Potential failure of the Australian CFC rules in the digital economy

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The controlled foreign company (CFC) regime operates to overcome the situation where resident investors defer or avoid paying tax on their foreign sourced income by retaining profits within their controlled companies abroad. However, its prescriptive approach is concerning as we enter the digital era. One of the features which raises this concern is that income is categorised in a particular manner, which is examined by this article with reference to various revenue models in the digital economy. It observes that the existing framework provides tax planning opportunities with the effect to undermine policy objectives. This deterrence is likely to spread out among multinationals and small taxpayers alike as digitalisation becomes a prerequisite for doing business in modern commerce. The article first explains two structural taxing principles and how they relate to fiscal benchmarks. It discusses the operation of Australia's CFC rules to understand how the capital import neutrality benchmark is applied to exempt certain income from Australian tax. It further identifies key terms that provide the basis for giving this exemption, which are applied to the digital economy to demonstrate the extent to which the CFC rules are ineffective. In concluding remarks, the author suggests possible remedies based on the observations made throughout this article, but emphasises the need for broader analysis taking into account different industries, emerging business models and the use of intangibles. The reform is necessary with clear policy objectives and the consideration of other areas of tax law.

I. GROWING CHALLENGE IN THE DIGITAL ECONOMY

The Australian tax system has long recognised companies as legal persons, hence treating them as separate taxable entities from their owners.[1] The ability to create a company, however, is becoming more problematic as it provides opportunities to minimise or avoid paying taxes. A company created in a low or no taxing foreign jurisdiction can retain profits that would otherwise be allocated to a resident until distributions are made by way of dividends. The controlled foreign company (CFC) regime tackles this deferral effect with tax avoidance measures to restore the nation's tax base, for which the foreign company's income is assumed to be an Australian resident's income, provided that certain conditions are met.

The prescriptive approach of the CFC legislation, however, is at risk of being outmanoeuvred coming into the digital era. Pinto argued that one of the main drivers limiting the operational effectiveness was the underlying design features.[2] The primary design feature of concern is what a CFC is, but, when this concern is overcome, the way that the CFC rules categorise income is equally troublesome.[3] Furthering

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[1] The Australian Government introduced the federal income tax legislation in 1915, which allowed taxing on company's retained profits (after deducting dividends). Facing the revenue need during the World War II, Australia changed this to a rebate system and removed non-resident companies from its tax base. The rebate system collects tax on undistributed profits (before deducting dividends) at the company level whereby the final tax on company profits is adjusted in the hands of shareholders. This characteristic remains as the feature of the Australian corporate taxation for domestic shareholders.

[2] Dale Pinto, "A Proposal to Reform Income Anti-tax-Deferral Regimes" (2009) 12 *Journal of Australian Taxation* 41. The author also mentions about hybridity of entities as the other main driver affecting the effectiveness of the existing CFC rules.

[3] Pinto, n 2.

on his observations, this article examines how various revenue models in the digital economy apply to categorising income in an attempt to provide the basis for considerations when the time comes to reform the CFC rules.

The structure of this article is as follows. The following section briefly explains taxing principles to highlight that different policy objectives cause the adoption of conflicting taxing principles. The policy objectives differ upon whether a business is active or passive, therefore the subsequent part outlines how the CFC rules operate to make such distinction. It observes that tax treatment of income is approached in a categorical manner, from which the remainder of this article discusses various key terms categorising income. It demonstrates that ambiguity of interpreting these terms is greater in the digital context, posing a threat to manipulation. While the balance to achieve different policy objectives is not an easy task, this article argues that reform is justifiable, hence recommending the undertaking of a comprehensive review before potential tax revenue is foregone.

II. Policy intent of the CFC regime

Underlying taxing principles

Australian taxation is founded upon two structural principles, residence-based taxation and source-based taxation. The CFC regime is an extension of residence-based taxation as residents are taxed on their earnings. While the norm is to tax on direct earnings only, the CFC rules extend the taxing power to indirect earnings made through CFCs. It essentially taxes on foreign sourced income earned by foreign companies where the Australian taxation is justified on the basis that resident shareholders have the ability to shelter the income. The OECD rationalises that the sheltered income is deemed:

> i) [t]o be distributed ('fictive dividend' approach); or
> ii) [t]o have arisen in the hands the shareholder, i.e., that the company's activities are to be attributed to him ('piercing the veil' approach); or
> iii) [t]o have improved the ability of the shareholder to pay taxes because economically it is at his disposal, thus constituting a capital yield of a special nature.[4]

From an economic standpoint, residence-based taxation is supported by capital export neutrality (CEN) which promotes investors bearing the same tax burden irrespective of where they invest. This benchmark supports the mechanism of tax offsets for foreign tax paid or payable so that the amount of domestic tax among resident investors is neutral. Sandler notes that deferral or avoidance of domestic tax by establishing a company overseas hinders the CEN objective, which arises from the combination of which (1) a company is treated as a separate taxpayer from its shareholders and (2) there are jurisdictions which impose very low or no tax on certain entities or income.[5] As the retention of a taxable amount increases a potential return on investment by way of internal reinvestment as well as the time value of money, the CFC rules scrutinise separate entities in tax havens which are controlled by resident investors.

