislation setting out the detail of the proposed anti-roll-up fund rule<sup>4</sup>. Details surrounding the transferor trust changes are still to be developed. Legislation to give effect to these changes will be released for further comment before being finalised.

The comments received in respect of this consultation paper will be used to facilitate ongoing discussions between Treasury and industry which, ultimately, will inform Government on the legislative approach to take forward.

Importantly, the rules set out below do not at this stage represent the final view of the Government, and therefore contain certain policy and design features that are subject to final approval. Furthermore, the final design of the rules will need to be fiscally responsible and balanced against other pressing needs within the Australian budget.

Against this backdrop, the Government invites your comments on the rules set out below, including on issues mentioned in the specific consultation questions. You may also like to raise other matters that will assist in the final design of the law.

## LEGISLATIVE SCHEME

The Assistant Treasurer's CFC consultation paper of January 2010 put forward a range of significant reforms to modernise the CFC rules. The centrepiece for these reforms is the proposed active business income exemption which is designed to ensure only passive income is attributed to Australian resident controllers. A detailed explanation of this exemption together with examples that illustrate its operation is set out below.

There are also a number of other important reforms that feature in the proposed CFC rules which are also explained below. These include:

- De minimis passive income test

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1 Assistant Treasurer's Press Release No. 003 of 5 January 2010.

2 Assistant Treasurer's Press Release No. 049 of 12 May 2010.

3 Assistant Treasurer's Press Release No. 106 of 13 May 2010.

4 Assistant Treasurer's Press Release No. 144 of 24 June 2010.

- AFI subsidiary exemption
- Control and joint control
- Grouping relief
- Lightly taxed entities
- Tainted royalties
- Removal of double taxation
- Participation interests
- Deductibility rules
- Dividend exemption
- Subtractive approach (Attachment A)

This paper provides an explanation of the operation of each of these features. Draft rules on which the final legislation might be based are separately attached at Attachment B.

## **ACTIVE BUSINESS INCOME EXEMPTION**

Although Australia's tax policy for the treatment of foreign income is diverse, the economic rationale is clear. During the process of the review by the Board of Taxation, it was articulated as a blend of two benchmarks: capital import neutrality (CIN) and capital export neutrality (CEN).

CIN advocates source-based taxation. That is, income earned by Australians overseas should not be subject to further tax in Australia, regardless of the tax rate in the foreign country.

By contrast, CEN advocates residence-based taxation. That is, the return on all capital owned by Australians should be taxed at Australian rates, whether it is invested in Australia or overseas.

CIN promotes neutrality with overseas investors, whereas CEN promotes neutrality with alternative Australian investments.

The 'blend' which can be inferred from Australia's current approach to the taxation of foreign income is essentially as follows: as long as profits are retained within a company or within certain parts of non-portfolio corporate groups, CIN should apply to active income, and CEN should apply to passive income. The basis of this blend is that commercial activity should be encouraged; and that, where that activity occurs outside Australia (under Australian ownership) its ability to compete with businesses under foreign ownership should not be impeded by the additional burden of Australian taxation. On the other hand, passive income is derived from more idle investment, which is not core business of a competitive enterprise. Absent the need to compete overseas, there is no justification for Australia to forgo its fundamental right to tax the worldwide income of its residents. If Australia does forgo that right, it will tend to encourage Australian residents to invest for relatively modest yields overseas, in preference to investing in Australia at higher pre-tax yields.

## The role of the active business income exemption

The active business income exemption has been devised because it has proven to be difficult to devise comprehensive objective tests that ensure that Australian controlled overseas subsidiaries with profits derived from genuine overseas activities are excluded from attribution.

Unfortunately, the objective test that distinguishes between active and passive income solely by reference to its standalone classification has been shown to be inadequate and does not always produce the desired policy outcome.

This occurs because types of income do not accurately fall within discrete 'active' or 'passive' categories. Absent an understanding of the context in which the income is obtained it is now recognised that there is insufficient information to conclude that a particular category applies. Labelling particular types of income, without more context, as 'passive' is a process which presumes too much about the circumstances in which the income is derived by the recipient. Where that presumption is inaccurate, the recipient (or in this context, the recipient's Australian resident controller) is unfairly disadvantaged.

Consequently, the proposed rules will continue to begin by targeting income which is 'prima facie passive income' (Rule 4-10). The rules will then go on to exclude, if necessary, items which are inherently passive in nature, but which are derived in an active context. There is therefore to be a rule which converts 'prima facie passive income' to just 'passive income' (Rule 4-11). That is the essential conversion which takes due account of the context in which the income is received and the commercial demeanour of the recipient CFC.

At its simplest, it would be possible to say that any 'prima facie passive income' derived by a CFC which carries on a business should be excluded from passive income.

Unfortunately, that would be an overly generous approach because there is abundant jurisprudence which effectively assumes that every company that uses its assets to produce income, is carrying on a business. Arguably, when a company simply holds investments in the most passive way, it can be said to be carrying on a business.

Accordingly, it is necessary to legislate an 'active business test' which sets a higher threshold than merely carrying on a business. That higher threshold is intended to distinguish between idle investment (which is passive) and competitive effort (which is active).

## The legislative features of the active business test

As presently drafted, prima facie passive income is accepted as active income and is excluded from attribution (absent any separate express and particular inclusion) where it:

*'arises in the ordinary course of the active conduct of a trade or business by the entity'.  
(Rule 4-11(1))*

Note that this test is applied to each item of prima facie passive income and it is not sufficient to show that the CFC is engaged in the active conduct of a trade or business to render all its income active.

The active conduct of a trade or business by an entity is then defined as:

*'the competitive participation by the entity in industrial, commercial or financial undertakings, evidenced by human activity'. (Rule 4-11(2))*

Importantly, the human activity does not have to be performed by a director or employee of the CFC: the activity may be out-sourced to a contractor, subcontractor, or an agent.

## Competitive participation

The concept of 'competitive participation' is intended to entail the notion that the CFC must be taking part in some type of competitive activity in a market to obtain income or profits from one or more sources. It is not necessary for the entity to have more than one client or customer at any given time, nor is it necessary for there to be a series of sequential business dealings. In some cases, it could be sufficient to satisfy the test if a company obtains a customer by competitively tendering for as a single contract.

The test would not be failed if a client or customer was a related party. As long as it can be demonstrated that the entity had to compete with others in order to successfully undertake a transaction or transactions, that entity would be involved in competitive participation. This goes to the central objective of the CIN benchmark.

Competitive participation can also exist where the entity is in the market place negotiating supply costs. A business will generate more profit if the cost of inputs can be reduced and the sale price remains stable; this activity is simply another means of competing with rivals for business.

## Related legislative measures

It is important to appreciate that the 'active business income exemption' is not the only legislative measure which is being proposed to address the possibility of excessive attribution of quasi-active income. There is also:

- (a) a special rule for CFCs of Australian Financial Institutions (Subpart 4-C);
- (b) grouping relief (Subpart 4-D) for passive income derived from a fellow-group CFC, where the fellow-group CFC's income is not attributable (eg. because it is active); and
- (c) a de minimis passive income exemption (Subpart 1-B) which operates as an initial high-level exemption so that modest amounts of passive income may be disregarded.

However, it is also proposed that an integrity measure should deny Australian deductions to related parties (either as an Australian taxpayer or as CFCs) where the related party's expenditure constitutes prima facie passive income, but not attributable income, of a CFC. [Part 30].

## Active business income exemption examples

As explained above, the active business income exemption has been developed because it has previously proven to be difficult to devise comprehensive objective tests that ensured that Australian controlled overseas subsidiaries' profits derived from genuine overseas activities were excluded from attribution.

This section explains how the active business income exemption applies in practice through a series of brief examples. Given that the rule applies on a case-by-case basis, it is anticipated that taxpayers will be able to apply to the Tax Office for a ruling in respect of the application of the active business income exemption for cases where it is difficult to discern its precise application.

Importantly, the examples do not examine the issue of whether a *business is being carried on* (for which there is much separate case law and ATO guidance). They are only concerned with whether there is the active conduct of a business as defined.

### **Example 1: interest — ordinary course of business**

Artichoke is a CFC resident in China. Artichoke is a service company providing civil engineering services from its office in Shanghai. In the year ended 30 June 2011, Artichoke enjoys good cash flow from clients. Artichoke also holds money, representing the ordinary working capital requirements of its business, in bank accounts and derives interest income.

Cash flow management in the form of holding money in a bank account for working capital purposes is an inherent part of Artichoke providing civil engineering services. Therefore the interest income earned on the bank deposits arises in the ordinary course of Artichoke's business of providing civil engineering services.<sup>5</sup>

### **Example 2: interest — ordinary course of business**

Beetroot is a CFC resident in Ukraine. Beetroot has a food processing factory in Kiev. The factory has been highly profitable for many years and profits have been accumulating in bank deposits, as opposed to being distributed by way of dividend. The size of the deposits is substantially greater than what might be required for the normal working capital demands of the business as it stands. However, Beetroot has been pursuing the opportunity to expand its business by purchasing a larger factory and is holding the funds with the intention of using them towards the purchase when a suitable factory is found. Beetroot is able to demonstrate from its actions and business plan that it has a realistic intention of investing these funds in the near future.

