



## WEEKLY COMMENT: FRIDAY 24 AUGUST 2012

1. Last Tuesday 14 August, The Minister of Revenue introduced a *Supplementary Order Paper* ("the SOP") containing further amendments to the *Taxation (Annual Rates, Returns Filing and Remedial Matters) Bill* ("the Bill"). The SOP runs to 39 pages, including the Explanatory Note at the end, and contains significant amendments to:
  - The treatment of depreciation and insurance receipts of damaged property. While these amendments are focused on property damaged as a result of the Christchurch earthquakes, a number of the amendments apply generally, and not just to such property.
  - The CFC and FIF rules.
  - GST on premiums and receipts under a contract of insurance.
2. This week I look at the changes to the CFC rules, and I will look at the FIF changes next week. All of the content from this week's *Weekly Comment* will soon be included in a new website section on CFCs.

### The CFC rule changes

3. The CFC changes are back dated and come into force on 30 June 2009, by amending clause 2(12) of the Bill:
  - The formula for calculating **net attributable CFC income or loss** in section EX 20C has been fundamentally changed.
  - As part of the new formula, the **later losses** deductions provided for in s. EZ 32C have been repealed.
  - The formula applies in 2 parts when a CFC is excessively debt funded and entered into funding arrangements before 21 June 2012.
  - A new concept of an **elective attributing CFC** has been introduced, which is a CFC that would be a non-attributing active CFC, except for the fact that the interest holder has elected to return net attributable CFC income or loss of the CFC.
  - New **deduction limiting rules** are being introduced for an attributed CFC loss from an elective attributing CFC.
4. The above changes are also relevant for FIFs for which an interest holder uses the attributable FIF income (AFI) method. I will deal with the changes as they affect FIFs next week.

## **Net attributable CFC income or loss**

5. The SOP contains a fundamentally different formula for calculating a person's net attributable CFC income or loss from the one that currently exists in section EX 20C(2). Clause 22D of the SOP contains a complete revision of section EX 20C. I have set out the new calculation in a series of 8 Flowcharts in a PDF attachment on the *New Calculation of Net Attributable CFC Income or Loss*. Please refer to the PDF attachment for the details.
6. In broad terms, the deductions from the attributable CFC amount ("attributable CFC") have been divided into 3 categories:
  - (a) Apportioned funding income;
  - (b) Apportioned funding costs; and
  - (c) Other deductions.
7. Apportioned funding income is income from financial arrangements that is unexpected – i.e. income that has arisen due to exchange fluctuations on a financial arrangement that is in fact a liability and not an asset. Such "unexpected" income is allowed as a deduction, subject to 2 adjustments that serve to reduce the deduction that is allowed:
  - (a) There is an adjustment for the extent to which such liabilities are on-lent to associated CFCs (the "funding fraction"); and
  - (b) There is an adjustment for the extent to which such liabilities fund income of the CFC that is not attributable (the "asset fraction").
8. Apportioned funding income is calculated, under s. EZ 32D, in 2 parts when a CFC is excessively debt funded and entered into financial arrangements that provided funds to it before 21 June 2012 ("old funding arrangements"):
  - (a) Part 1: relates to funding income from only old funding arrangements; and
  - (b) Part 2: relates to funding income from funding arrangements entered into on or after 21 June 2012.
9. Apportioned funding costs are interest and other costs relating to financial arrangements or deductible equity distributions that would ordinarily be a deduction, subject again to 2 adjustments:
  - (a) There is an adjustment for the extent to which the liabilities are on-lent to associated CFCs (the "funding fraction"); and
  - (b) There is an adjustment for the extent to which such liabilities fund income that is not attributable, but this adjustment in relation to costs depends on the extent of debt-funding:
    - (i) If the CFC is not excessively debt-funded, the adjustment is for the extent to which the CFC's assets fund income that is not attributable: but
    - (ii) If the CFC is excessively debt-funded, the adjustment is for the extent to which all of the foreign assets held by the interest holder fund income that is not attributable.
10. The methods for determining whether a CFC is excessively debt-funded in section EX 20D and EX 20E have not changed.

