Changes to the controlled foreign company rules in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012 makes a number of changes to the controlled foreign company rules to help them work as intended. One change brings all income from a business of insurance into the definition of passive income, to prevent unintended loss of revenue. Other changes allow the taxation of passive income and losses to be more symmetric, to prevent over-taxation.

This special report provides early information for interested parties and precedes full coverage of the legislation that will be published in the *Tax Information Bulletin*.

Income from an insurance business of a controlled foreign company

*Sections EX 20B(3)(f) and EZ 32E of the Income Tax Act 2007*

Profits from a business of insurance of a controlled foreign company (a CFC) are generally taxable. However, certain types of insurance income, such as reinsurance claims income, were unintentionally omitted from the definition of “attributable income” in section EX 20B(3) of the Income Tax Act 2007. This means tax losses have arisen even though there are no economic losses. The new Act amends the definition of “attributable income” with retrospective effect, to include income from a business of insurance, however that income arises.

**Key features**

The definition of “attributable income” has been amended to include income from a business of insurance or from being an insurer, however that income arises. Where this leads to a retrospective liability for tax, any consequent use-of-money interest charge will be relieved.

**Detailed analysis**

*Section EX 20B(3)(f)*

Section EX 20B(3)(f) has been amended to include income from a business of insurance, however that income arises. This includes reinsurance income, third-party recoveries and the like.
Income from a business of insurance is explicitly supplemented by income received by a person from being an insurer. The income would be included even if the insurer was an insurer for just one person and might not be considered to be “carrying on an insurance business” according to the ordinary meaning of that phrase.

**Section EZ 32E**

The change to section EX 20B is retrospective. As a consequence, tax liabilities for past years may arise and use-of-money interest could be imposed. Section EZ 32D relieves such interest if it arises.

The interest is relieved if a person took a tax position before the enactment of the amendment, and the enactment results in an additional tax liability. Interest is not imposed on the relevant addition, for the period from the initial due date until the later of 30 June 2012 or a revised due date determined by Inland Revenue for the payment of the interest.

**Application date**

The amendments apply for income years beginning on or after 1 July 2009, which corresponds with the application date for the reformed controlled foreign company rules.

**Amendments to make taxation of controlled foreign companies more symmetric**


The controlled foreign company (CFC) rules were extensively reformed in 2009. A New Zealand resident with an income interest of more than 10% in a controlled foreign company is taxed on the passive profits earned by that company. Passive profits comprise passive income, such as interest and royalties, and deductions for related expenditure. To reduce compliance costs, there is also an “active business test”: a CFC’s profits are not taxed if the CFC’s gross passive income is less than 5% of its total income.

In some cases the reformed rules are not working as they should, and income is being taxed while deductions for related expenditure are not being allowed. In particular:

- Some CFCs that take out foreign currency loans to finance their active businesses are being taxed on foreign exchange gains on those loans, but are not allowed deductions if there are foreign exchange losses.
- Some CFCs that incur expenditure in a year when they pass the active business test, to earn passive income in another year, are being taxed on the passive income but are not receiving deductions for the related expenditure.

The Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act addresses these problems.
Key features

When a CFC borrows money to fund its business, income from the loan will normally be taxable only if deductions would be allowed for expenditure on the loan. (Income from a loan would most commonly be an exchange rate gain on a foreign-currency loan.)

A taxpayer may elect not to apply the active business test to a CFC, to enable more deductions to be claimed for expenditure incurred in earning passive income. Restrictions apply to the use of deductions when an election has been made.

Application date

The amendments apply for income years beginning on or after 1 July 2009, which corresponds with the application date for the reformed controlled foreign company rules.

Detailed analysis

Section DN 4

Section DN 4 restricts the use of an attributed loss of CFC when the CFC is an “elective attributing CFC”. A CFC is an elective attributing CFC when the taxpayer has elected not to apply the active business test to the CFC under section EX 73. The first year that an election applies in respect of a CFC is called the CFC’s “election commencement year”.