Reinvesting in, and expanding, operations is integral to Beetroot's business. Therefore interest income derived from the holding of funds for this purpose is earned in the ordinary course of that business.

However, if the funds are not going to be reinvested in the food processing business, the interest income accumulating in the bank account would not be earned in the ordinary course of that business.

### **Example 3: interest — commencing a new business**

Chilli is a CFC resident in Switzerland. For a number of years, Chilli has supplied European supermarkets with organic food products bought from Australia. The business has earned premium profits and has had excess cash funds since 2005. From 2005 until 2010 those excess funds have been deposited with a bank. From 2008 until 2010 the size of the deposits and the amounts of interest were of such magnitude that the interest could not be said to arise in the ordinary course of Chilli's business of supplying food products.

With effect from 1 July 2010, Chilli has embarked upon a more business-like approach to funds management. In addition to its core food business it hires bond traders and foreign

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<sup>5</sup> In many cases, such interest income may be independently excluded from attribution under the de minimis exemption [rule 1-11].

exchange dealers and sets up a financial trading operation within its former administrative offices. This is sufficient to constitute a new separate business from that of the food supply business. The prima facie passive income earned in the financial trading operation will satisfy the active business income test because the income is derived in the ordinary course of the funds management business and that business is actively conducted.

#### **Example 4: treasury function — ordinary course of business**

Dandelion is a CFC resident in Ireland. Dandelion is a wholly-owned subsidiary of an Australian-owned multinational group, and manages part of the treasury function for that group. This includes:

- (a) daily funds management: borrowing funds from group members with excess cash and lending funds to group members with cash shortfalls;
- (b) borrowing medium and long term funds from external credit providers;
- (c) managing currency and interest rate risks through a variety of hedging, swapping and similar financial arrangements, mostly with counterparties which are not group members; and
- (d) placing surplus group funds with money markets.

All of Dandelion's transactions with other group members are conducted on arm's-length terms. Dandelion has a sophisticated, trading-room operation in Dublin and coordinates its trading activity with similar treasury functions conducted (overnight, Dublin time) by the parent company in Sydney.

Notwithstanding that many of Dandelion's transactions are conducted with group members, the 'prima facie passive income' which Dandelion derives in its above activities can be said to 'arise in the ordinary course of the active conduct of a trade or business'.

However, if Dandelion also makes separate long-term investments which require no significant or regular management or maintenance, those investments may not be incidental to Dandelion's other active business. Consequently, income and gains derived from those investments might not be said to 'arise in the ordinary course of the active conduct of a trade or business'. A CFC which carries on an active business should not be permitted to shelter a mere investment which is unconnected with that active business.

#### **Example 5: investment business — not active conduct of a business**

Eggplant is a CFC resident in the British Virgin Islands (BVI). It has its central management and control established in the BVI through the authority and conduct of directors who are based in the BVI and who provide their services on a non-exclusive professional basis. Eggplant carries on an investment business and does not carry on any other business. It has no employees. Eggplant holds a share portfolio of international stocks and maintains bank deposits. Although portfolio changes occur from time to time, normally consistent with recommendations from Eggplant's ultimate owner in Australia, there is no day-to-day activity undertaken on behalf of Eggplant and the establishment of the original portfolio was simply a function of investment, as opposed to that of a commercial enterprise.

The directors of Eggplant do not undertake activities which would satisfy the description of competitive participation. The entity is not competing with rivals to procure business and generate profits; the directors simply meet to consider and approve the recommendations

made by the Australian resident. Therefore the business of Eggplant cannot be said to be actively conducted.

As Eggplant does not participate in a competitive manner in overseas markets there is no justification for permitting Eggplant's Australian controller to enjoy the benefit of capital import neutrality.

### **Example 6: start-up phase**

Fennel is a CFC resident in Indonesia. Fennel was incorporated in 2009 for the purpose of operating a petro-chemical plant in Sumatra. Although 200 billion rupiah has been paid into Fennel as share capital and although construction of the plant has commenced, no active business is yet underway. Meanwhile, most of the 200 billion Rupiah (approximately AUD25 million) has been deposited with an Indonesian bank.

Because no active business has commenced, the interest income derived by Fennel from the bank deposit cannot be said to arise in the ordinary course of such a business. This will remain the case until Fennel commences carrying on its active business.

### **Example 7: wind-down phase**

Garlic is a CFC resident in Poland. Garlic is now in voluntary liquidation after closing down its business as an employment agency in Warsaw. The liquidator has sold all of Garlic's assets but the distribution of the proceeds has been delayed, pending tax clearance in Poland. The proceeds are held on deposit with a bank.

Interest derived from the bank deposits after Garlic has ceased to conduct its business as an employment agency does not arise in the ordinary course of a business which is actively conducted, because there is no such business.

### **Example 8: rent — not in ordinary course of business**

Jackfruit is a CFC resident in Fiji. It owns an apartment in a condominium in Fiji which is available both for short-term tourist rental, and for free use by the ultimate owner and associates of the ultimate owner of Jackfruit. The tourist rentals together with the cleaning and maintenance of the apartment are managed by an estate agent in Fiji. The apartment is usually occupied by associates of Jackfruit and the ultimate owner for at least two months of each year.

The activities of Jackfruit cannot be said to occur in the ordinary course of the active conduct of a trade or business. There is only one apartment and it is occupied for free by associates of Jackfruit and the ultimate owner for holidays. Objectively viewed, a significant reason for Jackfruit owning the property is to provide free accommodation. In this case, the income derived cannot be said to arise in the ordinary course of carrying on a business.

In the event that it could be concluded that the income was derived in the ordinary course of carrying on a business, it cannot be concluded that the business was actively conducted due to the low scale of activity.

### **Example 9: rent — ordinary course of business; actively conducted**

Kale is also a CFC resident of Fiji. Kale owns twelve apartments in the same condominium as Jackfruit, one of which is available for free use by associates of the ultimate owner of Kale. The tourist rentals are short-term contracts (typically for one or two weeks) and are

managed by the same estate agent who looks after Jackfruit's apartments. However, the twelve apartments demand more intensive marketing, management and maintenance, sufficient to occupy at least 20% of the time of one of the estate agent's employees, and 50 per cent of the time of a contractor who cleans the apartments and carries out various repairs and maintenance on a regular basis.

In the case of the apartment available for free use by the owner's associates, the deemed rental income (pursuant to Division 13 of ITAA 1936) cannot be said to 'arise in the ordinary course of the active conduct of a trade or business'. However, the rents derived from the other eleven apartments can be said to so arise.

There is a spectrum of degrees of activity between Jackfruit and Kale and the critical dividing line will depend upon specific facts and circumstances of each case. However, in simple terms and in most cases, a mere investment is insufficiently active, whereas a working enterprise is sufficiently active to satisfy the active business test, provided that the enterprise is conducted on a competitive basis and in a business like manner. Scale is also a relevant factor.

### **Example 10: rent — actively conducted**

Chickpea is a CFC resident in Germany. It is one of a number of CFCs within the Splitpea group which holds a portfolio of rental properties in Europe. The management of the rental properties for all the CFCs, including Chickpea, is undertaken by an entity 'Manager'. Manager has an office in London with a staff of twenty.

Chickpea is one of a number of participants competing with other landlords for tenants. The human activity associated with letting and managing the properties, while not performed by Chickpea itself, is undertaken on Chickpea's behalf by Manager. Therefore, the business of Chickpea is 'actively conducted' for the purpose of the 'active business test'.

### **Example 11: rent — not in the ordinary course of business**

Lentil is a CFC resident in the Philippines. Lentil has conducted business in Manila for many years as a firm of quantity surveyors. At one time, it had over 150 personnel and occupied three floors of a Manila office building under a ten year lease (expiring in 2014). In 2009, business fell away and Lentil reduced its personnel to 100, thus enabling one of the three floors to be sublet to another tenant. The sublease is for five years ending 2014.

Lentil carries on a business of quantity surveying. Leasing premises to tenants is not part of the ordinary course of Lentil's business, nor does the subleasing constitute a separate business in the relevant period. Therefore the rental income does not arise in the ordinary course of Lentil's business and does not pass the active business test.

However, if the sublease was for a shorter period and did not extend to the end of Lentil's head lease, it may be possible for Lentil to demonstrate that the sublease is merely temporary and therefore incidental to Lentil's quantity surveying business. In that case, the rental income from the sublease could be said to arise in the ordinary course of the active conduct of Lentil's quantity surveying business.

### **Example 12: rent — actively conducted**

Mushroom is a CFC resident of the Cayman Islands. It is one of a number of 'special purpose entities' owned by the Fungus group which is resident in Australia and which operates a number of ships as an international shipping line. Each vessel is owned by a

separate subsidiary company, and Mushroom owns one vessel. The vessel has been leased, on bareboat terms, to an unrelated party for an extended period (ie more than 12 months). Under the terms of the charterparty Mushroom is not responsible for the maintenance, navigation or insurance of the vessel. Mushroom has no separate employees. All it has done is to use its capital to acquire ownership of the vessel and allowed it to be leased on terms acceptable to and negotiated by Fungus.

Mushroom did not and does not actively seek out lessees for its vessel. It did not engage in the negotiation of the charterparty, nor does it have ongoing responsibility for running or upkeep of the vessel while it is chartered. The human activity involved in the negotiation of the charterparty was human activity associated with Fungus's business of negotiating the group's contracts, rather than being human activity associated with Mushroom's business of boat leasing. Therefore, Mushroom's business is not 'actively conducted' for the purpose of the active business test, and the prima facie passive income does not pass the active business income test.

