



## WEEKLY COMMENT: FRIDAY 31 AUGUST 2012

1. Last week I looked at the changes to the CFC rules in the *Supplementary Order Paper* ("the SOP") introduced on 14 August containing further amendments to the *Taxation (Annual Rates, Returns Filing and Remedial Matters) Bill* ("the Bill").
2. This week I look at the FIF changes and at the same time I am taking the opportunity to discuss more generally **the new attributed FIF income method** and **non-attributing active FIFs** in terms of the modifications in section EX 50 to the attributed CFC income calculation rules introduced in the *Taxation (International Investment and Remedial Matters) Act 2012*. All of the content from this week's *Weekly Comment* will soon be included in a new website section on FIFs.

### The FIF rule changes

3. The FIF changes all apply to income years commencing on or after 1 July 2011:
  - The **Australian resident FIF exemption** for an income interests of 10% or more is being amended so that it will apply only if the percentage calculated under section EX 50(4) for the person and the FIF is at least 10%. Currently, the exemption can apply to an indirect income interest of less than 10% as long as the direct holder of the interest holds at least 10%.
  - The application of the attributable FIF income (AFI) method to **indirect foreign company interests** is being changed.
  - As with CFCs, a new concept of an **elective attributing FIF** has been introduced, which is a FIF for which the AFI method is used and that would be a non-attributing active FIF, except for the fact that the interest holder has elected to return net attributable FIF income or loss of the FIF.
  - New **deduction limiting rules** are being introduced for an attributed FIF loss from an elective attributing FIF.

### Australian resident FIF exemption

4. Section 29 of the *Taxation (International Investment and Remedial Matters) Act 2012* repealed the grey list FIF exemption in section EX 35 and replaced it with an exemption for a person's rights in an Australian resident FIF that "at all times in the year ... are a direct income interest of 10% or more" [section EX 35(a)].
5. Clause 23B of the SOP repeals existing section EX 35(a) and replaces it with an exemption for a person's rights in an Australian resident FIF in relation to which "at all times in the year, the item income interest calculated under section EX 50(4) for the person and the FIF is 10% or more".

6. According to the explanatory note in the SOP:

“An amendment in *new clause 23B* to *section EX 35* relates to income of a CFC from a listed Australian company of a type to which the attributing rules do not apply if the resident's interest in the Australian company is more than 10%. Currently, if a CFC holds an interest of more than 10% in such a company, none of the CFC's income from the Australian company is attributed to a New Zealander with an interest in the CFC. That exemption should not apply except when the New Zealander's indirect interest in the Australian company, typically found by multiplying the New Zealander's direct interest in the CFC by the CFC's direct interest in the Australian company, is 10%. The change is retrospective to income years beginning on or after *1 July 2011*.”

7. The general rule in section EX 21(33), when a CFC owns a FIF, is to look through the CFC and treat the FIF as being separately owned by the interest holder. However, section 39(3) of the *Taxation (International Investment and Remedial Matters) Act 2012* inserted new section EX 58(5)(b) which excludes from the look-through treatment for an underlying FIF of a CFC:

“Any amount from an interest that would be excluded under section EX 35 from being an attributing interest if held by the person instead of the CFC.”

8. The wording of section EX 58(5)(b) together with the words in existing section EX 35(a) result in Australian resident underlying FIF interests being ignored if the CFC holds an interest of at least 10%. The new wording of section EX 35(a) in clause 23B of the SOP requires the person's interest to be recalculated to see if the exemption applies.

#### **Foreign company interests held through FIFs**

9. The general rule in section EX 50(6) & (7), when using the AFI attribution method for a FIF that holds an interest in a foreign company, is to look through the FIF and treat the interest in the foreign company as a separate FIF. The FIF is treated as if it were a CFC and the look-through treatment referred to in paragraph 7 above applies.
10. However, section 35(6) of the *Taxation (International Investment and Remedial Matters) Act 2012* introduced a new section EX 50(7B) which contains a number of exceptions to the look-through rule – i.e. circumstances in which the interest in the underlying foreign company is ignored. These are:
- (a) If the foreign company meets the accounting standards test or the tax measures (default) test to be a non-attributing active CFC and the AFI method could be used for the foreign company if the interest was held directly by the person;
  - (b) If the foreign company meets the accounting standards test or the tax measures (default) test to be a non-attributing active CFC and the person is able to include the foreign company in the same test group as the top tier FIF for the purposes of those tests;
  - (c) If the top tier FIF would meet a modified version of the accounting standards test to be a non-attributing active FIF if certain amounts, relating to the FIF's interests in the underlying foreign companies that are included in the FIF's accounts or the consolidated accounts of the FIF's test group under the equity method or a dividends and net fair value changes, are included in the items “added passive” (numerator) and “reported passive” denominator; in order for this exclusion to apply the top tier FIF

must first pass one of the active income tests on its own (i.e. excluding the additional amounts from the underlying companies);

(d) If the interest in the underlying foreign company would be excluded by section EX 35 from being an attributing interest if the interest were held by the person.