The policy principle underlying the legislation is that losses of an elective attributing CFC are tagged with the name of the CFC and the CFC’s election commencement year.

The tagged losses may be used to reduce attributed CFC income, but only if the income comes from the same CFC which is still an elective attributing CFC (or FIF), or another elective attributing CFC (or FIF) with the same election commencement year. This condition applies in addition to the other, existing conditions for use of losses, such as jurisdictional ring-fencing.

Unused tagged losses of a CFC are forfeited if the election made in respect of the CFC expires or is revoked.

A new subsection (1B) has been added to section DN 4, to restrict the use of losses of elective attributing CFCs, in the way just described. Subsection (1) has also been rewritten to apply only to losses that are not from elective attributing CFCs; the effect of the rewritten provision is not intended to be different in any other respect from the original.
### Example – loss of elective attributing CFC

A taxpayer has the following amounts of attributed CFC income and loss for the 2015–16 income year:

CFC A (United States), loss of $80 million  
CFC B (United States), income of $60 million  
CFC C (United States), income of $20 million  
CFC D (United States), income of $10 million  
CFC E (United States), loss of $35 million  
CFC F (Austria), income of $50 million

CFC A, CFC B and CFC F are elective attributing CFCs and all have an election commencement year of 2013–14. CFC D is an elective attributing CFC and has an election commencement year of 2014–15. CFC C and CFC E are not elective attributing CFCs.

Subsection (1B) allows the taxpayer to use $60 million of CFC A’s loss, because CFC A and CFC B have the same election commencement year and there is $60 million of attributed CFC income from CFC B.

CFC A’s loss may not be used to reduce CFC C’s income (because CFC C is not an elective attributing CFC), CFC D’s income (because CFC D has a different election commencement year), or CFC F’s income (because CFC F is not resident in the United States).

The remaining $20 million of CFC A’s loss cannot be used under section DN 4 and must instead be used under subpart IQ.

Subsection (1) allows the taxpayer to use $30 million of CFC E’s losses, because CFC E is not an elective attributing CFC, CFC C and CFC D are resident in the United States and the combined income of CFC C and CFC D is $30 million.

The remaining $5 million of CFC E’s losses cannot be used to reduce income from CFC F because CFC F is not a United States company, and must instead be used under subpart IQ.

### Section DN 8

Section DN 8 makes changes having the same effect as the changes to section DN 4, except that they apply to FIF losses rather than attributed CFC losses.

### Section DZ 19

Section DZ 19 has been repealed retrospectively. It was a temporary measure and has been replaced by other measures in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act. (See changes to section EX 20C.)

### Section EX 18A

Section EX 18A has been amended so that the taxpayer will calculate attributed CFC income or loss for a CFC if the CFC is an elective attributing CFC for the taxpayer.

The attribution calculation will be undertaken even if the CFC would otherwise be a non-attributing active CFC under section EX 21B.
Section EX 20C

Section EX 20C has been rewritten to change the tax treatment of a CFC’s income from a loan that provides funds to the CFC. Income from a loan would typically be the result of an exchange rate gain on a foreign-currency loan.

In most cases, such income will be included in attributable income only to the extent that expenditure or loss relating to the loan would have been included (if there were any). That is, there will generally be symmetry between included income and included expenditure. Previously, the income was included completely.

The rewording of the section is not intended to have any other effects.

Subsection EX 20C(2)

Subsection EX 20C(2) contains the formula for net attributable CFC income or loss:

\[
\text{attributable } \text{CFC} - \text{apportioned funding income} - \text{apportioned funding costs} - \text{other deductions}
\]

“Attributable CFC” less “apportioned funding income” is, generally speaking, the gross taxable income of the CFC. “Attributable CFC” is calculated in the same way as it has always been, but the subtraction of “apportioned funding income” is new.

“Apportioned funding costs” and “other deductions” are, generally speaking, tax deductions of the CFC. They are calculated in the same way as they have always been, although some of the terminology in the relevant subsections has changed.