### **Example 13: rent — ordinary course**

Nashi is a CFC resident in Singapore. Nashi is an airline operator providing commercial domestic and international services. Nashi owns a large fleet of aircraft. There is a long lead time for delivery of new aircraft and Nashi has to estimate aircraft requirements well in advance. In the 2009 year, two new aircraft were delivered but business was down because of the global financial crisis, so the new aircraft were temporarily surplus to Nashi's current requirements. To avoid Nashi having idle aircraft, Nashi chose to lease the aircraft to unrelated third parties for 24 months from January 2009.

While Nashi's business is that of being a commercial airline, an integral part of its business is managing its fleet of aircraft, including leasing aircraft that are surplus to its current business requirements. Therefore the rental income derived from leasing the aircraft arises in the ordinary course of Nashi's business, and because the business is actively conducted, the rental income passes the active business income test.

### **Example 14: royalty — actively conducted**

Olive is a CFC resident in the Netherlands. Olive owns the global rights to some food-drying technology developed in USA by a related company (also a CFC). Although Olive procures the maintenance of the international registrations for the intellectual property (via a firm of patent attorneys), it has neither undertaken nor arranged any material improvement or development of the technology since it was acquired. It has no employees and no contract for ongoing research. Olive receives royalties from the related US company and also from unrelated third parties in Europe.

Olive does not seek out new licensees for the food drying technology, nor does it engage in the improvement of the existing technology so as to increase its value and therefore the potential royalties from licensing the technology. While there is human activity involved in the maintenance of the international registrations for the intellectual property, it cannot be considered to be sufficiently linked to competitive participation in commercial undertakings or the earning of the businesses income to evidence competitive participation. Olive's business

is therefore not ‘actively conducted’ for the purpose of the active business test, and its prima facie passive income does not pass the active business income test.<sup>6</sup>

### **Example 15: royalty — actively conducted business**

Parsnip is a CFC resident in Israel. Parsnip owns the global rights to desalination technology which was originally developed by a related party resident in Australia. Parsnip has subcontracted the further development of this technology to an independent research firm in Israel, with the consequence that the original technology has been substantially improved. Parsnip has actively marketed the technology in other countries and now has licence agreements with third parties around the world, as well as a licence back to the Australian originator, and licenses with other CFCs in the same group.

Parsnip seeks out new licensees for its desalination technology, competing with other businesses marketing similar technology. It also improves its product, through development by a subcontractor, which increases the value of the technology and potential future income streams. Human activity is involved in the marketing activities, and in the development of the technology by the subcontractor. Therefore, Parsnip’s business is ‘actively conducted’ for the purpose of the active business test.<sup>7</sup>

### **Example 16: royalty — actively conducted business**

Quince is a CFC resident in Singapore. Quince owns the global rights (excluding Australia) to a digital gaming device which was originally developed by its parent company in Australia. The rights were transferred to Quince in 2005. Since acquiring the rights, Quince has actively marketed them around the world. It has a sales force of 20 full-time employees and a management team of five. However, the device has not been further developed, altered, or improved by or on behalf of Quince.

The ‘prima facie passive income’ derived by Quince can be said to ‘arise in the ordinary course of the active conduct of a trade or business’.<sup>8</sup>

### **Example 17: insurance — actively conducted business**

Spinach is a CFC resident in Bermuda. Spinach is a general insurance company and a subsidiary of an Australian company. Spinach does not provide insurance to Australian residents, nor to related parties. It has an office in Bermuda with a staff of ten. Most of its business comes from brokers in other countries.

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6 Note however, that the royalties derived from the related CFC in USA will likely not be attributable, to the extent that they both:

- (a) qualify for grouping relief, as per rule 4-30(2); and
- (b) do not constitute ‘tainted royalty income’ as per rule 4-1(2).

7 Moreover, the royalties will not constitute ‘tainted royalty income’ for the purposes of Rule 4-1(2). However, note that, to the extent that the royalties are received from the Australian originator, the originator will be denied a deduction for its royalty expense, pursuant to *Part 30*.

8 However, the royalties will be ‘tainted royalty income’ because Quince both:

- (i) acquired the rights (directly or indirectly) from a related party resident in Australia; and
- (ii) has not further developed the technology. [See page 19 for definition of Tainted Royalty Income.]

Spinach seeks out new business and offers insurance at competitive rates to unrelated parties. This involves human activity on the part of Spinach's employees who operate from Spinach's offices in Bermuda. Therefore Spinach's business is actively conducted for the purpose of the active business test.

Spinach's business is providing general insurance and the income from insurance premiums (which is prima facie passive income because it profit from a 'financial arrangement') arises in the ordinary course of that business.

As the income from insurance premiums arises in the ordinary course of Spinach's business, and that business is actively conducted, the income passes the active business income test and therefore is not passive income.

### **Example 18: captive insurance — actively conducted business**

Tomato is a CFC resident in the Bahamas and is a subsidiary of an Australian listed public company. Tomato provides general insurance cover for all members of its large corporate group, both inside and outside Australia. It reinsures the covered risks with third-party reinsurers outside Australia. The maintenance of the various insurance policies and the annual canvassing for reinsurance quotations requires the work of a team of five people based in Nassau. Since an insurance policy is a 'financial arrangement'; the profits from providing insurance are 'prima facie passive income'.

Although the policies provided by Tomato are all provided to related parties, it is nevertheless the case that Tomato is actively engaged in a competitive business outside Australia, as evidenced by the negotiation of reinsurance terms with third parties. Accordingly, the profits 'arise in the ordinary course of the active conduct of a trade or business'.<sup>9</sup>

### **Example 19: CGT event — actively conducted business**

Uva is a CFC resident in Norway. Uva is in the business of buying and selling real estate in Scandinavia. It has a fully staffed office in Oslo, including a dedicated buying team and a dedicated selling team. It prefers to acquire ageing shopping centres, which it then remodels prior to re-sale. When it sells real estate it derives 'a profit from a CGT event that happens in relation to an asset'. Accordingly, the profit is 'prima facie passive income' (Rule 4-10).

However, the profit 'arises in the ordinary course of the active conduct of a trade or business' and is therefore not 'passive income' (Rule 4-11).

### **Example 20: CGT event — predominant purpose**

Vanilla is a CFC resident in New Zealand (a listed country which does not impose tax on capital gains). Vanilla sells a factory which was used by it for many years (to scour wool), but it has been leased to a tenant for the past 18 months. Vanilla realises a capital gain which is 'prima facie passive income' (Rule 4-10).

Since the factory was held for the predominant purpose of scouring wool, and therefore to produce income which was not 'prima facie passive income', the capital gain will not be

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<sup>9</sup> However, note that the payer of those premiums will not be entitled to Australian tax deductions for the premiums they pay, see *Part 30*.

passive income (Rule 4-11). The production of rental income during the past 18 months was not the predominant purpose of holding the factory as an asset.

Whilst each such case would need to be viewed on its merits, there would normally be a reasonable presumption that an asset has been held 'predominantly' for a purpose where that purpose was satisfied for at least 50% of the ownership period.

### **Example 21: CGT event — predominant purpose**

Wasabi is a CFC resident in South Korea which operates a steel mill. Wasabi has a wholly owned subsidiary (also in South Korea) which fabricates flat steel products. Wasabi sells the shares in its wholly-owned subsidiary company. Wasabi has held those shares as a capital asset for many years.

Wasabi's capital gain will constitute 'passive income' because the subsidiary was held for the predominant purpose of providing returns on Wasabi's equity interest (which are 'prima facie passive income' and therefore covered by Rule 1-1) and the sale of the shares did not occur in the ordinary course of the active conduct of Wasabi's trade or business. Accordingly, the gain is not excluded from 'passive income' under Rule 4-11.<sup>10</sup>

### **Principles gleaned from examples**

The examples above explain how the active business income exemption applies in practice. From these examples it is possible to discern the following principles:

- (a) Each CFC must be viewed independently to determine whether or not it conducts an active business. Whilst its active business may be conducted by others (on its behalf), a CFC which merely invests capital cannot treat its investment as active by arguing that the CFC is a member of a group of active companies.
- (b) Scale of activity is relevant. Consequently, CFCs which have greater capital and/or resources are more likely to be able to demonstrate that their 'prima facie passive income' is actually the product of a working enterprise.
- (c) Excessive liquidity for a temporary period can give rise to prima facie passive income which is outside the ordinary course of the active conduct of a trade or business. This will often be the case where funds are available to a CFC before it commences business. However, where funds are accumulated during a business operation and there is evidence of them being earmarked for an active business purpose within a reasonable period of time, the active business test will likely be passed. As a rule of thumb, two years is taken to be a reasonable period of time.
- (d) A CFC which operates as a treasury service provider to related parties (eg within a multinational or dual-listed company group) is able to establish a scale of operation which is sufficiently active to pass the active business test. This would be relevant to services provided to related parties where the relationship is not sufficiently close to qualify for the grouping (Rule 4-30) relief.

