



RECENT CHANGES IN THE TAXATION OF CONTROLLED FOREIGN COMPANIES (“CFCs”)

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PDF ATTACHMENTS:

1. Attributable CFC amount
2. CFC calculation rules
3. Complete CFC calculation
4. Elective attributing CFCs: election procedure
5. New calculation of net attributable CFC income or loss
6. Non-attributing CFCs
7. Old CFC calculation (superceded)

1. INTRODUCTION

1. The new Controlled Foreign Company (“CFC”) rules were enacted in the *Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009*. The relevant sections of the *Income Tax Act 2007* are as follows:
 - (a) The rules are mainly contained in Subpart EX.
 - (b) Sections CQ 1 to CQ 3 are the taxing provisions, which set out when attributed CFC income arises.
 - (c) Sections DN 1 to DN 4 set out the rules for deducting CFC losses.
 - (d) The rules for carrying forward and using attributed CFC losses are contained in Subpart IQ.
 - (e) Tax credits relating to CFCs are covered in Subpart LK.
2. The main focus in this section is on the recent changes to the CFC rules from 2011 onwards. However, there is also a brief overview of the general rules, with links to the relevant pages on Inland Revenue’s website.

2. INCOME TAX LAW CHANGES FROM 2011 TO 2013

3. The *Taxation (Tax Administration and Remedial Matters) Act 2011* (the “Tax Administration Act 2011”) was enacted with a date of assent of 29 August 2011 and contained a few amendments, including the temporary section EZ 32C which is now repealed. Refer to the PDF attachment *Old Net Attributable CFC Income Or Loss Calculation* for a description of the calculations required under s. EZ 32C.
4. The *Taxation (International Investment and Remedial Matters) Act 2012* (the “International Investment Tax Act”) was enacted with a date of assent of 7 May 2012 and contained a significant number of amendments, particularly the calculations relating to excessively debt funded CFCs, the introduction of the concept of a “taxed CFC connection” for intra-CFC group exemptions and other changes consistent with the changes to the foreign dividend exemption in s. CW 9.
5. The *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* (the “Annual Rates Tax Act”), with a date of assent of 2 November 2012, contained a number of very significant amendments including a revised formula for calculating Net Attributable CFC Income Or Loss and the ability to elect to be an attributing active CFC.
6. The *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill* (the “Livestock Tax Bill”) was introduced on 13 September 2012 and reported from the Finance and Expenditure Committee on 6 June 2013, but does not contain any changes other than a changed reference to a section that does not apply to the calculation rules.
7. The *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* (the “Superannuation Tax Bill”) was introduced on 20 May 2013 and contains changed references to the mineral mining rules in the CFC calculation rules, to align them with the new mineral mining provisions proposed in the Bill.

3. MEANING OF CFC

8. The meaning of CFC is covered in section EX 1. The following explanation has been taken from Inland Revenue's website.
9. CFCs must have the following three attributes to be considered a CFC:
 - (a) CFCs are companies: they include most entities that have a legal existence separate from that of their members, as well as some other entities such as unit trusts.
 - (b) CFCs are non-residents: A company that is a CFC must first be foreign. This means it must not be resident in New Zealand, or must be treated as not being resident under a double tax agreement.
 - (c) CFCs are controlled by New Zealand residents: A non-resident company will not be a CFC unless it is controlled by New Zealand residents. The most common case of control is 100% ownership of the non-resident company by a New Zealand company. However, control exists whenever a:
 - (i) A group of 5 or fewer New Zealand residents has total control interests of more than 50%, or
 - (ii) A single New Zealand resident has a control interest of 40% or more and no unassociated non-resident owns a greater control interest, or
 - (iii) A group of 5 or fewer New Zealand residents can control the exercise of shareholder decision-making rights for the company.
10. Control interests are not limited to voting rights. They can include:
 - (a) Any shareholding
 - (b) Any shareholder decision-making rights
 - (c) The right to receive income from the company, or
 - (d) The right to receive distributions from the company's net assets.
11. The rules require that the highest percentage of any of these interests is used to determine whether or not there is control. There are also rules that aggregate the control interests of associated persons.