Modifications for active business

Sandler then provided two extreme mechanisms to overcome the deferral or avoidance effects, (1) exemption of foreign sourced income as it eliminates the relevance of deferral in domestic taxation, and (2) complete elimination of deferral by taxing on all income of foreign companies controlled by resident investors.[6] Australia does not adopt the complete elimination of deferral, but rather designates certain income as falling under the CFC rules. It is not of immediate concern as the scope of this income

[4] OECD, "International Tax Avoidance and Evasion: Four Related Studies" in *Issues of International Taxation* (OECD, 1987) Vol 1, [24].

[5] Daniel Sandler, *Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries* (Kluwer Law International, 2nd ed, 1998) 4-5.

[6] Daniel Sandler, *Pushing the Boundaries: The Interaction between Tax Treaties and Controlled Foreign Company Legislation* (Institute of Taxation, UK, 1994) 9-10. In the United States, the Kennedy administration proposed the complete elimination of deferral in 1962. It was rejected, and passive income and certain base company income from sales and services were included within the scope of the CFC rules.

is broad. However, the rigidity of this categorical approach here indicates that any issue in relation to income categorisation may not easily be remedied.

At the same time, the exemption method applies to certain income earned from active business. The policy objective for this exemption was conveyed at the introduction of the CFC regime in the Explanatory Memorandum to the *Taxation Laws Amendment (Foreign Income) Bill 1990* (Cth) and the *Taxation (Interest on Non-Resident Trust Distributions) Bill 1990* (Cth) as below:

> The broad aim of the proposals in relation to companies is to attribute to Australian residents income, **other than active business income**, derived by foreign companies that are controlled by Australian residents other than in the case of a company that is subject to a tax system comparable to Australia's or is predominantly engaged in active business.[7]

This approach is consistent with the tax treatment on active businesses outside the CFC rules. For example, branch profits of a resident's business abroad are exempt from Australian tax.[8] The policy driver for this is that resident enterprises retain relative competitiveness in global markets. It acknowledges that locating a business function in a particular jurisdiction is not always tax-driven, as evidenced in the moving of manufacturing to a country where labour is cheap being an economic decision. Penalising legitimate economic decisions on the basis that incidental tax advantages are generated can be harmful to the nation in a long run.

In contrast to the underlying residence-based taxation of the CFC regime, this measure can be explained by source-based taxation.[9] It is supported by a different fiscal benchmark, capital import neutrality (CIN) which provides that the tax burden of investors who compete in the same market must be neutral. The consultation paper released by the government in 2010 explained the mix of these fiscal benchmarks embedded in Australia's CFC rules:

> Although Australia's tax policy for the treatment of foreign income is diverse, the economic rationale is clear. During the process of the review by the Board of Taxation, it was articulated as a blend of two benchmarks: capital import neutrality (CIN) and capital export neutrality (CEN). … The basis of this blend is that commercial activity should be encouraged; and that, where that activity occurs outside Australia (under Australian ownership) its ability to compete with businesses under foreign ownership should not be impeded by the additional burden of Australian taxation. On the other hand, passive income is derived from more idle investment, which is not core business of a competitive enterprise. Absent the need to compete overseas, there is no justification for Australia to forgo its fundamental right to tax the worldwide income of its residents. If Australia does forgo that right, it will tend to encourage Australian residents to invest for relatively modest yields overseas, in preference to investing in Australia at higher pre-tax yields.[10]

The CIN goal is met by two measures within the CFC regime. First, foreign companies deriving a low level of passive earnings are not subject to the CFC rules (entity approach). Second, certain income is excluded from the CFC rules on the condition that the income is deemed to have been earned from carrying on active business (income approach). For the income approach, there are different conditions upon the type of income. The following section discusses how the two fiscal benchmarks are applied to the operation of Australia's CFC rules.

III. Categorisation of income

Since the United States first introduced the CFC rules in 1962, there were only 22 countries that followed in the footsteps of the United States as at January 2000.[11] In 2015, the OECD commented that "30 of the

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[7] Explanatory Memorandum, *Taxation Laws Amendment (Foreign Income) Bill* 1990 (Cth) and the *Taxation (Interest on Non-Resident Trust Distributions) Bill 1990* (Cth) 3 (emphasis added).

[8] *Income Tax Assessment Act 1936* (Cth) s 23AH.

[9] The author acknowledges criticisms of CEN and CIN. Also, David Weisbach, in his article entitled "The Use of Neutralities in International Tax Policy" (Coase-Sandor Institute for Law & Economics, University of Chicago Law School, 2014), provides useful reference to different economic rationales such as capital ownership neutrality, national neutrality and market neutrality. For the purpose of this article, the concepts of CEN and CIN are considered only, so has the Australian Government.

[10] Commonwealth, *Reform of the Controlled Foreign Company Rules*, Consultation Paper (July 2010) 3.