Subsection EX 20C(3)

Subsection EX 20C(3) defines apportioned funding income, which will not be attributed. Ordinarily, apportioned funding income will be determined by the formula:

\[
\text{funding income} \times \text{funding fraction} \times (1 - \text{asset fraction})
\]

These terms are defined in more detail in subsections (5), (6) and (8).

In broad terms, “funding income \times \text{funding fraction}” is the amount of income from loans the CFC has taken out, after adjusting for any on-lending.

Multiplication by \(1 - \text{asset fraction}\) determines the portion of the income that relates to funding of active assets. This portion of the funding income is not taxable. In the same way, expenditure on the loan would be non-deductible if it related to the funding of active assets.

If a CFC is carrying on a business of banking or insurance or is directly or indirectly controlled by someone who is, there is no apportioned funding income.
Subsection EX 20C(5)

Subsection EX 20C(5) defines funding income, which appears in the equation in subsection (3). Funding income is income from a financial arrangement that provides funds to the CFC – income from a loan the CFC has taken out, in other words.

There will not normally be income from a loan, but there can be if, for instance, the loan is in a foreign currency and there is an exchange rate gain on conversion to New Zealand dollars.

Note that only income from financial arrangements is included. Contrast this with paragraph EX 20C(7)(a), which includes certain equity instruments as well as financial arrangements. The underlying assumption here is that a CFC will not have accrual income from equity instruments it has issued, though it may have deductible expenditure in some cases.

Paragraph (b) prevents income from being funding income if the financial arrangement is expected to generate income. A key characteristic of a loan taken out is that it will result in expenditure, not income, over its term. If income is expected, it will be attributed.

Exchange rates can vary significantly, and it is quite likely that there will be income in at least one year of a long-term financial arrangement, even though it is not clear which year. The test in paragraph (b) is not intended to catch such a case. Rather, the test is intended to catch cases in which net income is reasonably expected over a particular period that is predictable in advance, such as the entire term of the arrangement or a specific sub-period of the term.

The test is applied when the CFC enters the arrangement and again if the terms of the financial arrangement are altered. It is an objective test. The intentions or expectations of the parties may be relevant, but it is a hypothetical reasonable person’s expectations that are being evaluated.

Subsection EX 20C(6)

Subsection EX 20C(6) calculates the item “funding fraction”. Funding fraction adjusts the amount of funding income to remove the effects of on-lending. That is, it makes an adjustment if the CFC has provided funding – implicitly out of the CFC’s own borrowings – to an associated CFC.

The funding fraction is the proportion of funding which is not implicitly on-lent.

It is compulsory to make the adjustment for on-lending when apportioned funding income is being calculated.

“Funding fraction” also applies in the calculation of apportioned funding costs, but in that case it is optional to make an adjustment for on-lending.

The difference between the cases of income and cost is due to incentives.

In the case of apportioned funding costs, there is an incentive to adjust for on-lending. This will often increase the amount of expenditure that is fully deductible. However, taxpayers are given the option to forego the advantages of adjustment if, say, the calculations would be too costly. The risk that tax revenue will be undermined as a result of this choice is limited.
In contrast, in the case of apportioned funding income, the incentive is not to adjust for on-lending, because that will make more of the funding income tax-free. This would significantly increase the risks of tax revenue being undermined, particularly if choices were made to adjust for on-lending in the case of costs but not in the case of income.

Taxpayers can voluntarily avoid different outcomes for costs and income by adjusting for on-lending in both cases.

Example – calculation of funding fraction

A CFC has taken out a $25 million interest-only loan to fund its active business.

In 2013–14 the CFC has $10 million of funding income. Paragraph EX 20C(6)(c) gives a funding fraction of 1, because there is no on-lending (the item “group funding” is nil).

In 2014–15 the CFC lends $15 million, also on interest-only terms, to an associated CFC.

In 2015–16 the CFC has $10 million of funding costs and the CFC’s New Zealand owner decides to rely on paragraph EX 20C(6)(b) to reduce compliance costs. “Funding fraction” is 1.

