



**WEEKLY COMMENT: FRIDAY 26 SEPTEMBER 2014**

1. This week I continue looking at the Foreign Investment Fund (“FIF”) taxation regime by taking a look at the choice between FIF calculation methods. The choice between methods is important because, as noted last week, different methods yield different results. In addition, the rule changes enacted in the *Taxation (International Investment and Remedial Matters) Act 2012* have had a significant impact on the choice of methods for income years beginning on or after 1 July 2011.
2. The available choices can be grouped into four main areas as follows:
  - (a) Individuals and family trusts with a FIF interest that is an ordinary share in a foreign company;
  - (b) Non-family trusts and companies with a FIF interest that is an ordinary share in a foreign company;
  - (c) Any person with a FIF interest that is a non-ordinary share in a foreign company;
  - (d) Any person with a FIF interest that is an entitlement to benefit from a foreign superannuation scheme or a foreign life insurance policy (to be covered next week).

**Individuals and family trusts with a FIF interest that is an ordinary share**

3. If the person is a natural person (individual), or a trustee of a trust for the benefit of a loved one or a charity (generally a family trust), with a FIF interest that is an ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

<b>Individuals or family trusts with ordinary shares</b>	<b>AP</b>	<b>BE</b>	<b>AFI</b>	<b>FDR</b>	<b>COST</b>	<b>CV</b>	<b>DRR</b>
<u>Pre-1 July 2011 income years</u>  <u>Default methods:</u> For < 10%, FDR if practical, or Cost. For ≥ 10%, AP if allowed, or CV/DRR	✓	✓	✗	✓	✓	✓	✓
				Only < 10%	Only < 10%		
<u>1 July 2011 onwards income years</u>  <u>Default methods:</u> FDR, if it is practical to use it. Cost, if it is not practical to use FDR.	✗	✗	✓	✓	✓	✓	✗

4. Let's first look at the choices, for individuals and family trusts with a FIF interest that is an ordinary share in a foreign company, for the **income years beginning on or before 30 June 2011** – i.e. before 1 July 2011:
- (a) The **AP method** is the only method that can result in a FIF loss that can be deducted against other income. The shares must meet the requirements to use the method, as well as the accounting requirements:
    - (i) The shares must be quoted on a stock exchange or widely offered to the public; and
    - (ii) Audited financial statements prepared under GAAP (or the equivalent) must be readily available.
  - (b) The **BE method** can also result in a loss, but the loss is ring-fenced and can only be used against current or future BE income from FIFs in the same jurisdiction. The shares do not have to be listed, or meet the AP method accounting requirements, so the BE method can be useful for “start-up” investments, but information must be available for the Commissioner to check the calculations.
  - (c) The **FDR method** can only be used for FIF interests:
    - (i) Of less than 10% (at some time in the year if the FIF is a grey list company with dividends being taxable under s. CD 36(2), and at all times in the year if the FIF is not a grey list company); and
    - (ii) If the CV method is not chosen for any FIF interests for which the FDR method could have been used.
  - (d) The **Cost method** can only be used for FIF interests:
    - (i) Of less than 10% (at some time in the year if the FIF is a grey list company with dividends being taxable under s. CD 36(2), and at all times in the year if the FIF is not a grey list company); and
    - (ii) For which the FDR method is allowed (i.e. the CV method has not been chosen in the income year for any FIF interests for which the FDR method could have been used) but it is not practical to use the FDR method because the person cannot determine the market value of the interest at year-end except by independent valuation.
  - (e) The **CV method** includes realised and unrealised gains in the calculation of FIF income, so can be useful if the net return from FIFs is below the deemed 5% in the FDR and Cost methods. Individual investors and family trusts can switch freely between the CV and FDR methods on a portfolio basis. (As noted earlier, the portfolio includes shares and units in FIF interests less than 10%, but excludes life policies or superannuation entitlements unless they were issued by companies.)
  - (f) The **DRR method** can be used only if the income interest is at least 10%, and:
    - (i) The individual's FIF interests don't exceed \$250,000, measured at book value if the DRR method was used the previous year, or otherwise at market value (*this option is not available to family trusts: family trusts cannot use the DRR method by meeting this requirement that FIF interests do not exceed \$250,000*); or
    - (ii) It is not practical for the person to use the AP or CV methods; or
    - (iii) The person used the DRR method for the FIF interest in the previous year and must continue using it because it remains available for use.