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<sup>10</sup> Note the capital gain may nevertheless qualify for a reduction as a result of the existing 'participation exemption' in subdivision 768-G of the *Income Tax Assessment Act 1997*

- (e) Whilst the activities of professional directors outside Australia may be sufficient to demonstrate that a CFC's central management and control (and therefore possibly its residence) is outside Australia, there can be no presumption that their roles will enable the CFC's income to pass the active business income test.
- (f) 'Competitive participation' is capable of being established not only in a CFC's mode of income derivation (eg selling), but also in its mode of procurement (eg buying). There are circumstances where the basis of the CFC's existence, and its place of operation, is dictated entirely by the opportunities for efficient procurement of supply.
- (g) At Rule 4-11, in determining whether an asset or financial arrangement has been held for the predominant purpose of producing active income, a rule of thumb could be applied if that purpose has been satisfied for at least 50 per cent of the time during which the CFC held the asset or financial arrangement.

## DE MINIMIS PASSIVE INCOME TEST

As explained above a fundamental policy objective of the CFC regime is that where, for legitimate commercial reasons, Australian residents invest capital in foreign active businesses the capital imported into a foreign jurisdiction should be taxed at the same competitive level as other investments in that jurisdiction (capital import neutrality). The active business income test is intended to achieve this objective by excluding from the passive income of a CFC amounts that arise in the ordinary course of the active conduct of a trade or business of the CFC.

The de minimis passive income test supplements the active business income test by providing a simplified exception from attribution, thereby reducing the compliance costs of investors in a CFC with relatively small amounts of passive income.

The de minimis passive income test provides an exemption from attribution if less than 5 per cent of the income of a CFC as determined by reference to its financial accounts has a passive character.

Where a CFC satisfies these requirements, taxpayers will not be required to consider any potential further application of other aspects of the broader CFC regime (such as the active business income test). Further, allowing the determination of whether the 5 per cent de minimis test is satisfied to be done by reference to the financial accounts of the CFC is expected to reduce compliance costs because affected entities are able to rely on accounting information that they maintain for other purposes.

All of the income of a CFC for a statutory accounting period will not be subject to attribution if:

- the CFC prepares financial reports according to the relevant accounting standards; and
- the CFC's passive financial account income for the relevant period is less than 5% of its financial account income for that period. [Rule 1-11]

The financial account income of the CFC for the period is its income recognised in its financial accounts for that period. The passive financial account income of the CFC for the period forms a part of its financial account income for that period, to the extent that the financial account income has a passive character.

Passive financial account income would include dividends, interest, rent, annuity payments, royalties and profits from a financial arrangement as determined by reference to the CFC's financial accounts. A profit from a CGT event that happens in relation to an asset would also be included as passive financial account income.

## **AFI SUBSIDIARY EXEMPTION**

Special rules for AFI subsidiaries operate to supplement the active business income test by ensuring that income earned through legitimate, commercial, financial intermediary business activities carried about by AFI entities through a CFC resident is effectively subject to the CIN benchmark. This is the case even though the income earned through these activities would generally fall within the scope of prima facie passive income. Whilst the active business income test may serve this purpose adequately in many cases, a special concession is necessary for AFI subsidiaries because of the inherent bias of the CFC regime against income of the type ordinarily derived by such entities. The object of these provisions is to reduce compliance costs for AFI subsidiaries by providing special rules that recognise the active character of certain income earned in the carrying on of a financial intermediary business. [Rule 4-20]

The passive income of a CFC that is classified as an AFI subsidiary does not include certain income, being excluded AFI income [rule 4-24], where at the time the income is gained the CFC's sole or principle business is banking business. [Rule 4-21]

A CFC is an AFI subsidiary when it is controlled by a company that is an AFI. Special rules also apply to appropriately determine whether or not a CFC is an AFI subsidiary when it is jointly controlled by two or more companies. [Rule 4-22]

An AFI is an Australian entity that falls within the relevant definition that essentially carries on the activities of a financial institution; for example, a company that is an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

The concessional treatment for AFI subsidiaries will be broadly consistent with that afforded under the current CFC rules. The meaning of 'financial intermediary business' and the types of income that will be excluded from the passive income of an AFI subsidiary will be developed in consultation with industry.

The exclusion for certain types of income from the passive income of an AFI subsidiary does not preclude application of the active business income test available to CFCs more generally. This means that where an AFI subsidiary that fails to meet the requirements to exclude a particular amount of income from passive income under the specific AFI concession, the AFI subsidiary may satisfy the active business income test in relation to that income.

Similarly, the grouping concession that reduces the passive income of a CFC in respect to income derived from activities with group members may be available where a particular amount of income of an AFI subsidiary falls outside of the AFI subsidiary exclusion.

## **CONTROL AND JOINT CONTROL**

The definition of control for the purposes of the proposed CFC rules takes its meaning from the Australian Accounting Standards and in particular AASB 127: *Consolidated and Separate Financial Statements*.

AASB 127 is to be applied in the preparation and presentation of consolidated financial statements for a group of entities under the control of a parent. The following terms are defined in AASB 127:

- Group — A group is a parent and all its subsidiaries.
- Parent — A parent is an entity that has one or more subsidiaries.
- Subsidiary — A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity.
- Control — Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The term “control” is further explained in Paragraph 13 of AASB 127.

*“Control is presumed to exist when the parent owns, directly or indirectly, through subsidiaries, more than half of the voting power of an entity unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists when the parent owns half or less of the voting power of an entity when there is:*

*power over more than half of the voting rights by virtue of an agreement with other investors;*

*power to govern the financial and operating policies of the entity under a statute or an agreement;*

*power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or*

*power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.”*

The Commentary to AASB 1024 (which preceded AASB 127) also points out that the concept of control is defined as a capacity, thereby allowing for the role of dominance to be a passive one, rather than one which is necessarily actively exercised. Furthermore, it may be possible to control the voting rights of another entity without holding a majority interest in the voting rights. This could occur in the absence of another entity dominating the composition of the board of directors. Also, the definition of control may result in an entity being under the control of two unrelated entities. An example would be where an entity exercises dominance of the decision-making in relation to the operating policies of a second entity, while another entity simultaneously possesses the capacity to dominate decision-making of that second entity, but without exercising that power.<sup>11</sup>

The concept of joint control envisaged in these rules also draws from the Accounting Standards and in particular AASB 131 (Interests in Joint Ventures). That standard defines joint control as the contractually agreed sharing of control over an economic activity and exists only when the strategic financial and operating decisions relating to the activity require

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11 AASB 1024 paragraphs xv-xxiv

the unanimous consent of the parties sharing control (the venturers). Naturally, these rules would only be concerned with joint ventures (JV) that are established as foreign companies or possibly as foreign trusts.

The existence of a contractual arrangement distinguishes interests that involve joint control from investment in associates in which the investor merely has significant influence. The contractual arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the arrangement is incorporated in the articles or other by-laws of the JV. Whatever its form, the contractual arrangement is usually in writing and deals with such matters as:

- the activity, duration and reporting obligations of the JV;
- the appointment of the board of directors or equivalent governing body of the JV and the voting rights of the venturers;
- capital contributions by the venturers; and
- the sharing by the venturers of the output, income, expenses or results of the JV.

The contractual arrangement establishes joint control over the JV. Such a requirement ensures that no single venturer is in a position to control the activity unilaterally.

The contractual arrangement may identify one venturer as the operator or manager of the JV. If the operator has the power to govern the financial and operating policies of the JV, it controls the venture and the JV is a subsidiary of the operator and not a JV.

A jointly controlled entity is a JV that involves the establishment of a company, partnership or other entity in which each venturer has an interest. The entity operates in the same way as other like entities, except that a contractual arrangement between the venturers establishes joint control of the economic activity of the entity.

One relevant example of a jointly controlled entity is when an entity commences a business in a foreign country in conjunction with the government or other agency in that country, by establishing a separate entity that is jointly controlled by the entity and the government or agency. Where the non-government entity is an Australian entity, it will be taken to be a controller of the foreign JV company despite the fact that a foreign government/agency jointly controls the foreign company. That Australian entity will be an attributable taxpayer, other things being equal.

## **GROUPING RELIEF**

A grouping exemption has been developed in recognition of the principle that dealings between related parties largely amount to a shifting of taxable profits from one entity to another. Where they don't have that effect (eg, the payment is not deductible), they should not result in the creation of taxable income because they give rise to prima facie passive income. [Rule 4-30].

As a result, in working out the passive income of a CFC for a statutory accounting period, any prima facie passive income that is referable to a financial benefit provided by another entity that is a member of the same CFC group, is ignored.

It is proposed that the definition of a 'group company' draw from the definition of 'control' under AASB 127.

For integrity reasons, however, the provider of the prima facie passive income will not be entitled to an Australian tax deduction for its expenditure, in circumstances where that provider is either an attributable taxpayer of the CFC or another CFC of that attributable taxpayer: [Part 30].

## Example

Island Co is a CFC of Aust Co. Aust Co makes an interest payment to Island Co. The interest payment is considered to be prima facie passive income of Island Co. However, given the nature of Island Co activities, the interest income is not considered to be passive income (and ultimately not attributable income) of Island Co. As a result Aust Co will not be entitled to a tax deduction in relation to the interest payment, because that income will not be reflected in the attributable income of Island Co.