In 2016–17 the CFC has $10 million of funding income. “Funding fraction” is 0.4.

Subsection EX 20C(8)

Subsection EX 20C(8) calculates the item “asset fraction”, which is the fraction of the CFC’s assets that generate (gross) attributable income. On-lent amounts (see subsection (7)) are excluded from the calculation if they were excluded in subsection (6), and not otherwise.

A similar fraction is used for calculating apportioned funding costs. However, in that case the fraction is modified if the CFC is excessively debt funded, so that the deductions of an excessively debt funded CFC would be more limited than those of another CFC. The intention of the excessive debt-funding limitation is to discourage excessive debt funding. It would be inconsistent with this intention to also limit the taxation of any income arising from the debt.

Example – calculation of “asset fraction”

In 2015–16 a CFC takes out a $10 million interest-only loan to fund its business. There is no on-lending.

There is $1 million of income from the loan, owing to an exchange rate gain exceeding interest expense.

By value, 80% of the CFC’s assets are used to derive an attributable CFC amount (passive income) and not to derive an amount that is not an attributable CFC amount. The asset fraction is therefore 0.8. The amount which can be subtracted as apportioned funding income is $200,000 and $800,000 remains attributable.

Suppose that instead there was $1 million of expenditure on the loan, and that the CFC is excessively debt funded under section EX 20D with a cost fraction of 0.3. The cost fraction of 0.3 would be used to calculate the apportioned funding costs. Deductions of $300,000 would be attributed and $700,000 would be ignored.
**Section EX 20D**

Section EX 20D has been amended consequential to the changes made to section EX 20C.

**Section EX 21B**

Section EX 21B has been amended so that no active business test is carried out for a CFC when the CFC is an elective attributing CFC for the taxpayer.

**Section EX 73**

Section EX 73 is a new provision allowing the taxpayer to make an election. The taxpayer may elect not to apply the active business test to a CFC in which they have an income interest of 10% or more or to a FIF for which they use the attributable FIF income method.

**Subsection EX 73(1)**

A taxpayer may elect that a CFC or FIF in which they hold an income interest is an “elective attributing CFC” or “elective attributing FIF” (terms which are defined in section YA 1). The active business test in section EX 21B is not applied to such a CFC or FIF, and there is a full calculation of attributable income.

The election may be made only if the active business test would be applied; that is, only if it is for a CFC in which the person has a 10% or greater income interest, or for a FIF for which the attributed FIF income method is used.

**Subsection EX 73(2)**

A CFC or FIF may not be an elective attributing CFC or FIF if it carries on a business of banking or insurance or is controlled by somebody who does. Such entities are in any case extremely unlikely to be non-attributing active CFCs.

In addition, a CFC may not be an elective attributing CFC if it qualifies for the Australian exemption in section EX 22.

**Subsections EX 73(3) and (4)**

An election under section EX 73 is normally effective from the beginning of the income year following the notice of election. That is, elections must be prospective. This is to minimise the likelihood of elections being made only in cases in which a loss arises.

There are two exceptions to this general rule.

First, because section EX 73 applies for income years beginning on or after 1 July 2009, it is possible to make a retrospective election. A retrospective election must be made by the end of the income year in which the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act receives Royal assent, or at a later time if Inland Revenue allows it. The expectation is that Inland Revenue would allow a late election only in extraordinary circumstances, such as when the taxpayer’s income year ends very soon after the date of Royal assent. When made, the election applies from the beginning of the first income year beginning on or after 1 July 2009, for a CFC or 1 July 2011, for a FIF.
Secondly, Inland Revenue has some general discretion to allow a late election. The expectation is that this general discretion would be rarely used, such as when a late election was due to factors beyond the taxpayer’s control, and not in circumstances in which the election was made merely because a loss actually arose during the year.

*Subsections EX 73(5) to (8)*

An election under section EX 73, once it applies, is effective until it is revoked or expires. If it is revoked by the taxpayer or it expires, it ceases to be effective from the beginning of the income year in which it is revoked or expires.