[11] Pinto, n 2, 51.

countries participating in the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project had CFC rules, and many others [had] expressed interest in implementing them".[12] Although CFC rules are a unilateral measure, common features can be observed at a high level, which are, to define the scopes of taxpayers (by their control over a foreign entity), attributable income and tax havens. This section examines the scope of attributable income and how income may be exempt from this scope while excusing discussions that other design features may be affected by the digital economy.[13]

Attributable income

The characterisation of income versus capital has proven to be difficult to define in common law. Despite the difficulty, the CFC regime introduces a way to characterise earnings, independent of other tax provisions, for the purpose of determining the tax base of a CFC. It provides that "tainted income" is attributable, which comprises of passive income, tainted sales income and tainted services income. These types of income are prima facie passive earnings for the tax treatment pursuant to the CEN objective. While there are exceptions, this article does not explore them further as being outside its scope.[14]

Passive income generally refers to investment income from a capital input which requires minimal exertion.[15] Tainted income, also referred to *base company income*, includes:

(1) **sales income** from goods bought from, or sold to, an **Australian associate*;[16]
(2) **sales income** from manufactured goods of which any of the raw materials or goods were bought from an Australian associate;[17] and
(3) **services income** is from the provision of services to an **Australian customer*.[18]

Note 1. For the purpose of this article, an *Australian associate* means (1) an associate and Part X Australian resident or (2) an associate who is not a Part X Australian resident but carries on business at or through a permanent establishment in Australia.[19]

Note 2. For the purpose of this article, an *Australian customer* means (1) a Part X Australian resident who does not receive services in connection with carrying on business at or through a permanent establishment outside Australia or (2) a non-Part X Australian resident who receives services in connection with carrying on business in Australia.[20]

There has been criticism that base company income may not be passive earnings per se. The Tax Institute of Australia submitted that there was no sound tax policy basis for including the base company income within the scope of tainted income:

> We would submit that there is no tax policy basis for the tainted services income (TSI) definition to include income earned by a CFC from providing services to Australian customers, especially customers who are not associates of the CFC. International transfer pricing tax laws, which are the single biggest tax issue facing most multinational businesses, simply do not permit the 'deflection' of services income

[12] OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report,* OECD/G20 Base Erosion and Profit Shifting Project (2015) 9.

[13] For example, digitalised transactions make it difficult to identify the correct taxpayer for the purpose of assessing tax residence.

[14] If a CFC is a resident in one of the listed countries (which are currently Canada, France, Germany, Japan, New Zealand, United Kingdom of Great Britain and Northern Ireland and United States of America), limited tainted income prescribed as "eligible designated concession income" applies only. Also, certain income such as certain types of trust income applies automatically.

[15] *Income Tax Assessment Act 1936* (Cth) s 446. Passive income of a statutory accounting period includes dividends, unit trust dividends, a distribution taken to be a dividend, tainted interest income, annuities, tainted rental income, tainted royalty income, consideration for the assignment of any copyright, patent, design, trade mark or other like property or right, income from trading tainted assets, get gains from disposing tainted assets, net tainted commodity gains and net tainted currency exchange gains.

[16] *Income Tax Assessment Act 1936* (Cth) s 446(1)(a)-(b).

[17] *Income Tax Assessment Act 1936* (Cth) s 447(1)(c).

[18] *Income Tax Assessment Act 1936* (Cth) s 448(1).

[19] See *Income Tax Assessment Act 1936* (Cth) ss 317-318 (definitions of "Part X Australian resident" and "associates" respectively).

[20] See *Income Tax Assessment Act 1936* (Cth) s 317 (definition of "Part X Australian resident").

> to a low-tax country. … In our view, there is no tax policy justification for continuing the position that taxes an Australian shareholder on its share of income from a CFC's sales to its Australian customers. Such a policy inhibits the offshore expansion of Australian multinationals, including via investment in joint ventures and creates a tax and compliance cost that is not faced by other participants in international markets.[21]

The Board of Taxation made a recommendation in 2008 to remove the base company income rules and develop integrity rules instead.[22] As this recommendation was not implemented, base company income continues to include income that may be earned from legitimate offshore businesses. It may appear contrary to the CIN benchmark applicable to active businesses, but the design is so to remove "any taxation incentive for conducting activity offshore, regardless of whether genuine business operations are being conducted".[23] Effectively, the CEN goal to overcome tax deferral or avoidance is intact by catching income that could or should be earned directly by resident investors. For example, tainted sales income targets interposed companies which enable a resident taxpayer to inflate deductions for foreign purchases or to decrease foreign sales income. Tainted services income encompasses all services income in connection with Australia so that mobile activities, particularly those involving intangibles, are not artificially relocated to foreign companies.

Tax treatment of active business income

The "entity approach" excludes foreign companies from the CFC rules if the tainted income amount constitutes less than 5% of turnover (active income test).[24] The scope of this exclusion is narrower than that of active business companies, as tainted income includes the base company income earned from active businesses.

At a superficial level, it attempts to search for whether a CFC has "the ability to earn the income itself" by categorising foreign companies into those carrying on active business from passive business.[25] However, it falls short of assessing the economic contribution by way of functions, assets, risk and other like matters. Giving passive income for an example, royalty income is tainted income if the payer is an associate to a CFC even when the CFC carries out intensive research and development activities for which the royalty is consideration.[26] Using the level of tainted income as a proxy to determine whether a CFC carries on active business is rather obscure. It appears that this measure is intended to simplify the tax system by excluding companies that derive a relatively small proportion of tainted income that is outside the scope of the CFC rules.

This is not at all unfavourable in the context of tax avoidance, as lesser foreign companies are preliminarily eliminated from the CFC rules. It brings into question the next CIN measure, the "income approach" which excludes certain tainted income from the CFC rules on the basis that they relate to active business. Notably, more weight is placed on accurate assessment with this approach as the entity approach does not adequately address the CIN objective.