## LIGHTLY TAXED ENTITIES

Subpart 1-C exempts certain lightly taxed entities from including an amount of attributable income in their assessable income under the CFC rules. The taxation arrangements applicable to lightly-taxed entities, generally being taxed at 15 per cent, mean that any tax deferral benefits received by these entities would be minimal. The exemption for these entities is modelled on a similar exemption that exists in the former FIF rules<sup>12</sup>.

To give effect to the exemption, trustees of an entity classified as being a complying superannuation entity<sup>13</sup> for an income year would not be required to include an amount of attributable income in the entity's assessable income for that income year.

A complying superannuation entity is a complying superannuation fund, an approved deposit fund or a pooled superannuation trust. These entities take their meaning from the *Superannuation Industry (Supervision) Act 1993*.

It is also proposed to provide the exemption to complying superannuation entities to the extent that they hold an interest in an interposed partnership or trust that is required to include attributable income in the calculation of its net income. This will provide flexibility for these entities where they have undertaken an investment through a pooling entity. Other Australian resident entities that invest through the pooling entity would continue to be subject to the attribution rules. Interests held by a complying superannuation entity indirectly through an Australian company would not be entitled to this exemption.

An entity will also be exempt from the scope of the CFC rules for interests held in a controlled foreign entity that relates to a segregated exempt asset or a complying superannuation/FHSA asset of the taxpayer. The taxation arrangements applicable to these assets also mean minimal tax deferral opportunities exist.

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<sup>12</sup> Section 519B of *Income Tax Assessment Act 1936*

<sup>13</sup> See definition in subsection 995-1(1) of *Income Tax Assessment Act 1997*

## **TAINED ROYALTIES — RULE 4-1(2)**

Specific integrity concerns exist regarding the payment of royalties in respect of intellectual property (IP) which has been transferred out of Australia to a CFC where such transfers occur in a non-arm's-length transaction. Absent any special rules, it would be possible for IP that has been developed in Australia to be shifted to a CFC with the result that any royalty payments received by the CFC in respect of the use of the IP are subject to low rates of tax in a foreign jurisdiction rather than taxed in Australia.

In such circumstances, it may be that the taxation consequences of such transfers are inappropriate. For example, there may be concerns that the consideration paid for the transfer of such IP in non-arm's-length dealings may not fully reflect an appropriate value. The transfer pricing regime is meant to correct for anomalies in non-arm's-length dealings. However these rules may be ineffective in dealing with such transactions because, for example, a comparable price for such transfers is not able to be determined easily.

In light of these risks, a special rule applies to ensure that royalty payments received by a CFC in respect to IP transferred out of Australia are subject to attribution. Where the CFC is located in an unlisted country, such royalty income should be included in attributable income. For a CFC located in a listed country, this royalty income will only be attributable if the income is eligible designated concession income.

The exclusions from the attribution rules that will be available for passive income generally (that is, the active business income test and the grouping relief) would not apply to tainted royalty income.

Tainted royalty income would be income derived from IP only where both of the following circumstances exist. First, the intellectual property must have been transferred to the CFC, directly or indirectly, by a related party which is either an Australian resident or an Australian permanent establishment of a non-resident. Second, the CFC must have failed to substantially develop, alter or improve the IP during the CFC's ownership period.

The definition of royalty for the purposes of the tainted royalty rule should be modified to exclude royalties that are akin to rental payments. The current definition of royalty in subsection 6(1) of the ITAA 1936 is considered to be too broad because it includes rental income from the use of industrial, commercial and scientific equipment including the use of satellites, cable and optic fibre for broadcasting and reception. Such income should be eligible for an active business income exemption and the grouping exemption.

## **REMOVAL OF DOUBLE TAXATION**

To ensure no double taxation arises, actual distributions received by a resident taxpayer from a CFC will be non-assessable non-exempt income to the extent that the distributions relate to amounts that were previously included in the taxpayer's assessable income as attributable income from that CFC. [Rule 25]

In other words, where an amount is included in a taxpayer's assessable income under the CFC rules in relation to an income year, an amount (to the extent that it relates to previously attributable income) will not be included in that taxpayer's assessable income under any other provision of the Act for the same or any other income year.

Unlike the attribution account provisions in the current CFC rules, it is intended that the new provisions will not set out a prescriptive method of credits and debits that must be followed in

order to determine whether the dividends were out of previously attributed income. Rather, within a given framework, it will be the entity's responsibility to keep records that record and justify all transactions that are relevant for treating distributions from the CFC as being non-assessable non-exempt income, under section 262A of the ITAA 1936.

The provisions will also apply to remove possible double taxation consequences where interests in a CFC are disposed of in cases where amounts have been previously attributed but not distributed to the attributable taxpayer in relation to that CFC. In such cases, as is the case under the current rules, the rules would operate to reduce the capital proceeds amount.

Consideration is being given to allowing taxpayers to keep records of their CFC interests on a pooled/aggregated basis for this purpose. That is, a distribution received, directly or indirectly via one or more interposed partnerships or trusts, from a CFC would be non-assessable non-exempt to the extent that the taxpayer has an attribution surplus in relation to all CFC interests. Similarly, the reduction in a capital gain that would otherwise arise from a CGT event happening to an interest in a CFC might be determined on an aggregated basis rather than on a CFC-by-CFC basis.

## Participation interests

The amount of income that is attributable to an attributable taxpayer is determined by multiplying the taxpayer's *total participation interest* by the amount of the CFC's attributable income: [Rule 1-1]

A taxpayer's *total participation interest* at a particular time is the sum of:

- the taxpayer's direct participation interest in the other entity at that time; and
- the taxpayer's indirect participation interest in the other entity at that time. [Rule 100-1]

An entity holds a direct participation interest at a particular time in another entity equal to the percentage that the entity holds at that time of the total rights to returns on equity interests in the other entity to its members (otherwise than on winding-up) that are "distributions of profits". [Rule 100-3(1)]

There are two alternative rules that can apply if it is not possible to determine the entity's rights to returns on equity interests. These rules are based on rights to distributions of capital of the other entity or on the market value of the 'direct equity interests' in the other entity [Rules 100-3(3) to (6)]

An alternative to this approach, which is not contained in the draft rules but is separately attached at Attachment A, is the 'subtractive approach'.

The 'Subtractive Approach' has been proposed as an alternative method to the use of equity interests and participation interests when determining the attribution of attributable income. The 'Subtractive Approach' is built on the concept of 'control' and would apply only to Australian entities that in reality have the ability to control the investment and distribution decisions of the CFC.

Under the 'Subtractive Approach' for determining attribution, an 'Australian controller' of a CFC would be attributed with 100 per cent of the CFC's attributable income<sup>14</sup>.

The Australian controller would be allowed a tax offset/credit for Australian tax paid on attributed income to the extent that the previously attributed income is distributed<sup>15</sup> to any non-controlling, non-associated Australian investors or associated foreign investors in the CFC during an income year.

The Australian controller would also be entitled to a tax offset/credit to the extent that it can reasonably anticipate that distributions of attributable income will be made to non-controlling, non-associated investors or associated foreign investors in future income periods.

When previously attributed income is distributed to the Australian controller or an Australian associate, those distributions would be non-assessable, non-exempt income of the entity.

Further details of the approach are set out in Attachment A. We seek the views of interested parties on the merits of this approach.

## **Attribution of Attributable Income**

### **How is a CFC's attributable income calculated?**

The attributable income of a CFC is determined by first calculating what is called 'CFC taxable income' (not to be confused with the taxable income of the CFC), with specific adjustments, if any, subsequently made to determine the final amount of attributable income.

Where an election or choice is required in calculating the CFC's attributable income, that election or choice will be made by the controller of the CFC.

### **How is CFC taxable income determined?**

CFC taxable income is calculated on the assumption that the CFC is an Australian resident for the entire income year.

In addition to the residency assumption there are also a set of principles that assist in determining what amounts are to be taken into account in calculating CFC taxable income. [Rule 3-10(a)]

The main principles are:

- An amount is only included in the ordinary or statutory income of the CFC to the extent that the amount is referable to the CFC's adjusted passive income for that income year; and
- An amount is treated as being a general or specific deduction of the CFC only to the extent that the amount is referable to the CFC's adjusted passive income for that income year. [Rule 3-10(b)]

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<sup>14</sup> In the case of 'joint control', attributable income would be split appropriately amongst the joint controllers.

<sup>15</sup> Or declared as a distribution.

These principles provide the framework for determining the types of income that are considered to be assessable income of the CFC when determining the CFC's attributable income. Generally, other income received by the CFC, not being adjusted passive income, is disregarded for the purposes of applying the CFC rules.

The subsidiary principles, outlined below, provide further guidance in determining the final amount of CFC taxable income.

First, to ensure no double taxation consequences arise, amounts that have already been taxed in Australia as assessable income of the CFC will be treated as non-assessable non-exempt income of the CFC when determining CFC taxable income for the purposes of the attribution rules [Rule 3-10(c)(i)].

Further, an amount will not be a deduction in determining CFC taxable income where that amount was an actual deduction of the CFC in determining its Australian taxable income. [Rule 3-10(c)(ii)]

In certain circumstances, in calculating CFC taxable income, it may be necessary to calculate the net income of a foreign partnership or trust. The above principles and subsidiary principles applicable to CFCs also apply to a trust or partnership when determining its net income.