In general, it is not intended that taxpayers will revoke elections. The concern here is that an election will be revoked after attributed deductions have been taken but before the related attributable income arises, leading to under-taxation.

However, revocation is possible if it is extremely unlikely that any related attributable income will arise after the revocation. For instance, revocation might be allowed if deductions were taken for exchange rate losses on a bank deposit, and the deposit was subsequently withdrawn and paid out as a dividend. In such a case, it is extremely unlikely that any more attributable income would arise from the deposit. For the revocation to be effective, it must not be made for a purpose or effect of reducing a tax liability, and Inland Revenue must agree to the revocation in writing.

With two exceptions, an election expires automatically if the CFC ceases to be a CFC in which the taxpayer holds an income interest of 10% or more or if the FIF ceases to be a FIF for which the taxpayer uses the attributable FIF income method. Note that a FIF that qualifies for the Australian exemption in section EX 35 is no longer a FIF for which the attributable FIF income method is used, which will trigger expiry of the election. Other exemptions from the FIF rules will have the same effect.

The first exception occurs when a CFC in which the taxpayer holds an interest of 10% or more becomes a FIF for which the taxpayer uses the attributable FIF income method (for instance, if the taxpayer maintains a holding of 20% in the foreign company but an unrelated non-resident acquires the remaining 80% interest). In that case, the election continues to be effective but is treated as having been made for the FIF. The election commencement date is unchanged.

The second exception occurs in the reverse case, when a FIF for which the taxpayer uses the attributable FIF income method becomes a CFC in which the taxpayer has an income interest of more than 10% and which is not a non-attributing Australian CFC. Again, the election continues to be effective, but is treated as having been made for the CFC with no change to the election commencement date.

The election also expires automatically if the foreign company carries on a business of banking or insurance or is controlled by someone who does, or if a CFC becomes eligible for the Australian exemption in section EX 22.
Subsection EX 73(9)

Any CFC or FIF losses attributed to a taxpayer who was subject to an election under section EX 73 for the CFC or FIF, and have been carried forward under subpart IQ, are forfeited when the election is revoked or expires. The relevant losses (those implicitly tagged with the name of the CFC or FIF and an election year) are not carried forward from the previous year into the year in which the revocation or expiry is effective.

Any losses arising from the CFC or FIF in the year that an election ceases to be effective are either normal attributed losses under sections DN 4 or DN 8, if the losses are required to be attributed, or are not recognised at all.

Example – effect of revoking an election

In 2013–14 a taxpayer makes an election under section EX 73 in respect of a CFC. There is an attributed loss of $1.3 million in 2014–15, which is carried forward under subpart IQ. In 2015–16 there is attributed income of $0.6 million, which reduces the carried forward loss to $0.7 million. In 2016–17 an attributed loss of $0.4 million would be calculated.

Suppose that in 2016–17 the taxpayer sets up a banking business, so that the election expires. The remaining $0.7 million of historical losses are not carried forward to 2016–17. However, the attributed loss of $0.4 million is recognised as an ordinary attributed loss and may be used under section DN 4, including by carrying it forward under subpart IQ via section DN 4(3).

Suppose instead that in 2016–17 the CFC becomes Australian resident and qualifies for the exemption in section EX 22. The remaining $0.7 million of historical losses are not carried forward to 2016–17, and the $0.4 million current-year loss is ignored.

When one of the exceptions in paragraphs EX 73(7)(a) or (b) applies, the tagged losses of the elective attributing CFC or FIF become tagged losses of the elective attributing FIF or CFC respectively, with no change to the date they were incurred. This is to ensure that if the election does subsequently expire, all losses – whether arising before or after the change from CFC to FIF (or vice versa) – are forfeited.

Subsection EX 73(10)

After an election is revoked or expired, it will usually not be possible to make another election in respect of the CFC or FIF. This is to prevent CFCs or FIFs from entering and exiting the tax system in a way that would result in recognition of deductions and non-recognition of related income.