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[21] Tax Institute of Australia, Submission to the Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes* (6 July 2007) 7-8. This view was also expressed in Deloitte's Submission dated 16 July 2008 at 8.

[22] Commonwealth Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes*, Report to the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs (2009) 27-32.

[23] Commonwealth Board of Taxation, n 22, [3.54].

[24] See *Income Tax Assessment Act 1936* (Cth) s 432(1)(f) (*ITAA 1936*). It states that a company is taken to pass the active income test in relation to a statutory accounting period if, inter alia, the tainted income ratio is less than 0.05. Tainted income ratio is calculated as *gross tainted turnover* divided by *gross turnover* (see *ITAA 1936* s 433). *Gross tainted turnover* consists of (1) passive income, (2) tainted sales income and (3) tainted services income (see *ITAA 1936* s 435). *Gross turnover* broadly means the gross revenue at the statutory accounting period subject to adjustments pursuant to *ITAA 1936* ss 434, 436 (see *ITAA 1936* s 434).

[25] OECD, n 12, 47. The substance approach looks at the ability to earn the income itself.

[26] *Income Tax Assessment Act 1936* (Cth) s 317. It states that tainted royalty income excludes royalties when all of the following conditions are satisfied: (1) the royalties are derived in the course of carrying on business, (2) the royalty paying entity is not an associate and (3) either (a) a CFC originated the matter or thing for which royalty is consideration; or (b) a CFC has substantially developed, altered or improved that matter or thing with result to substantially enhance its market value.

In respect of base company income, the following income is not subject to tax under the CFC rules:

Tainted Sales Income where –

(1) goods are substantially altered and a substantial part of that alteration is carried out by the CFC's directors or employees;[27] or
(2) a substantial part of manufactured goods is carried out by the directors or employees;[28] or

Tainted Services Income where –

(3) services are directly related to goods and the goods are either substantially altered with the result of enhancing market value or not acquired from another entity (self-produced).[29]

The observations from the above are as follows. First, the exclusion of tainted sales income depends on whether the sales involve goods or manufactured goods. Substantial alteration in the above only applies to *goods*, not *manufactured goods*, which indicates that the activity of manufacturing is taken to be active business. Second, the conditions on which income is excluded differ upon whether income is derived from a sale of goods or a provision of services. Tainted sales income, for example, requires that directors or employees carry out substantial alteration or manufacturing of goods. On the other hand, the underlying goods for tainted services must be either internally enhanced in value or self-produced.

This disparity presents a concern that the CIN benchmark may be misused in circumstances where income is categorised as either tainted sales income or tainted services income. The following section considers whether the digital economy intensifies this concern. It examines key terms such as "manufacturing" and "goods" which provide the principles for categorising income. Also, the meaning of "substantial alteration", which provides the basis for excluding certain tainted income from the scope of the CFC rules, is sought. It proposes that greater ambiguity in applying the terms to the digital economy carries more opportunities for tax planning, hence justifying reform of the CFC rules.

IV. What is manufacturing?

The use of "manufactured goods" appears to overcome the narrow interpretation of "goods" as in finished goods and avoids the exclusion of sales income by an artificial change in the identity of goods. Australian courts have considered the meaning of "manufacturing" in relation to the old *Sales Tax Assessment Act (No 1) 1930* (Cth) shedding some light through common law.

In *WEA Records Pty Ltd v Federal Commissioner of Taxation* (*WEA Records*),[30] the duplication process of master video tapes onto cassettes was determined to be manufacturing because a commodity was brought into existence. Davies J said:

> [T]he duplication process … brought into being a commodity which was different from the blank cassettes on which the videos were recorded. A cassette adapted to take a video recording is one thing. A cassette containing a video recording is another … The commodities are different because the video recording, which is the predominant feature of the one, is absent from the other. The process whereby this occurs is not mere treatment but production and, to my mind, manufacture, using that term in its ordinary sense.[31]

In *Commonwealth of Australia v Genex Corp Pty Ltd* (*Genex*),[32] the developing process of photographic films into negatives was distinguished from the *WEA Records' Case*. The ordinary meaning of manufacturing is "to ask whether that which is made is 'a different thing' from that out of which it is made".[33] The chemical process for removing the silver substance that was not exposed to the light and

[27] *Income Tax Assessment Act 1936* (Cth) s 447(4).

[28] *Income Tax Assessment Act 1936* (Cth) s 447(4A).

[29] *Income Tax Assessment Act 1936* (Cth) s 448(3).

[30] *WEA Records Pty Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 799; 96 ALR 365.

[31] *WEA Records Pty Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 799; 96 ALR 365, 370.

[32] *Commonwealth of Australia v Genex Corp Pty Ltd* (1992) 176 CLR 277; 24 ATR 328.