11. The deduction for “other deductions” is essentially unchanged from the current deduction in section EX 20C(9) and still consists of 3 elements:
  - (a) A deduction for amounts that do not relate to financial arrangements and relate to the derivation of attributable CFC income; and
  - (b) A deduction for amounts that relate to financial arrangements that provide funds to the CFC to the extent such amounts exceed funding costs adjusted for on-lending (but before the adjustment for assets not used to derive attributable income); and
  - (c) A deduction for amounts that relate to financial arrangements that do not provide funds to the CFC, but do result in amounts included in the “arrangement” portion of attributable CFC income.
12. As part of the changes in the SOP, the deduction for “later losses” legislated in the *Taxation (Tax Administration and Remedial Matters) Act 2011* as section EZ 32C has been repealed (by clause 28B of the SOP), with effect from 30 June 2009, so that amendment is of no effect whatsoever. Pending the enactment of the Bill, however, section EZ 32C remains law. For those of you who are interested, I have included, for the purposes of comparison, a PDF attachment of the “old” *net attributable CFC income or loss calculation* inclusive of the enormously complicated “later losses” deductions.
13. Without having gone into the nitty gritty of the calculations, I venture to guess that the back dating of the current amendments to 30 June 2009 substitutes for the adjustment allowing losses to be carried back (the “later losses” deductions).

### **Elective attributing CFC**

14. New section EX 73 in clause 25BA of the SOP will allow an interest holder to elect that a CFC that would otherwise be a non-attributing active CFC instead be a CFC that attributes CFC income or loss. In general, this election would probably only be made if the interest holder would have an attributed CFC net loss. The ability to make this election is being backdated so as to come into effect on 30 June 2009.
15. A CFC for which such an election is made is defined as an “elective attributing CFC” and the first year for which such an election would be effective is define as the “election commencement year”.
16. This election will not be available for a CFC that is:
  - An entity carrying on a business of banking or insurance or is directly or indirectly controlled by such an entity; or
  - A non-attributing Australian CFC.
17. The election will be effective for all accounting periods of a CFC ending in the interest holder’s income years beginning on or after 1 July 2009 if the election notice is filed by the end of the interest holder’s income year in which the Bill receives the Royal assent (or a later date if allowed by the Commissioner).
18. If the election is not filed within the time referred to above, the election will be effective for all accounting periods of the CFC starting in the interest holder’s income years beginning after the date the notice is filed (or a later date if agreed by the Commissioner). This will also be the case if an earlier election made by a person associated with the interest holder has ceased to be of effect.

19. There are additional rules relating to:

- Revocation of the election;
- The election ceasing to be of effect; and
- A subsequent or “further election” being made after an election is revoked or ceases to be of effect.

20. There are new rules that limit a deduction that a person is allowed in an income year for an attributed CFC loss from an elective attributing CFC. These rules are contained in a new section DN 4(1B) set out in clause 18B of the SOP. In general, there can be no net attributed CFC loss from all of a person’s elective attributing CFCs from the same country taken together.

21. I have set out the operation of the election rules in a Flowchart in a PDF attachment titled *Elective Attributing CFCs: Election Procedure*. Please refer to the PDF attachment for the details.

### **Non-attributing CFCs**

22. The introduction of the ability to elect for a non-attributing active CFC to be an elective attributing CFC has changed the decision tree relating to the determination of whether CFC income or loss should be attributed or not.

23. In addition, the *Taxation (International Investment and Remedial Matters) Act 2012* contained a number of changes to the non-attribution tests, including introducing the concept of a “taxed CFC connection”.

24. I have set out the entire decision tree in a series of Flowcharts in the attached PDF titled *Non-attributing CFCs*. Please refer to the PDF for all the details.

### **Attributable CFC amount**

25. The *Taxation (International Investment and Remedial Matters) Act 2012* also contained a number of amendments to the calculation of “attributable CFC amount” in section EX 20B. *Tax Information Bulletin* Vol 24 No 6 July 2012 (“the TIB”) contains a good explanation of the changes.

26. I have set out the calculation of “attributable CFC amount” in a table format, inclusive of all of the changes in the *Taxation (International Investment and Remedial Matters) Act 2012*, and where relevant, further changes proposed in the Bill. I have also included, where it is helpful to do so, additional explanations provided in the TIB. Please refer to the PDF attachment *Attributable CFC Amount* for all the details.

### **Calculation of a person’s attributed CFC income or loss**

27. For completeness, I have collated all the PDFs previously referred to in this *Weekly Comment* as a single PDF attachment *Calculation of a Person’s Attributed CFC Income or Loss*. For those of you who are interested, this will provide a complete reference to the calculation of a person’s attributed CFC income or loss, inclusive of all of the latest amendments in the *Taxation (international Investment and Remedial Matters) Act 2012* and the Bill inclusive of the SOP. For additional completeness, I have also included a separate

PDF on the calculation rules in section EX 21 *Calculation Rules: Attributable CFC Income and Net Attributable CFC Income/Loss*.

28. As noted earlier, all of the above will soon be included in a new separate website section on CFCs.



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