However, following expiry another election may be made if certain conditions are met, and if Inland Revenue agrees to the new election. The expiry must have been due to an oversight, and notice of the new election must be made within a reasonable period.

More importantly, the new election must not be made with a purpose of allowing deductions to be attributed – at any time – without the attribution of corresponding income – also at any time.
It is not expected that Inland Revenue would agree to a new election in many cases, but there could be unusual cases in which it would be appropriate to be able to make a second election.

**Example – a second election**

In 2013–14 a taxpayer makes an election under section EX 73 in respect of a CFC.

In 2016–17 the directors of the CFC hold some board meetings in New Zealand while participating in trade shows here. They are unaware of the tax consequences of these meetings, one of which is that the CFC becomes a New Zealand resident. However, this is an isolated occurrence and the company ceases to be New Zealand resident soon after. There is no real change in the activities or balance sheet of the company over its period of residence.

In 2017–18 the taxpayer asks to make a second election in respect of the CFC under section EX 73.

In deciding whether to agree to an election, Inland Revenue might take into account that: any losses attributed while the first election was active were forfeited; the company was subject to full taxation during its period of New Zealand residence; there was no obvious change in the business of the CFC or its assets or liabilities while it was resident; and the directors were unaware of the tax consequences of the New Zealand meetings.

**Subsection EX 73(11)**

Subsection EX 73(11) is an anti-avoidance provision, to prevent multiple elections and revocations or expiries by the transfer of a CFC interest between associated persons.

If a person has made an election in respect of a CFC or FIF and the election has expired or been revoked, an associated person will not be able to make an election in respect of that foreign company unless Inland Revenue agrees. Inland Revenue must be satisfied that the election has not been made with a purpose of allowing deductions to be attributed without the attribution of corresponding income.

There may be cases in which associated persons quite legitimately make elections in relation to a single CFC. It seems more likely that these would involve individuals rather than companies.

**Example – election by an associated person**

A parent makes and revokes an election for a CFC and then, on retirement many years later, transfers the CFC interest to an adult child who was previously not involved in the investment.

Acting completely independently, the adult child wishes to make an election for the CFC, and satisfies Inland Revenue that this will not lead to deductions being attributed when corresponding income is not.
Subsection EX 73(12)

Notices of election or revocation under section EX 73 must be made in writing, and provided to Inland Revenue using the prescribed form and by the prescribed means. The current procedure is to send a letter with the relevant details in it to competent.authority@ird.govt.nz. For an initial election, the CFC or FIF in question should be identified, as should the period for which the election is made. For revocations or elections for which agreement is sought, further information will be required to satisfy Inland Revenue that the relevant conditions are met.

Section EZ 32C

Section EZ 32C, which was a temporary provision to allow certain exchange rate losses and gains of CFC to be offset, has been repealed with retrospective effect. It has effectively been made redundant in any case by the addition of the item “apportioned funding income” to section EX 20C(2).

The effect of the retrospective repeal is that section EZ 32C never applies.

Section EZ 32D

Section EZ 32D is a transitional provision for CFCs that have income from borrowed funds. As a result of changes discussed in this report, income from such borrowed funds may be subtracted from attributable income under section EX 20C(2).

However, in calculating the amount of income to be subtracted, usually no account is taken of excessive debt-funding of the CFC. This can lead to a higher proportion of income being attributed but a lower proportion of corresponding deductions being allowed. In most cases this is intentional and designed to discourage excessive debt-funding (see the discussion of amendments to section EX 20C(8) elsewhere in this report).

There are some cases, though, in which existing loans were taken out before the new CFC rules came into force in 2009. Under the old CFC rules, it is probable that the income and deductions were treated similarly: either both completely within the tax base or both completely outside of it, regardless of the level of debt. To provide some continuity in such cases, a taxpayer who has taken out loans before 21 June 2012 may take excessive debt-funding into account for those loans.

To apply section EZ 32D, the taxpayer effectively undertakes two calculations under subsection EX 20C(3)(b)(ii) for the CFC and adds the results together, instead of undertaking a single calculation under that subsection.