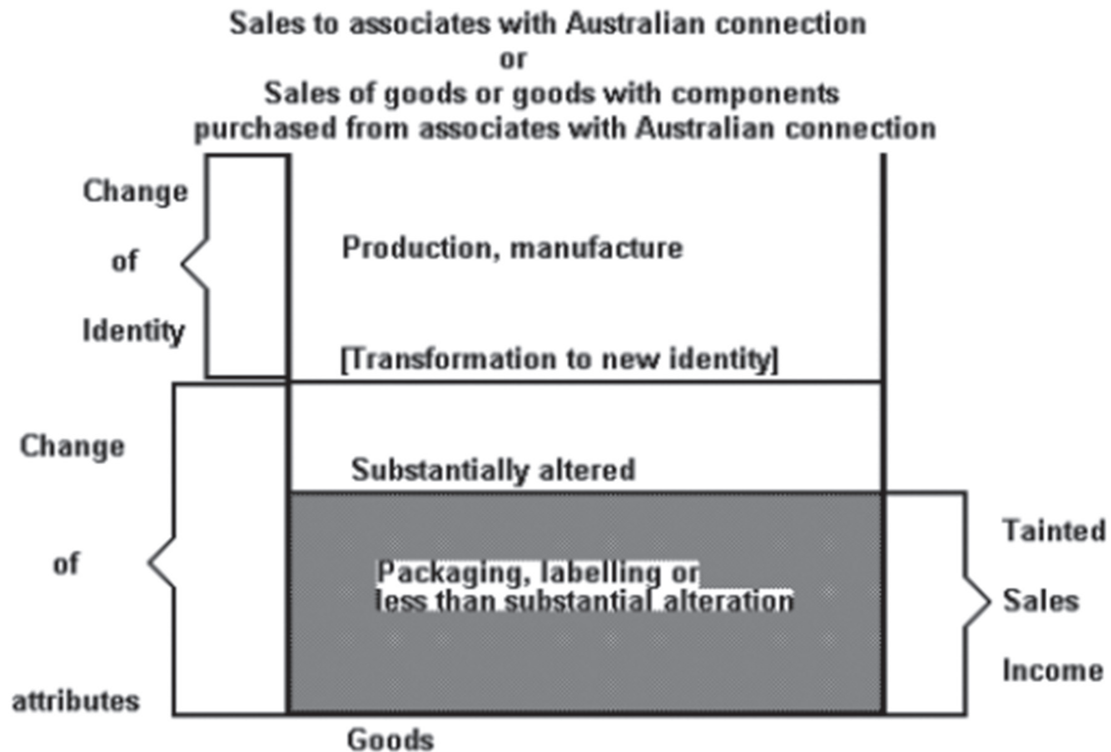
[33] *Commonwealth of Australia v Genex Corp Pty Ltd* (1992) 176 CLR 277, [17]; 24 ATR 328, referring to *McNicol v Pinch* (1906) 2 KB 352, 361 (Darling J).

subsequently making an image visible on the plastic film did not bring a new commodity into existence. The court agreed with Mahoney J in the appellate court and Hill J in the Full Federal Court, which inferred that the process was a service involving modification to the existing goods[34] because the plastic film remained the same goods whether they were "unexposed, exposed, or so treated that the chemical upon them disclose in negative form the images to which they were exposed".[35]

The case did not address a situation where a blank plastic film (or blank films) could be put underneath the original film during the developing process for duplication. According to the *WEA Records' Case*, the process of making a copy creates a new commodity, hence being designated as manufacturing. However, the same process is to be considered a service in respect of the original film according to the *Genex's Case*.

This separate treatment of the same process for the meaning of manufacturing generates difficulty when uncertainty exists as to what is considered a new commodity. In the simple model of cloud computing, the original software is temporarily recreated on a server and each subscriber has the right to use the software remotely.[36] One may argue that the process of recreating the software on the server is manufacturing by reason of a commodity being brought into existence. It is, however, also valid to argue that the process does not constitute manufacturing due to the temporary nature of the software, falling short of constituting a new commodity. From a taxpayer's point of view, it is beneficial to characterise an activity as manufacturing, as sales income from manufactured goods avoids being taxed under the CFC rules. See Figure 1 below.[37]

FIGURE 1. CIN measure of tainted sales income.



[34] *Genex Corp Pty Ltd v Commonwealth* (1991) 30 FCR 193, 22 ATR 178; 101 ALR 161, 173 (Hill J).

[35] *Kodak (A/asia) Pty Ltd v Commonwealth* (1990) 21 NSWLR 402, 408-409 (Mahoney J); 21 ATR 1096.

[36] Lothar Determann, "What Happens in the Cloud: Software as a Service and Copyrights" (2014) 29 *Berkeley Technology Law Journal* 1095, 1099-1100. Note the Graphical User Interface may be predictable expressions (eg text and graphics) or more complicated expressions as often seen in gaming or video footage.

[37] Explanatory Memorandum, *Taxation Laws Amendment Act (No 2) 1992* (Cth) Ch 5.

The figure shows an orderly linear value chain for commoditising goods. This model, however, hinges on the manufacturing process being clear cut. In other words, whether goods are changed in their identity as opposed to attributes. This notion is troublesome in the context of digital goods, as seen in the example of cloud computing. It raises a question as to whether distinguishing manufactured goods from goods is necessary.

In terms of the CIN measure, there is no substantial difference in determining active business whether goods are manufactured or substantially altered. Rather, manufacturing is used as a *tick-of-a-box* to ascertain that genuine business activities are carried out. In the author's view, there is no clear benefit conferred in segregating manufactured goods from goods, particularly in the digital context. Provided that substantial alteration of goods has the capacity to consolidate manufacturing within its meaning, it is recommended that the reference to manufacturing be removed from the CFC rules.