The final subsidiary principle to be taken into account in determining CFC taxable income is that when applying the Australian taxation laws to determine an entity's attributable income the modifications listed in Subdivision 3-C are to be taken into account. [Rule 3-10(c)(iv)]

## **What are the modifications to Australia's taxation laws?**

The residency assumption, together with the principles discussed above, will reduce the requirement for certain specific CFC provisions. Where possible it is intended that the CFC rules will rely on the general provisions of the taxation laws in determining the attributable income of a CFC. For example, where a CFC derives income through a permanent establishment in a foreign country, instead of a specific CFC provision applying (like existing section 403) taxpayers will rely on the general taxation laws (section 23AH) to determine the tax treatment of that income.

The need to modify Australia's taxation laws when determining the attributable income of a CFC has been mitigated with the redefining of the passive/active divide to better target passive income and the move to a single controller model for the CFC rules.

Nevertheless, subject to the proposed changes outlined below, the existing list of modifications will form the basis of the modifications to Australia's taxation laws when calculating the attributable income of a CFC:

- Divisions 974 and 230 of *Income Tax Assessment Act 1997* will no longer be disregarded. With the CFC rules applying to the actual controller of an entity, taxpayers who are required to calculate a CFC's attributable income should have ready access to the required information. Further, to the extent that the CFC has Australian sourced income or gains they may be required to apply Division 974 and 230 in any case.
  - An additional factor for the inclusion of Division 230 is that it operates as an integrity rule concerned with the timing of recognition of gains and losses. Excluding Division 230 from the CFC rules may also allow arbitrage opportunity for certain arrangements. That is, depending on whether an outcome under

Division 230 is favourable or not, a controller could either hold the asset in Australia (where Division 230 applies) or in an offshore entity (if Division 230 did not apply). The current exclusion for Division 230 in the CFC rules was only in place pending the review of the attribution rules.

- Section 25-90 of *Income Tax Assessment Act 1997* will be disregarded. Essentially, section 25-90 operates to ensure that the thin capitalisation rules will be the sole determinant as to whether debt deductions are allowable deductions. With the thin capitalisation rules (Division 820) disregarded it is appropriate to also exclude section 25-90.
- Existing section 387 of *Income Tax Assessment Act 1936* which provides for a reduction in attributable income for current year distributions will not be replicated. Proposed changes to existing section 23AJ (see Rule 20-1) mean interim dividends will always be non-assessable non-exempt amounts for attributable taxpayers or not part of attributable income of another CFC.

## Integrity rule

The rule contained in Part 30 operates as an integrity rule for the grouping relief provision, the active business income test and the AFI subsidiary exemption.

In relation to grouping relief [Rule 4-30], the integrity rule will deny a deduction to an attributable taxpayer or to another CFC that is a member of the CFC group in those instances where the deduction related to a payment of amount of prima facie passive income that is not reflected in the attributable income of the CFC for that period.

The rule is intended to ensure that the grouping relief provision cannot be used as a device to artificially shift taxable profits out of the Australian tax net.

For the same reason that the deductibility restriction is necessary for grouping relief, it is also necessary for the active business income test and the AFI subsidiary exemption.

In the absence of such a rule, inappropriate profit shifting can occur where a CFC together with a related party (whether or not that related party is a group member with the CFC) engages in transactions that give rise to an exclusion from attribution for the CFC and a deduction under Australian tax law for the related party.

## Dividend exemption

Part 20 sets out the proposed circumstances in which corporate taxpayers may be entitled to a dividend exemption in respect of dividends it receives from a foreign company. It is broadly modelled on existing section 23AJ of the ITAA 1936.

One of the requirements that Part 20 turns on is that the distribution by 'the distributing company' is made in respect of an equity interest held by another company.

A problem highlighted with this approach in consultations was that, due to the potentially wide range of exotic instruments that may fit the 'equity interest' definition, it may be very difficult for Australian companies to discern whether they hold a participation interest of 10 per cent or more.

To address this compliance problem it is proposed that, in determining whether companies have a sufficient interest in the distributing company (ie. the non-portfolio 10% test), the test be based on a more traditional legal form of ownership. That is, whether the receiving company has a 10 per cent or greater interest in either the paid-up capital, voting rights, returns of profit or capital, or returns upon winding up. There is a similar rule to this approach contained in section ss.350(1) of the current CFC rules.

Once the position of the taxpayer in respect of this threshold test is determined, entitlement to the dividend exemption will be permitted provided the distribution is not made in respect of an interest that is a debt interest (within the meaning of debt interest in section Division 230 of the ITAA 1997).

Importantly, once a taxpayer has established that they hold a non-portfolio interest, eligibility to the dividend exemption only applies to distributions paid on equity interests.

## SUBTRACTIVE APPROACH

The 'subtractive approach', outlined below, has been proposed as an alternative method to the use of equity interests and participation interests when determining the attribution of attributable income.

The 'subtractive approach' is built on the concept of 'control' and would apply only to Australian entities that in reality have the ability to control the investment and distribution decisions of the CFC.

### Overview

Under the 'Subtractive Approach' for determining attribution, an 'Australian controller' of a CFC would be attributed with 100 per cent of the CFC's attributable income<sup>16</sup>.

The Australian controller would be allowed a tax offset/credit for Australian tax paid on attributed income to the extent that the previously attributed income is distributed<sup>17</sup> to any non-controlling, non-associated Australian investors or associated foreign investors in the CFC during an income year.

The Australian controller would also be entitled to a tax offset/credit to the extent that it can reasonably anticipate that distributions of attributable income will be made to non-controlling, non-associated investors or associated foreign investors in future income periods.

When previously attributed income is distributed to the Australian controller or an Australian associate, those distributions would be non-assessable, non-exempt income of the entity.

### Policy Rational

The Subtractive Approach would ensure that an Australian entity with the ability to dictate the investment and distribution decisions of the CFC (the controller) would be taxed on an accruals basis on the attributable income of the CFC.

#### Reduces compliance and administrative costs

The 'Subtractive Approach' provides a simple means to determine how attributable income will be attributed. As the tax consequences would only arise for the Australian controller of the CFC, there would be no requirement for an investor or CFC to identify and measure their participation interest in the CFC in order to determine the Australian taxation consequences.

It is expected that the Australian controller would be able to rely on the CFC's accounts to determine their share of attributable income which has actually been distributed to non-controlling, non-associate investors and the share of that income that has been distributed to the controller or its associates.

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<sup>16</sup> In the case of 'joint control', attributable income would be split appropriately amongst the joint controllers.

<sup>17</sup> Or declared as a distribution.

### Protects the Australian revenue by being less open to manipulation

The 'Subtractive Approach' proposes a method of attribution which is based on actual control rather than participation interests and because of this, it is less susceptible to manipulation aimed at avoiding attribution.

The 'Subtractive Approach' may have the additional benefit of being able to apply in non-common law entity situations by reducing the risk of controllers of such entities avoiding attribution due to the absence of a participation interest.

### Provides for taxation outcomes which are broadly consistent with economic outcomes

The tax credits/offsets available to the Australian controller for tax paid on previously attributed income which is distributed to non-associated investors or associated foreign investors (or reasonably anticipated to be distributed in a future period) would ensure that the taxation outcomes for the Australian controller and the non-controlling, non-associated investors or associated foreign investors reflects the economic outcomes of arrangements where parties other than the controller or its Australian associates receive or expect to receive income from a CFC.

The allowance of a credit/tax offset for anticipated future distributions of attributable income to non-associated, non-controlling investors or associated foreign investors (for a set period) would further ensure that the Australian controller is not subject to a timing mismatch between when the income is attributed to the controller and when a credit/offset is available because of actual distributions paid or declared in an income year.

Non-controlling and non-associated investors would be liable to Australian tax consequences only at the time actual dividend payments are received.

### Issues

It is recognised that the subtractive approach may raise concerns in certain circumstances, however, given the application of the CFC rules will be significantly narrowed under the new rules, it is not expected to apply to the majority of offshore commercial arrangements.

A potential criticism of the approach is that the controller would be taxed on amounts which it may never receive as a distribution because it does not have a participation interest in the CFC. However, in practice, this situation is unlikely to arise. In the majority of genuine commercial arrangements, the controlling entity is expected to be a substantial direct or indirect shareholder in the CFC — generally the head company of an economic group. The tax credit/offsets available to the controller are designed to ensure that the Australian controller is not taxed on amounts which are not actually received by it or its Australian associates.

Another potential criticism of the approach is that the Australian controller would pay tax on the share of attributable income which is going to enure for the benefit of an associate. However, it is considered that in the majority of cases, the associates of the Australian controller will be Australian resident members of the Australian controller's economic group and therefore the burden of tax will in substance be borne by the economic group as a whole. Some concerns that have been raised in submissions about the broadness of the definition of associate, however, the proposed change to a 'single controller' concept will significantly narrow the effect of the 'associates' test.

Finally, the approach may give rise to timing differences where there is a non-controlling, non-associated investor. In this situation the Australian controller may be taxed on amounts

of attributable income in one year even though those amounts are eventually distributed to a non-controlling, non-associated investor or a non-resident associate in a later year. The tax credit/exemption features of the approach should assist in alleviating this problem.

## **Consideration of potential adjustments**

### **Tax credit/offset for distributions of previously attributed income**

The Australian controller would be allowed a tax offset/credit for Australian tax paid on attributed income to the extent that the previously attributed income is distributed to any non-controlling, non-associated investors or associated foreign investors in the CFC during an income year.