The first calculation is for funding income that relates to old funding arrangements – those entered into before 21 June 2012. The calculation under subsection EX 20C(3)(b)(ii) has been modified so that excessive debt-funding is taken into account, by using the item “cost fraction” instead of the item “asset fraction”.
The second calculation is for the remaining funding income, and uses the item “asset fraction” as normally.

Example – transitional rule for excessively debt-funded CFCs

A taxpayer has a CFC that took out a $100 million loan in 2007–08. The outstanding balance of the loan in 2013–14 is $US65 million. The CFC takes out another loan in 2013–14 of US$40 million.

In 2013–14 there is $6.5 million of funding income from the old loan and $4.0 million of funding income from the new loan. The CFC’s asset fraction is 0.6 but the CFC is excessively debt-funded and its cost fraction under section EX 20D is 0.4. The CFC has not lent money to anybody.

Under section EZ 32D, apportioned funding income is calculated in two parts.

First, there is apportioned funding income from the old loan of $6.5 million × 1 × (1–0.4) = $3.9 million, because the excessive debt funding is taken into account and the cost fraction is used.

And secondly, there is apportioned funding income from the new loan of $4.0 million × 1 × (1–0.6) = $1.6 million, because excessive debt funding is not taken into account and the asset fraction must be used.

The total amount of apportioned funding income, which will be subtracted in the attribution formula in section EX 20C(2), is $5.5 million.

Section IQ 2

Section IQ 2 has been amended to restrict the use of a CFC loss or a FIF loss when the CFC or FIF is an elective attributing CFC or FIF.

Subsection (1) has been rewritten to apply only to losses that are not from elective attributing CFCs or FIFs. The effect of the rewritten provision is not intended to be different in any other respect from the original.

Subsection (1BA) has been added to section IQ 2 to restrict the use of losses of an elective attributing CFC or FIF. The amount of loss that may be used to reduce an income tax liability is limited to the amount of attributed income from elective attributing CFCs or FIFs having the same election commencement year as the CFC or FIF. Subsection (1BA), like subsection (1), also requires that the income be from CFCs or FIFs resident in the jurisdiction where the CFC or FIF was resident when the losses arose.
Example – use of carried forward losses of elective attributing CFCs

A taxpayer wholly owns four CFCs:

CFC A, United States, elective attributing CFC, election commencement year is 2013–14
CFC B, United States, elective attributing CFC, election commencement year is 2013–14
CFC C, United States, not an elective attributing CFC
CFC D, Portugal, elective attributing CFC, election commencement year is 2013–14

Losses are carried forward to 2014–15 under subpart IQ as follows:

Losses of elective attributing CFCs: $12 million (United States, CFC A, 2013–14)
Other CFC losses: $3 million (United States)

And there is CFC attributed income for 2014–15:

CFC A, $7 million
CFC B, $1 million
CFC C, $5 million
CFC D, $7 million

$8 million of the $12 million loss that came from CFC A may be used to reduce income, because CFC A and CFC B have the same election commencement year as CFC A, are resident in the United States, and generate combined attributed income of $8 million. The remaining $4 million of loss is carried forward as a loss of the elective attributing CFC to 2015–16.

The $3 million loss that is not a loss of an elective attributing CFC may be used entirely, because CFC C is resident in the United States and has income of $7 million.

(See the discussion of amendments to sections DN 4 and DN 8 for more background information.)

Section YA 1 (election commencement year, elective attributing CFC, elective attributing FIF)

Section YA 1 defines the terms “election commencement year”, “elective attributing CFC” and “elective attributing FIF”. Their use has been described elsewhere in this report.

An elective attributing CFC (or FIF) is an elective attributing CFC (or FIF) only for an interest holder who has made an election under section EX 73. Another holder of an interest in the same CFC who has not made an election does not treat the CFC as an elective attributing CFC. Similarly, the election commencement year of a particular elective attributing CFC is the election commencement year only for the interest holder who made the election.