After overcoming issues arising from the term "manufacturing", the meaning of "goods" remains essential for characterising income. In the earlier example of cloud computing, it may also be argued that, even though there are goods, income is derived from the subscription provider's ability to enable subscribers to use the software as well as to store and retrieve information on servers. The income is then categorised as services income where the CIN measure requires that the services are provided to an Australian customer instead of requiring dealings with an associate. An indirect provision of services through a nonresident company or companies is also captured as tainted services income in this concept.[38]

V. What are goods?

Depending on how much focus is given to "goods", income may be categorised as sales income or services income. Services income does not include income from the sales of goods.[39]

Within the CFC rules, the term "goods" is defined to include "(a) ships, aircraft and other vehicles; (b) animals, including fish; (c) minerals, trees and crops, whether on, under or attached to land or not; and (d) gas and electricity".[40] This is not of great value in the discussion of the digital economy, therefore the ordinary meaning is to be sought to extract the characteristics of goods. The *Macquarie Dictionary* states that goods are "possessions, especially movable effects or personal belongings" such as "articles of trade; wares; merchandise, especially that which is transported by land".[41] Tangibility stands out as an obvious feature of goods in this definition.

Tangibility

Boulding pointed out that the terms "goods" and "services" were used as if they were one word, "goodsandservices" and noted that the distinct characteristics needed to be conceptualised in cross-disciplinary studies.[42] In the field of marketing, the distinction between goods and services is particularly important, as marketing uses different strategies and methods depending on whether retailing deals with goods or services. Traditionally, tangibility was thought to be one of the primary attributes for the distinction. This has, however, received considerable criticism in recent years. For example, in the traditional model, it has been established that a physical DVD is a good. However, it is unclear whether a downloadable movie containing the same screen play should be classified as a good or servicing a good. If a downloadable movie is classified as a good, relevance of tangibility as the feature to distinguish goods from services diminishes. When a downloadable movie is classified as either goods or services, the need for differentiated marketing is questionable.

[38] *Income Tax Assessment Act 1936* (Cth) s 448(1A).

[39] *Income Tax Assessment Act 1936* (Cth) s 448(2).

[40] *Income Tax Assessment Act 1936* (Cth) s 317 (definition of "goods").

[41] *Macquarie Dictionary* (Macquarie Library, 2005) (definition of "goods").

[42] Kenneth Boulding, "Notes on Goods, Services, and Cultural Economics" (1997) 1 *Journal of Cultural Economics* 1.

Other traditional attributes used alongside tangibility are perishability, inseparability and variability.[43] Perishability comes from the same stem of tangibility. Inseparability and variability are characteristics attached to services, which affirms or rejects the existence of goods in an opposing manner. However, technology enables services to be provided with consistency and minimal human activities, hence dissatisfying the inseparability and variability of legitimate services in favour of the classification of something as goods.

For the purposes of the Goods and Services Tax (GST), tangibility distinguishes goods from services by the definition of goods meaning "any form of tangible personal property".[44] That said, it generally makes little difference in terms of tax outcomes as the tax is imposed on the value added, irrespective of whether value-adding activities are performed for goods or services. Notably, in the GST legislation, bitcoins are treated as tradable assets in a goods-like manner although they are intangible property satisfying all characteristics of services discussed above. Intangible property is generally treated in this manner in taxation. The capital gains tax is a good example where tax is imposed on the transfer of an asset that is "any kind of property" which includes intangible property.[45] It observes that tangibility along with the other attributes mentioned above is a seemingly outdated concept to categorise sales income and services income.

Ownership

Ownership may be used to characterise goods, which was advocated by Polito who said: "the transfer ownership identifies a good, and the change in the condition of an object identifies a service."[46] The transferability of ownership, hence tradability, was also highlighted by Rathmell as a feature of goods.[47]

Under the ownership model, intangibles can be recognised as goods, as in property law. However, making a distinction has never been an easy task. The characterisation of electricity as goods in *Peter Jägerskiöld v Torolf Gustafsson*[48] raised much uncertainty while digital goods are further blurring the line between goods and services.[49] Challenges are seen in the context of the European Union (EU) internal market law, which has two distinctive sets of rules: free movement of goods and free movement of services. There were two cases, *Usersoft GmbH v Oracle International Corp* (*UserSoft*)[50] and the joint cases of *Football Association Premier League Ltd v QC Leisure* and *Karen Murphy v Media Protection Services Ltd* (*Premier League*),[51] which attracted much attention.

In the *UserSoft's Case*, a German company bought second-hand software licence keys and sold them to customers who then directly downloaded software from the copyright holder, Oracle's website. Although the licence keys may fall short of constituting goods in the absence of delivering software to customers, the European Court of Justice (ECJ) applied the *exhaustion principles*[52] under the freedom of movement

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[43] Robert Winsor, Jagdish Sheth and Chris Manolis, "Differentiating Goods and Services Retailing Using Form and Possession Utilities" (2004) 57 *Journal of Business Research* 249, 250.

[44] *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 195-1. It states that *goods* means any form of tangible personal property.

[45] *Income Tax Assessment Act 1997* (Cth) s 108.5.

[46] Tony Polito, "Extending the Product Process Diagonal to Service Organizations" (Proceedings for the 1996 Annual Meeting of the Northeast Decision Sciences Institute, St Croix, 17 April 1996).

[47] John Rathmell, "What Is Meant By Services" (1966) 30 *Journal of Marketing* 32.