4. OVERVIEW OF ATTRIBUTED CFC INCOME CALCULATION

12. The following overview of the calculation of attributed CFC income is taken from Inland Revenue's website. The overview is a helpful explanation, but it was published in 2010. The detailed revised calculations are explained in later sections. The overview is purely for the purpose of providing a conceptual basis to understand the calculations.
13. There is a signposting provision in section EX 18A showing the scheme for finding a person's attributed CFC income or loss under the new rules.
14. Sections CQ 2 and DN 2 provide that a person has attributed CFC income or loss if the person has an income interest of 10 percent or more in a CFC that has net attributable CFC income or loss and is not a non-attributing active CFC or a non-attributing Australian CFC. Special rules apply to income from personal services.

15. The rules for calculating *net attributable CFC income or loss* for a CFC are set out in sections EX 20C to EX 20E and section EX 21 as follows:
 - (a) Section EX 20C provides that net attributable CFC income or loss is to be calculated using a prescribed formula and lays down the main rules concerning deductibility of expenditure.
 - (b) Sections EX 20D and EX 20E make provision regarding the deductibility of interest expenditure for excessively debt-funded CFCs.
 - (c) Section EX 21 applies the Act (subject to certain modifications) for specified purposes as though a CFC were a New Zealand resident. Those specified purposes include the calculation of net attributable CFC income or loss.
16. *Net attributable CFC income or loss* is the income or loss of a CFC that is attributed to New Zealand residents with an income interest of 10 percent or more. *Non-attributing active CFCs and non-attributing Australian CFCs are not subject to attribution other than for any income or loss derived from personal services.*
17. Sections CQ 2(2B) and DN 2(2) make special provision for income or loss derived by a CFC from *personal services* under section EX 20B(3)(h). *This income is always subject to attribution:* under sections CQ 2 and DN 2 if the CFC is a non-attributing active CFC or a non-attributing Australian CFC; otherwise, under section EX 20B(3)(h) and (9). In view of this, income from personal services may be disregarded for the purposes of determining whether a CFC is a non-attributing active CFC (section EX 21D(7)(a)). Where such income is attributed under the CFC rules, the equivalent attribution rule in subpart GB does not apply (section GB 27(3)(e)).
18. Net attributable CFC income or loss is calculated under sections EX 20C to EX 20E and provides the basis for attribution to resident shareholders, much as branch equivalent income did previously. The starting point for calculating *net attributable CFC income or loss for a CFC* is to determine the *attributable CFC amount* in accordance with section EX 20B. This amount is then reduced to reflect expenditure incurred by the CFC, giving a net figure.
19. The relevant formula is found in section EX 20C(2) and refers to two categories of allowable expenditure - limited funding costs and other deductions.
20. As a general rule, deductions for expenditure incurred other than under a financial arrangement will be allowed if the expenditure is incurred by the CFC in deriving an attributable CFC amount. Different rules apply to expenditure incurred by a CFC under financial arrangements because of the difficulties associated with matching debt to particular income streams.

4.1 Treatment of funding costs

21. Of expenditure (typically, interest) incurred under financial arrangements that provide funds to the CFC, only a *fraction* is deductible. The fraction is based on the value of the attributable assets of the CFC as a proportion of its total assets. If a CFC is excessively debt-funded, the fraction is calculated by reference to the assets of all the interest holder's CFCs. The same rule applies to certain dividends that are deductible for the purposes of calculating net attributable CFC income or loss, namely distributions

relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.