It is expected that the Australian controller would rely on the CFC's accounts to determine the share of attributable income which has actually been distributed to non-associated investors or associated foreign investors in the CFC. The approach should be able to build upon the account or records that the CFC would maintain in order for the Australian controller to determine the amount of income to be attributed or credit to be claimed, thereby further reducing complexity and uncertainty.

### **Tax credit/offset for anticipated distributions of previously attributed income**

In order to alleviate the potential timing differences that would otherwise arise where income is attributed to the controller in one income year but is actually distributed to a non-associated investor or a foreign associate in a later year, a tax credit/offset would also be available to the extent that the Australian controller can reasonably anticipate that distributions of attributable income will be made to non-controlling, non-associated investors or associated foreign investors in future income periods.

In order to prevent undue deferral, such a credit could be limited to that amount which is referable to distributions anticipated in the subsequent two income years. Integrity rules may be necessary to ensure that anticipated distributions are not excessive relative to actual distributions that are subsequently made to non-controlling, non-associate investors or associated foreign investors.

Consideration would also need to be given to allowing a tax credit/offset to the Australian controller for amounts of purely passive income which have been distributed indirectly to a non-associated entity. For example, where the CFC pays a distribution of previously attributed income to an Australian company which is a member of the Australian controller's economic group but is not 100% owned by the Australian controller. Once again, it is envisaged that such amounts would be able to be determined having regards to the Australian controller's group accounts.

The availability of the tax credit/offset should not be restricted to a particular income year or a specified period. This is because income may be attributed in one year and not actually distributed until a later year where there may be no attributable income for the latter year.

The CFC must be able to reasonably determine which profits are being distributed. This could be by way of a last in first out (LIFO) or first in first out (FIFO) rule.

### **Exemption for compensation payments**

It has been suggested that compensation payments made by an Australian associate to the Australian controller for tax paid in respect of attributable income received by the associate should be tax exempt income to the controller. Accordingly, the necessity of such a rule will be considered.



# ATTACHMENT B

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## **Part 1—Attribution of attributable income**

- **Subpart 1-A—Main rule regarding attributable income**

- **Rule 1-1 Attribution of attributable income**

(1) If a CFC has attributable income for a statutory accounting period, an Australian resident entity that is an attributable taxpayer for the CFC at the end of that period includes the amount mentioned in subrule (2) in its assessable income for the income year in which that period ends.

(2) The amount is the attributable income multiplied by the percentage that is the entity's total participation interest (see Part 100) in the CFC at the end of that statutory accounting period.

(3) Subrule (1) does not apply if:

(a) Subpart 1-B applies (the “de minimis passive income”); or

(b) Subpart 1-C applies (lightly taxed entities).

- **Subpart 1-B—The “de minimis passive income” exception**

- **Rule 1-10 Object of the “de minimis passive income”**

The object of this Subpart is to reduce compliance costs [for taxpayers] by providing an exception from attribution if less than 5% of the income (determined by reference to financial accounts) of the relevant CFC has a passive character.

- **Rule 1-11 The “de minimis passive income” exception**

Subrule 1-1(1) does not apply if:

(a) the CFC prepares an audited financial report for the period that would comply with subsection 230-210(2) of the *Income Tax Assessment Act 1997* if the period were the entity's income year; and

(b) the CFC's passive financial account income for that period is less than 5% of its financial account income for that period (as recognised for the period in its financial accounts for that period).

- **Rule 1-12 Financial account income**

The *financial account income* of the CFC for the period is its income recognised for the period in its financial accounts for the period.

- **Subpart 1-C—Lightly taxed entities exception**

Subrule 1-1(1) does not apply if:

(a) the attributable taxpayer is a complying superannuation entity [*for the income year in which that statutory accounting period ends*]; or

- (b) the attributable taxpayer is a life insurance company [*when that statutory accounting period ends*] and [*all*] of the attributable taxpayer's interest in the CFC is a complying superannuation/FHSA asset or a segregated exempt asset of the attributable taxpayer; or
- (c) all of these requirements are satisfied:
  - (i) the attributable taxpayer is a trust or partnership interposed [*directly*] between the CFC and another entity;
  - (ii) the other entity is an entity mentioned in paragraph (a) or (b);
  - (iii) disregarding this paragraph, [*to the extent that*] the net income of the trust would be included in the assessable income of the other entity.

## **Part 2—Attributable taxpayers, control and CFCs**

- **Rule 2-1 Attributable taxpayers**

An entity (the *first entity*) is an *attributable taxpayer* for another entity (the *second entity*) at a time if, at that time:

- (a) the first entity is an Australian resident; and
- (b) the first entity:
  - (i) controls the second entity; or
  - (ii) is an associate of another entity that controls the second entity; and
- (c) the first entity holds a total participation interest in the second entity of greater than zero.

- **Rule 2-2 Control and joint control**

- (1) For the purposes of rule 2-1:
  - (a) determine whether an entity controls a CFC in accordance with accounting standard AASB 127 (or another accounting standard prescribed by the regulations for the purposes of this rule); and
  - (b) if two or more entities jointly control a CFC, treat each of them as controlling the CFC; and
  - (c) determine whether 2 or more entities jointly control a CFC in accordance with accounting standard AASB 131 (or another accounting standard prescribed by the regulations for the purposes of this rule).
- (2) If 2 entities each hold 50% of the equity interests in a CFC, treat them for the purposes of subrule (1) as jointly controlling the CFC unless there are circumstances that prove that they do not jointly control the CFC.

- **Rule 2-3 Controlled foreign companies (CFCs)**

A company is a *controlled foreign company* (or *CFC*) [for a particular period] if:

- (a) the company is not an Australian resident for the period; and
- (b) there is at least one attributable taxpayer for the company for the period.

### **Part 3—Calculation of attributable income**

- **Subpart 3-A—Attributable income**

- **Rule 3-1 Attributable income**

(1) The *attributable income* of a CFC for a period (the *current period*) is its CFC taxable income for the current period, after including the add-ons in subrule (2) and subtracting the carve-outs in subrule (3):

(2) The add-ons are as follows:

- (a) if:
  - (i) the CFC changed residence at a time; and
  - (ii) the time was before the start of the current period; and
  - (iii) the CFC held an asset covered by rule 4-10(f) or (g) at the time; and
  - (iv) a CGT event happens in relation to the asset in the current period; and
  - (v) the CGT event gave rise to a profit for the CFC that was not reflected in its CFC taxable income for the current period because of rule 3-100 ;

add the amount that would have been reflected in its CFC taxable income for the current period in respect of the gain (disregarding whether the amount is not eligible designated concession income or not for CFCs in listed countries);

(b) [extra paragraphs — to be determined, if any].

(3) The carve-outs are as follows: [to be determined, if any].

- **Subpart 3-B—CFC taxable income—general rules**

- **Rule 3-10 CFC taxable income**

The *CFC taxable income* of a CFC for a period is the amount that would be its taxable income for the period if:

- (a) these assumptions were made:
  - (i) the CFC is an Australian resident for the entire period;

- (ii) the period is an income year, and that income year is the financial year in which the period ends; and
- (b) these main principles were observed in working out that taxable income:
  - (i) treat an amount as being included in the ordinary income or statutory income of the CFC for the income year only to the extent that it is referable to its adjusted passive income [for the income year];
  - (ii) treat an amount as being a general deduction or specific deduction of the CFC for the income year only to the extent that it is referable to its adjusted passive income [for the income year];
- (c) these subsidiary principles were also observed in working out that taxable income:
  - (i) treat an amount as non-assessable non-exempt income of the CFC if it is included in the actual (Australian) assessable income of the CFC for the income year;
  - (ii) treat an amount as not being a deduction of the CFC if it is an actual (Australian) deduction of the CFC for the income year;
  - (iii) work out the net income (within the meaning of Division 5 or 6 of Part III of the *Income Tax Assessment Act 1936*) of a partnership or trust, as necessary, in accordance with rule 3-11;
  - (iv) take account of the modifications set out in Subpart 3-C.

- **Rule 3-11 Net income of partnerships and trusts**

Work out the net income for the income year of the partnership or trust mentioned in subrule 3-10(c)(ii) by making the assumptions and observing the main and subsidiary principles in rule 3-10 as if references in that rule (and provisions that have effect in relation to that rule) to the CFC were references to the partnership or trust.

- **Subpart 3-C—CFC taxable income—modifications of tax law**

- **Rule 3-100 Application of this Subdivision**

This Subpart applies for the purposes of working out the CFC taxable income of a CFC in accordance with rule 3-10.

*Subpart 3-C will specify that for a CFC resident in a listed country, include in assessable income only amounts that are eligible designated concession income.*

**Subject to the proposed changes set out in the consultation paper, the existing list of modifications will form the basis of the modifications to Australia's taxation laws when calculating CFC taxable income.**

## Part 4—Passive income

- **Subpart 4-A—“Adjusted passive income”**

- **Rule 4-1 Adjusted passive income**

- (1) An entity’s *adjusted passive income* is its passive income, other than the following:
  - (a) [to be determined, if any]
- (2) However, its *adjusted passive income* also includes the following:
  - (a) tainted royalty income

For explanation of tainted royalty income refer to page 19 of consultation paper.
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- **Subpart 4-B—Passive income—general**

- **Rule 4-10 Prima facie passive income**

*Prima facie passive income* is any of the following:

- (a) a return on an equity interest;
- (b) a return on a debt interest;
- (c) a payment of rent;
- (d) an annuity payment;
- (e) a royalty;
- (f) a profit from a financial arrangement (other than an amount mentioned in paragraphs (a) to (e));
- (g) a profit from a CGT event that happens in relation to an asset.