[48] *Peter Jägerskiöld v Torolf Gustafsson* (C-97/98) [1999] ECR I-7319.

[49] This phenomenon is also discussed with reference to streaming, downloading codes and data processing services in the OECD's report. See OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (2015) 53.

[50] *Usersoft GmbH v Oracle International Corp* (C-128/11) [2006] ECR I-0000.

[51] *Football Association Premier League Ltd v QC Leisure* (C-403/08) and *Karen Murphy v Media Protection Services Ltd* (C-428/08) (2011) ECR I-9083.

[52] Notably, a second-hand sale of digital contents is generally prohibited in Australia. See Jessica Stevens, "The Secondary Sale, Copyright Conundrum: Why We Need a Secondary Market for Digital Content" (2016) 26 AIPJ 179.

of goods to affirm the rights conferred in the initial purchase without further control by the copyright holder.[53]

In the *Premier League's Case*, the licence holders with the exclusive territorial right to broadcast sporting matches sued locals who bought foreign decoders against copyright infringement. The ECJ applied the freedom of movement of services on the basis that the decoder was only an instrument to enable services and the decrypting process by the decoders did not go beyond the benefit of the reception.

Hojnik observed that the ECJ was not taking a consistent approach to define digital goods, raising concerns about legal consequences in other areas of law (such as VAT).[54] Apart from the difficulty of applying the ownership model when the focal point of a transaction in relation to digital goods is uncertain, the pragmatic issue as to ownership is also that the legal ownership can be easily circumvented.

Economic ownership

In Australian taxation, the concept of economic ownership is used at times to prevent manipulation of the form. For example, a hire-purchase agreement is treated as if it were a sale of an asset for the purposes of capital gains tax.[55] The approach of using the economic basis over the form is also found in various tax provisions. For example, Australia uses the substance approach to determine whether an interest is of debt or equity.[56] The transfer pricing provisions instruct to disregard the form to the extent that the actual commercial or financial relations differ from the substance of those relations.[57] Anti-avoidance provisions tackle tax arbitrage, for which the substance may prevail the form.[58]

To achieve economic taxation, a tax effect should be indifferent regardless of whether an entity is undertaking research and development activities under a services agreement or a sales agreement. Similarly, there should be no tax preference if a travel agency, instead of helping customers buy tickets without taking temporary ownership in the middle, buys and sells the tickets as customers confirm their commitment for purchase.

It is an interesting question to ask when one can say economic ownership of digital goods is transferred. Let us start from software as goods according to the international standards.[59] It is understood that goods that were traditionally delivered in the physical form should be treated as goods even when the mode of delivery is changed (eg books, videos, software installation CDs, etc.) The transmission of satellite signals are never delivered in the physical form, therefore advertisements on the television can be concluded to be services.[60] This raises a question about movies as they can be delivered in the physical form but also be delivered via satellite for broadcasting, subscriptions, renting or buying. The general notion is that broadcasting and subscriptions are services. Determining the transfer of economic

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[53] Thomas Dreier, "Online and Its Effect on the 'Goods' Versus 'Services' Distinction" (2013) 44 *IIC International Review of Intellectual Property and Competition Law* 137, 138.

[54] Janja Hojnik, "Technology Neutral EU Law: Digital Goods within the Traditional Goods/Services Distinction" (2017) 25 *International Journal of Law and Information Technology* 63, 72-73.

[55] *Income Tax Assessment Act 1997* (Cth) s 104.5 (Event number B1).

[56] *Income Tax Assessment Act 1997* (Cth) Div 974. Australia's debt-and-equity rules have the power to re-characterise a debt interest on an aggregation basis to an equity interest upon the substance.

[57] *Income Tax Assessment Act 1997* (Cth) s 815-130(2).

[58] *Income Tax Assessment Act 1936* (Cth) Pt IVA. It comprises of the general anti-avoidance rules, the multinational anti-avoidance law and the diverted profits tax.

[59] Australia is a party to the Nice Agreement which establishes the international classification of goods and services for the purposes of registering trade marks and service marks. According to Class 9 of the *Nice Classification* (2017, 11th ed), goods include, inter alia, "all computer programs and software regardless of recording media or means of dissemination, that is, software recorded on magnetic media or downloaded from a remote computer network". Under Class 42 and Class 45, the following items are categorised as services: software-as-a-service (SaaS), rental, updating, maintenance and installation of computer software, computer software design, computer software consultancy and licensing of computer software.

[60] *Giuseppe Sacchi* (C-155/73) [1974] ECR 409. It affirms that advertisements transmitted by television signals are considered as services under a treaty.

ownership for renting is intricate. For instance, if the measurement is upon the limitation of availability such as duration of renting, publication and journals downloaded under subscriptions which become available to subscribers for forever can be said to have the economic ownership transferred.

Today, information flows quickly and also becomes redundant quickly (eg news, market research, etc). The importance of possession is becoming less relevant in some areas. If the value of ownership lowers, correspondingly, businesses may sell digital goods at the price of lease to convert services income to sales income. There is no cost involved in copying, and the customer's action of downloading remains the same irrespective of whether digital goods are leased or purchased. It notes that different tax treatment of goods or services makes room for manipulation in the digital context.

Mode of delivery

It has been observed that the distinction between goods and services is not clear based on ownership, either legal or economic. Subsequently, an alternative basis may be considered in practice. Here examines the mode of delivery.