22. Section EX 20C(8) defines the item "fraction" that is applied under the formula in section EX 20C(2) to restrict deductions for limited funding costs. Section EX 20C(10) to (12) and sections EX 20D and EX 20E are also relevant.
23. Typically, the fraction is based on the proportion, by value, of the CFC's assets that produce an attributable CFC amount (section EX 20C(10) and (11)). Thus, a CFC that uses one-third of its assets to earn attributable CFC amounts will be able to set one-third of its limited funding costs against those amounts when calculating its net attributable CFC income or loss. If an asset is used to derive both attributable and non-attributable amounts, its value will need to be apportioned. Asset values are adjusted to reflect any adjustment for on-lending under section EX 20C(5).
24. As a backstop against structures that concentrate debt in CFCs with mainly attributable assets in order to maximise allowable deductions, section EX 20C(8)(b) caps the fraction for a CFC that is excessively debt-funded at the amount calculated under section EX 20D. This cap is determined by reference to the assets of all the interest holder's CFCs (section EX 20D(9) to (13)). A CFC is considered to be excessively debt-funded if it has a debt-asset ratio, determined under section EX 20D(4), of more than 0.75 and also has a relative debt-asset ratio, determined under section EX 20E, of more than 1.10.
25. As explained above, the "fraction" is applied to limit funding deductions, by defining an item: "limited funding costs" against which the fraction is applied. Limited funding costs is an adjusted amount, based on a CFC's *funding costs* as defined in section EX 20C(6)(a). Funding costs comprise expenditure incurred under financial arrangements that provide funds to the CFC and distributions relating to fixed-rate foreign equity and deductible foreign equity distributions made by the CFC to New Zealand-resident companies or to other CFCs.
26. Limited funding costs are not fully deductible under the formula in section EX 20C(2); deductions are restricted by applying the fraction found under section EX 20C(8).
27. The rules provide flexibility for intra-group financing arrangements, recognising that multinationals may operate financing subsidiaries to obtain debt finance on behalf of the group and then on-lend the funds to operating subsidiaries. An adjustment for on-lending may be made when calculating the net attributable CFC income or loss of a CFC. The effect of the adjustment is to allow a full deduction for expenditure incurred under financial arrangements that provide funds to the CFC and for any deductible dividends to the extent the funds are on-lent to associated CFCs. A similar adjustment may be made when determining whether a CFC is excessively debt-funded.
28. When determining limited funding costs from funding costs, an adjustment may be made under section EX 20C(5). The adjustment is based on the value of funds on-lent by the CFC to associated CFCs (group funding) as a proportion of the CFC's own funding. Where funding costs exceed limited funding costs, the difference is allowed as other deductions (section EX 20D(9)(b)). The significance of this re-characterisation is that, under the formula in section EX 20C(2), other deductions are allowed in full rather than being restricted through the application of a fraction.

29. The effect of this adjustment is that, if a CFC borrows and then on-lends funds to an associated CFC, it is allowed a full deduction for its own interest expenditure on those funds. Thus, if a quarter of a CFC's funding is on-lent to associated CFCs, three-quarters of its funding costs will be included as limited funding costs subject to restriction, with the remainder being fully deductible. The adjustment is arithmetical and does not allow for borrowed funds to be matched to amounts on-lent.
30. Expenditure incurred under financial arrangements such as derivative instruments that do not provide funds to the CFC is either deductible or non-deductible according to whether any income derived from the arrangement would be included in the CFC's attributable CFC amount.

4.2 Treatment of other costs (i.e. not funding costs)

31. As noted previously, deductions for expenditure incurred other than under a financial arrangement will be allowed if the expenditure is incurred by the CFC in deriving an attributable CFC amount. The item, "other deductions", is defined in section EX 20C(9). Other deductions are allowed in full rather than being restricted through the application of a fraction:
- (a) Paragraph (a) of section EX 20C(9) deals with deductions not relating to financial arrangements and shares. This expenditure is deductible if it is (i) incurred for the purpose of deriving an attributable CFC amount and (ii) not incurred for the purpose of deriving an amount that is not an attributable CFC amount. If an item of expenditure relates to both attributable and non-attributable amounts, the combined effect of subparagraphs (i) and (ii) is to require apportionment of that expenditure.
 - (b) Paragraph (b) deals with any funding costs excluded from limited funding costs by virtue of the on-lending adjustment described earlier.
 - (c) Paragraph (c) deals with deductions relating to financial arrangements that do not provide funds to the CFC. Deductions are allowed only if they relate to an arrangement referred to in section EX 20B(4), namely one that would produce an attributable CFC amount if it produced a net gain rather than a net loss.