- **Rule 4-11 Passive income**

- (1) The *passive income* of an entity is its prima facie passive income, except to the extent that:
  - (a) the prima facie passive income arises in the ordinary course of the ‘active conduct of a trade or business’ by the entity; or
  - (b) the prima facie passive income is a profit mentioned in rule 4-10(f) or (g), and:
    - (i) the profit is not covered by paragraph (a); and

- (ii) the asset or financial arrangement was held for the predominant purpose of producing an amount covered by paragraph (a); or
- (c) [to be determined, if any]

*Active business test*

(2) The **active conduct of a trade or business** by an entity means the competitive participation by the entity in industrial, commercial or financial undertakings, evidenced by human activity.

(3) To avoid doubt, for the purposes of subrule (2):

- (a) the human activity may be by any individual (whether or not the employed by the entity).

- **Subpart 4-C—Passive income—AFI subsidiaries**

- **Rule 4-20 Object**

The object of this Subpart is to reduce compliance costs by providing a simplified version of rule 4-11 that recognises the active character of certain income generated by banking business.

- **Rule 4-21 Exception for AFI subsidiary**

The passive income of a CFC does not include its excluded AFI income (see rule 4-24) if:

- (a) the CFC is an AFI subsidiary (see rule 4-22) at the time the excluded AFI income was gained; and
- (b) the CFC's sole or principal business is banking business at that time.

- **Rule 4-22 AFI subsidiary**

(1) A CFC is an **AFI subsidiary** at a time when it is controlled by a company that is an AFI.

(2) However, a CFC is *not* an **AFI subsidiary** at a time if:

- (a) two or more companies jointly control the CFC; and
- (b) one or more of those companies is not an AFI.

(3) For the purposes of subrules (1) and (2):

- (a) determine whether an entity controls a CFC in accordance with accounting standard AASB 127 (or another accounting standard prescribed by the regulations for the purposes of this rule); and

- (b) determine whether 2 or more entities jointly control a CFC in accordance with accounting standard AASB 131 (or another accounting standard prescribed by the regulations for the purposes of this rule).

(3) An **AFI** or **Australian financial institution** means any of the following Australian entities:

- (a) a body corporate that is an ADI (authorised deposit-taking institution) for the purposes of the *Banking Act 1959*;
- (b) a person who carries on State banking within the meaning of paragraph 51(xiii) of the Constitution;
- (c) a registered entity under the *Financial Sector (Collection of Data) Act 2001*;
- (d) a life insurance company (as defined in the *Income Tax Assessment Act 1997*).

• **Rule 4-24 Excluded AFI income**

(1) A CFC's **excluded AFI income** is its prima facie passive income to the extent that it is any of the following:

- (a) *[interest income;*
- (b) *discount income [and gains];*
- (c) *gains from trading, and investment, in securities, derivatives and commodities;*
- (d) *dividend income from securities investment and trading;*
- (e) *income and gains from securities lending and repo arrangements;*
- (f) *underwriting income;*
- (g) *income and gains from asset securitisation;*
- (h) *leasing income from equipment financing and the leasing of ships and aircraft;*
- (i) *income and gains related to credit risk services;*
- (j) *royalty income from financial transactions;*
- (k) *property rental income from financing arrangements (such as income stream securitisation or assignment);*
- (l) *income and gains from the provision of other risk management services;*
- (m) *the hedging and foreign exchange gains related to these activities.]*

- **Subpart 4-D—CFC groups**

- **Rule 4-30 CFC groups**

(1) This rule applies if a CFC is a member of a CFC group *[throughout]* a statutory accounting period.

(2) In working out the passive income of the CFC for the period, disregard an amount of prima facie passive income that is [referable to] a financial benefit provided *[to the CFC]* by another entity that is also a member of the group *[throughout]*the period.

**It is proposed that eligibility for membership of a CFC group be based on the control concept used to determine the existence of a CFC. That is, Australian or foreign subsidiaries of the Australian controller that is an attributable taxpayer are able to be part of the CFC group.**

## Part 20—Distributions to Australia

- **Rule 20-1 Certain distributions on equity interests not assessable income and not exempt income**

(1) A distribution made by a company (the *distributing company*) to another company (the *receiving company*) in respect of an equity interest [*in the distributing company*] is not assessable income, and is not exempt income, of the receiving company if, at the time the distribution is made:

- (a) the distributing company is not an Australian resident; and
- (b) the receiving company is an Australian resident; and
- (c) the receiving company does not receive the distribution in the capacity of a trustee; and
- (d) any of the following requirements are satisfied:
  - (i) the receiving company holds a direct control interest (see rule 20-2) in the distributing company of at least 10%;
  - (ii) the receiving company is an attributable taxpayer for the distributing company.

*Rule 20-2, to be inserted, will define **direct control interest***

**For further explanation of dividend exemption refer to page 23 of consultation paper.**

- (2) Subrule (3) applies if:
- (a) disregarding that subrule, an amount is included in the assessable income of a company (the *receiving company*) under Division 5 or 6 of Part III of the *Income Tax Assessment Act 1936* for an income year because the receiving company is a partner in a partnership or a beneficiary of a trust; and
  - (b) another company (the *distributing company*) made a distribution [*whether in that income year or in an earlier income year*] in respect of an equity interest [*in the distributing company*] to:
    - (i) the partnership or trust; or
    - (ii) if there are entities interposed between the partnership or trust and the distributing company, and all of the interposed entities are partnerships or trusts—one of the interposed entities; and
  - (c) the amount mentioned in paragraph (a) is referable to the amount of the distribution; and
  - (d) the requirements in paragraphs (1)(a), (b), (c) and (d) are met.

(3) The amount mentioned in paragraph (2)(a) is not assessable income, and is not exempt income, of the receiving company.

(4) For the purposes of paragraph (2)(d), in determining whether the requirement in subparagraph (1)(d)(i) is met, reduce the receiving company's direct control interest in the distributing company to the extent that the interest is not referable to the partnership or trust mentioned in paragraph (2)(a).

## Part 25— Removal of Double taxation

A provision will be included to treat actual distributions received by an attributable taxpayer from a CFC as non-assessable non-exempt income to the extent that the distributions relates to amounts that were previously included in the taxpayer's assessable income as attributable income from that CFC.

To also remove the possibility of double taxation a provision will be included to reduce capital proceeds (or increase the cost base) where interests in a CFC are disposed in cases where amounts have been attributed but not distributed from that CFC.

## Part 30—Integrity rule—denial of deductions to Australian controller etc.

- **Rule 30-1 Integrity rule—denial of deductions to attributable taxpayer etc.**

(1) This rule applies if:

- (a) an entity is an attributable taxpayer for a CFC at a time in a statutory accounting period of the CFC; and
- (b) disregarding this rule, the entity is entitled to a tax benefit under the Income Tax Assessment Acts for an income year (whether or not that income year ends in or during that period, or starts during or after that period); and
- (c) the tax benefit is [*attributable to*] an amount of prima facie passive income of the CFC; and
- (d) the amount of prima facie passive income is not fully reflected in the attributable income of the CFC for that period.

(2) Reduce the tax benefit to the extent that the amount of prima facie passive income is not reflected in the attributable income of the CFC for that period.

(3) If the entity is an attributable taxpayer for another CFC at that time, this section applies in relation to the other CFC in the same way that it applies to the entity that is the attributable taxpayer.

(4) For the purposes of subrule (3), treat the other CFC as being entitled to a tax benefit under the Income Tax Assessment Acts for an income year, if in calculating its attributable income for a statutory accounting period, it is entitled to such a benefit.

## **Part 100—Participation interests**

### **Rule 100-1 Total participation interest**

An entity's *total participation interest* at a particular time in another entity is the sum of:

- (a) the entity's direct participation interest in the other entity at that time; and
- (b) the entity's indirect participation interest in the other entity at that time.

### **Rule 100-2 Indirect participation interest**

*[See section 960-185 of ITAA 1997]*

### **Rule 100-3 Direct participation interest**

(1) An entity holds a *direct participation interest* at a particular time in another entity equal to the percentage that the entity holds at that time of the total rights to returns on equity interests in the other entity to its members (otherwise than on winding-up) that are "distributions of profits".

(2) For the purposes of subrule (1), assume that all the profits of the other entity *[for a particular period]* were distributed to its members at that time.

(3) Subrule (4) applies if it is impossible/impracticable to determine the entity's direct participation interest at that time in the other entity under subrule (1).

(4) The entity holds a *direct participation interest* at that time in the other entity equal to the percentage that the entity holds at that time of the total rights to distributions of *[capital]* of the other entity to its members (otherwise than on winding-up).

(5) Subrule (6) applies if it is impossible/impracticable to determine the entity's direct participation interest at that time in the other entity under subrules (1) and (4).

(6) The entity holds a *direct participation interest* at that time in the other entity equal to the percentage that the entity holds at that time of the "direct equity interests" in the other entity (measured by market value).