5. The **default methods**, for individuals and family trusts with a FIF interest that is an ordinary share in a foreign company, **for income years beginning before 1 July 2011**, if no method is chosen, are:
- (a) For FIF interests of less than 10% for which FDR is allowed:
    - (i) The FDR method, if it is practical to use it; and
    - (ii) The Cost method if it is not practical to use the FDR method.
  - (b) For a direct income interest in a foreign company of at least 10%:
    - (i) The AP method, if the availability and accounting requirements are met, and it is practical to use it; or
    - (ii) The CV method, if use of the AP method is not allowed or not practical, and it is practical to use CV; or
    - (iii) The DRR method, if use of the AP method is not allowed or practical, and it is not practical to use the CV method.
6. For individuals and family trusts with a FIF interest that is an ordinary share in a foreign company, in **income years beginning on or after 1 July 2011**:
- (a) The **AP and BE methods** will not be available.
  - (b) The **AFI method** can result in a loss, but the loss is ring-fenced and can only be used against current or future AFI income from FIFs from the same jurisdiction. The method can be used for a FIF interest that is an income interest in a foreign company, subject to the minimum income interest restriction discussed below. The AFI method will be useful for “start-up” investments for which losses are initially incurred. The AFI method can only be used if there is sufficient information to allow the Commissioner to check the calculations – either sufficient information to satisfy the active income test or the more detailed information required to calculate attributable income, and if either:
    - (i) The person’s income interest is at least 10% and the person is not a PIE; or
    - (ii) The person’s income interest is less than 10%, but, the FIF is a CFC and:
      - a. The person cannot determine the market value at the beginning of the period except by independent valuation; and
      - b. No person that is a listed company, a portfolio investment entity (“PIE”), a superannuation scheme, unit trust, group investment fund, or a trustee of a trust with any of these entities as a beneficiary, holds an income interest in the CFC of 10% or more.
  - (c) The **FDR method** can be used for any income interest (the less than 10% restriction has been removed), providing that the person has not chosen to use the CV method for another FIF interest that is an ordinary share in a foreign company for which the FDR method could have been used [s. EX 46(8)(b)]. In other words, a person cannot “cherry-pick” between the FDR and CV methods in the same year depending on whether the actual return is below or above 5%.
  - (d) The **Cost method** can only be used if the FDR method is allowed (i.e. the person has not chosen to use the CV method in the income year for some FIF interests that the FDR method could be used for), but it is not practical to use the FDR method because the person cannot determine the market value at the beginning of the year except by independent valuation.

- (e) The **CV method** will continue to be available as it was for earlier income years. The method includes realised and unrealised gains in the calculation of FIF income, so will be useful if the net return from FIFs is below the deemed 5% in the FDR and Cost methods.
- (f) The **DRR method** cannot be used for a FIF interest that is ordinary shares in a foreign company.
7. The **default methods**, for **income years beginning on or after 1 July 2011**, if no method is chosen, will be:
- (a) The FDR method, if it is practical to use it; and
- (b) The Cost method, if it is not practical to use the FDR method.

**Non-family trusts and companies with a FIF interest that is ordinary shares in a foreign company**

8. If the person is a trustee of a trust that is not a family trust, or a company, and the FIF interest is an ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

<b>Non-family trusts or companies with ordinary shares</b>	<b>AP</b>	<b>BE</b>	<b>AFI</b>	<b>FDR</b>	<b>COST</b>	<b>CV</b>	<b>DRR</b>
<u>Pre-1 July 2011 income years</u>  Default methods: For < 10%, FDR if practical, or Cost. For ≥ 10%, AP if allowed, or CV/DRR	✓	✓	✗	✓	✓	✓	✓
<u>1 July 2011 onwards income years</u>  Default methods: FDR, if it is practical to use it. Cost, if it is not practical to use FDR.	✗	✗	✓	✓	✓	✗	✗

9. For **income years beginning before 1 July 2011**, the main distinctions in the case of trusts that are not family trusts and companies, with a FIF interest that is an ordinary share in a foreign company, are:
- (a) The FDR method can be used for FIF interests of 10% or more, if the trust or the company is a portfolio investment entity ("PIE") and the FIF is a foreign PIE equivalent.
- (b) The CV method cannot be used for FIF interests of less than 10%.
- (c) As is the case with family trusts, the DRR method can only be used by non-family trusts or by companies for FIF interests of at least 10%, and for which the other DRR method requirements (excluding the \$250,000 threshold requirement) are met. The method cannot be used by meeting the requirement that FIF interests do not exceed \$250,000.