5. RECENTLY ENACTED CHANGES TO THE CFC RULES

32. As noted earlier, the International Investment Tax Act and the Annual Rates Tax Act both contained significant changes to the CFC rules. The main legislated changes are briefly explained below.

5.1 Attributable CFC amount

(Refer to the attached PDF on Attributable CFC Amount)

33. The International Investment Tax Act 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.
34. The calculation of "attributable CFC amount" has been set out in a table format, inclusive of all of the changes in the International Investment Tax Act, and where relevant, further changes in the Annual Rates Tax Act. Also included, where it is helpful

to do so, are additional explanations provided in the TIB. Please refer to the PDF attachment *Attributable CFC Amount* for all the details.

5.2 Net attributable CFC income or loss

(Refer to the attached PDF New Calculation of Net Attributable CFC Income or Loss)

35. The Annual Rates Tax Act contained a fundamentally different formula for calculating a person's net attributable CFC income or loss from the one that previously existed in section EX 20C(2). Section 42 of the Annual Rates Tax Act contains a complete revision of section EX 20C. The new calculation has been set out 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.
36. Please note that the new formula applies in 2 parts when a CFC is excessively debt funded and entered into funding arrangements before 21 June 2012. See paragraph 122 below.
37. 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.
38. 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").
39. 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.
40. 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.
41. The methods for determining whether a CFC is excessively debt-funded in section EX 20D and EX 20E have not changed.
42. The deduction for "other deductions" is essentially unchanged from the previous 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.
43. As part of the changes in the Annual Rates Tax Act, the deduction for "later losses" legislated in the Tax Administration Act 2011, as section EZ 32C, has been repealed (by section 63 of the Annual Rates Tax Act), with effect from 30 June 2009, so that amendment is of no effect whatsoever.

5.3 Elective attributing CFC

(Refer to the attached PDF on Elective Attributing CFCs: Election Procedure)

44. 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.
45. New section EX 73 in section 52 of the Annual Rates Tax Act allows 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.
46. 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".
47. This election will not be available for a CFC that is:
- (a) An entity carrying on a business of banking or insurance or is directly or indirectly controlled by such an entity; or
 - (b) A non-attributing Australian CFC.
48. 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 that included 2 November 2012, the date of assent of the Annual Rates Tax Act (or a later date if allowed by the Commissioner).

49. 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.
50. There are additional rules relating to:
 - (a) Revocation of the election;
 - (b) The election ceasing to be of effect; and
 - (c) A subsequent or "further election" being made after an election is revoked or ceases to be of effect.
51. 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 section 24 of the Annual Rates Tax Act. 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.
52. The operation of the election rules has been set out in a Flowchart in a PDF attachment titled *Elective Attributing CFCs: Election Procedure*. Please refer to the PDF attachment for the details.

5.4 Non-attributing CFCs

(Refer to the attached PDF on Non-attributing CFCs)

53. 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.
54. In addition, as already noted in paragraph 33, the International Investment Tax Act contained a number of changes to the non-attribution tests, including introducing the concept of a "taxed CFC connection".
55. The entire new decision tree has been set out in a series of Flowcharts in the attached PDF titled *Non-attributing CFCs*. Please refer to the PDF for all the details.

5.5 Calculation of a person's attributed CFC income or loss

(Refer to the attached PDF on Calculation of a Person's Attributed CFC Income or Loss)

56. For completeness, all the PDFs previously referred to in Section 8 have been collated into a single PDF attachment *Calculation of a Person's Attributed CFC Income or Loss*. This will provide a complete reference to the calculation of a person's attributed CFC income or loss, inclusive of all of the latest enacted amendments in the International Investment Tax Act and the Annual Rates Tax Act. For additional completeness, a separate PDF on the calculation rules in section EX 21 titled *Calculation Rules: Attributable CFC Income and Net Attributable CFC Income/Loss* has also been included.

57. All of the above changes are also relevant for FIFs for which an interest holder uses the attributable FIF income (AFI) method. This method essentially imports the CFC calculation methods as an alternative for determining FIF income if the requirements to use the AFI method are met and the interest holder chooses to use that method. Refer to the separate section on FIFs.