11. *Tax Information Bulletin* Vol 24 No 6 July 2012, pages 28 to 30, contains a good explanation of the way in which section EX 50(7B) is meant to operate.

12. Clause 24B of the SOP amends section EX 50(7B) as follows:

(a) The exemption referred in paragraph 10(a) above where an underlying foreign company could be ignored if the AFI method could be used for it is being repealed.

(b) Hence, the exemption where an underlying foreign company would pass the active income test is limited to circumstances where it could be included in the top tier FIF's test group – i.e. the top tier FIF's holding is more than 50%.

(c) The exemption for underlying companies in which the top tier FIF holds less than 50% is being tidied up so that it clearly refers to “the FIF's interests” in the underlying companies, and not simply the “interest reported in the FIF's accounts or the consolidated accounts of the FIF's test group”.

(d) The exemption for an underlying foreign company that would be excluded by section EX 35 is being repealed. This is for same reason as explained in the previous section: the exemption would have applied if the top tier FIF held at least 10% of the Australian company, whereas section EX 35 is only meant to apply if the person holds at least 10%.

13. The rules for foreign companies held through FIFs and a summary of the explanation in the TIB have been set out in the attached PDF on *Applying the AFI Method to Indirect Interests In Foreign Companies*.

### **Elective attributing FIFs and deduction limiting rules**

14. These rules mirror the CFC rules discussed in last week's *Weekly Comment*. However, the election for FIFs can only apply to income years beginning on or after 1 July 2011, because the AFI method can only be used from then on.

15. Refer to the attached PDF on *Elective Attributing FIFs*.

### **Non-attributing active FIFs**

16. Section EX 50 as amended by section 35 of the *Taxation (International Investment and Remedial Matters) Act 2012* contains a number of modifications to the way in which the active income exemption tests apply to FIFs for which the AFI method is used:

(a) When applying the accounting standards test, providing that the FIF's income appears in the IFRS (NZ equivalents to international accounting standards) or IFRSE (international accounting standards) accounts of the interest holder or another person, *the accounts of the FIF itself (from which the information to perform the active income test is taken) are allowed to be prepared under US GAAP (US accounting standards)*. The FIF's income could appear in IFRS or IFRSE accounts as:

(i) A share of associate's income using the equity method in IAS 28 or IAS 31; or

(ii) Dividends and fair value changes under IAS 39.

(b) The rules under which FIFs are allowed to be grouped and treated as members of the same FIF test group for the purposes of the active income tests are also relaxed in comparison to the equivalent rules for CFCs, subject to the requirement that none of the companies in the group can be (actual) CFCs:

(i) The top tier FIF must hold more than 50% of companies in the group (the equivalent CFC requirement that the indirect holding by the investor should be more than 50% is relaxed);

(ii) The companies can be in different jurisdictions (the equivalent CFC requirement that the companies be in the same jurisdiction is relaxed);

17. These modifications are explained on pages 24 to 27 of *Tax Information Bulletin* Vol 24 No 6 July 2012.

18. The entire active income calculation rules, including all of the TIB explanations are contained in the attached PDF on *Non-attributing Active FIFs*.

### **Calculating attributable income from FIFs**

19. If the active income exemption does not apply, the “attributable CFC amount” must be calculated for FIFs for which the AFI method is used. In this regard, the rules relating to the exemption for intra-group payments of royalties, rent and interest are relaxed, under new section EX 50(4C), as follows:

(a) The person must use the AFI method for both the paying FIF and receiving FIF; and

(b) The paying FIF must be a non-attributing active FIF; and

(c) There must be a group of persons who hold more than 50% of both the paying FIF and the receiving FIF; and

(d) The paying and the receiving FIF must each have a taxed FIF connection with the same country or territory (i.e. resident and subject to tax in the same jurisdiction or have a parent company that satisfies the requirement).

20. The modified calculation of attributable CFC amount for FIFs has been fully set out, including IRD TIB explanations, in the attached PDF on *Calculation of Attributable CFC Amount for FIFs for which the AFI Method is used*.

### **The attributable FIF income (AFI) method**

21. The entire attributable FIF income (AFI) method, including indirect interests in foreign companies, the active income tests, the calculation of attributable CFC amount for FIFs, and the calculation of net attributable CFC income or loss for FIFs has been set out in the attached PDF on *Attributable FIF Income (AFI) Method and Active Income Exemption*.



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