10. For **income years beginning on or after 1 July 2011**, the main distinctions in the case of trusts that are not family trusts, and companies, with a FIF interest that is an ordinary share in a foreign company, are:

- (a) A PIE (either a trust or a company) cannot use the AFI method.
- (b) A company, or a trust that is not a family trust, cannot use the CV method.
- (c) Consequently there is no restriction on the use of the FDR method by a company or a non-family trust, because the CV method cannot be used.

**Any person with a FIF interest that is non-ordinary shares in a foreign company**

11. If the person holds a FIF interest that is a non-ordinary share in a foreign company, the choices for income years beginning before, and on or after, 1 July 2011 are as follows:

<b>Any person with non-ordinary shares</b>	<b>AP</b>	<b>BE</b>	<b>AFI</b>	<b>FDR</b>	<b>COST</b>	<b>CV</b>	<b>DRR</b>
<u>Pre-1 July 2011 income years</u> Default methods: CV, if it is practical to use it. DRR, if it is not practical to use CV.	✗	✗	✗	✗	✗	✓	✓ Only if no CV
<u>1 July 2011 onwards income years</u> Default methods: CV, if it is practical to use it. DRR, if it is not practical to use CV.	✗	✗	✗	✗	✗	✓	✓ Only if no CV

12. For years commencing before, and on or after, 1 July 2011, the CV method must be used for a FIF interest that is a non-ordinary share in a foreign company, unless it is not practical because the person cannot determine the market value of the attributing interest at the end of the income year. If the CV method cannot be used, the DRR method must be used.

**Any person with a FIF interest that is a foreign superannuation scheme entitlement or a foreign life insurance policy**

13. This will be covered next week when I will cover the FIF rules on Foreign Superannuation Entitlements and Life Insurance Policies.

**Changing between methods**

14. The general rule is that must be no change unless it is allowed. Once a person uses a particular calculation method to calculate FIF income or loss for an attributing interest in a FIF for a particular period, they must use the same method for interests in the FIF for the next period unless they are allowed to change.

15. A change will be allowed if:

- (a) A method is no longer available, due to a change in the law: a person who used the AP method before it was repealed can change to any other method, and a person who used the BE method before it was repealed can change to the AFI method; or

- (b) The requirements to use the method are no longer met: a person can change from the AFI method if the requirements to use the AFI method are no longer met – for example, the income interest goes below 10% or the FIF is no longer a CFC; or
  - (c) It becomes impossible to use the method because information to perform the calculations is no longer available: a person can change from the AFI method if the information required can no longer be obtained – this could, for example, occur when the active income test is no longer satisfied, resulting in the need for more detailed information to calculate attributable income under the default tax test; or
  - (d) The Commissioner agrees to a requested change.
16. Apart from the above, a person is allowed one “free” change, for each particular FIF, to or from the AFI method. The person must simply notify the Commissioner of the change and the reason for the change of method.
17. A person who wishes to change to or from the AFI method for a second time, for a particular FIF, must not only notify the Commissioner of the change, but must also be able to show that a change in circumstances has significantly altered the person’s ability to obtain sufficient information to use the AFI method and altering their income tax liability is not the principal purpose or effect of the change.
18. Taxpayers can change to using the FDR method from any of the AP, BE or DRR methods in the first income year on or after 1 July 2011, because these method are no longer available for a FIF interest that is an ordinary share in a foreign company. Taxpayers can change to using the FDR method from using the Cost method at any time if it becomes possible to obtain a market value at the start of the year by, for example, the FIF becoming listed on a stock exchange.
19. Taxpayers can stop using the FDR method and change to another method if it becomes impossible to obtain a market valuation at the start of the year other than by independent valuation.
20. Natural persons and trustees of a trust for the benefit of a loved one or a charity (generally family trusts) can change between the FDR and the CV methods from one year to the next without restriction. However, if the CV method is used in a year for a FIF that the FDR method could have been used for, the FDR method cannot be used in that year.



Arun David, Director,  
DavidCo Limited