The delivery of separable software may be sales income approaching the separability attribute from the perspectives of goods (instead of inseparability of services), and the delivery of software on an ongoing basis such as cloud offerings and subscriptions may be services income. Unfortunately, issues can also arise, when those deliveries are offered as one. Their interconnected functionality makes it difficult to separate income for categorisation. An analogous example is Internet Explorer where it is downloaded on the computer initially with an icon but its use is meaningless without the internet connection.

The continuous development in information and communication technology and new revenue models subsequently create a significant question mark as to what makes sales income as opposed to services income. With this ambiguity, the next part examines the meaning of "substantial alteration", in relation to which sales or services income may be exempt from tax under the CFC rules.

VI. What is substantial alteration?

The exemption applies to active business, and the active business is assumed to be carried on when goods from which sales income is derived, or in relation to which services income is derived, are substantially altered (or manufactured). As mentioned earlier in reference to the *Genex's Case*, the same activity can relate to a sale or service, hence this consistency in respect of both types of income being commendatory. Besides, there is no consideration of the proprietor's intention, motive or purpose and attempts to find objective factors. The appropriate starting point is whether an activity is taken to have made a "substantial alteration" to goods.

The meaning of "substantial" in the expression of "a substantial part" was considered in the South Australian Supreme Court. Mayo J in *AE Terry's Motors Ltd v Rinder*[61] said:

> 'Substantial' is not a word with a fixed meaning in all context. In certain associations it can be taken to stress the quality of solidarity or strength. I may be related to the appearance of some physical object. With other concepts it may refer to weight, volume, or area.[62]

The ambiguity was articulated in *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union*:[63]

> The word 'substantial' is not only susceptible of ambiguity: it is a word calculated to conceal a lack of precision. In the phrase 'substantial loss or damage', it can, in an appropriate context, mean real or of substance as distinct from ephemeral or nominal. It can also mean large, weighty or big. It can be used in a relative sense or can indicate an absolute significance, quantity or size. The difficulties and uncertainties which the use of the word is liable to cause are well illustrated by the guidance given by Viscount Simon

[61] *AE Terry's Motors Ltd v Rinder* [1948] SASR 167.

[62] *AE Terry's Motors Ltd v Rinder* [1948] SASR 167, 180 (Mayo J).

[63] *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union* (1979) 42 FLR 331.

> in *Palser v. Grinling* (1948) AC 291 where, after holding that, in the context there under consideration, the meaning of the word was equivalent to 'considerable, solid or big', he said: 'Applying the word in this sense, it must be left to the discretion of the judge of fact to decide as best he can according to the circumstances of each case …' (1948) AC, at p 317. (See also *A.E. Terry's Motors Ltd. V. Rinder* (1948) SASR 167, at p 180 and *Granada Theatres Ltd. V. Freehold Investment (Leytonstone) Ltd.* (1958) 1 WLR 845, at p 848.)[64]

The views by the court have been as diverse as something that is not merely trivial or minimal, but something that is of significance.[65] In the quantitative sense, this is equivalent to "some" to "much", but not necessarily the "most".[66] The cases dealing with trademarks have also shown a similar approach, where the word "substantial" in the expression of "substantial difference" could mean merely distinctive in comparison to another art[67] or significantly different from the fundamental form.[68] After all, it is "matters of degree".[69] It needs to be understood in the context of the legislative intent.[70]

Obviously, further judgment is necessary in relation to the provision of services. The legislation requires that services must be *directly related to* goods which are subject to the substantial alteration test. The meaning of "directly related to" is also subjectively measurable as for the words "substantial alteration". Davies J in *Hatfield v Health Insurance Commission*[71] said:

> Expressions such as 'relating to', 'in relation to', 'in connection with' and 'in respect of' are commonly found in legislation but invariably raise problems of statutory interpretation. They are terms that fluctuate in operation from statute to statute. … The terms may have a very wide operation but they do not usually carry the widest possible ambit, for they are subject to the context in which they are used, to the words with which they are associated and to the object or purpose of the statutory provision in which they appear.[72]

The Full Federal Court approved this in *Burswood Management Ltd v Attorney-General*,[73] determining that the reference to past cases was of little assistance and the meaning should be considered in the context of the relevant statute.[74] It is notable that some cases considered that "substantial alteration" excluded creating something new that made the original no longer identifiable.[75] However this does not seem to apply to the CFC rules when substantial alteration is considered a threshold by which legitimacy of active business is determined.

The Explanatory Memorandum to the *Taxation Laws Amendment Act (No 2) 1992* (Cth) states that the use of "substantial" or "substantially", for the purpose of the CIN measure, means "large or weighty" or "considerable, solid or big".[76] Due to the subjectivity inherent in this concept, a benchmark may be used in practice to determine whether goods are substantially altered. For example, the Australian Taxation

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[64] *Tillmanns Butcheries Pty Ltd v Australasian Meat Industry Employees' Union* (1979) 42 FLR 331, 348 (Deane J).

[65] *R v Lloyd* [1967] 1 QB 175, 177. It gives the meaning to something that is not merely "trivial or minimal".

[66] *Re Cashin* [1992] 2 Qd R 63 (Demack J).

[67] See, eg, *Macrae Knitting Mills Ltd v Lowes Ltd* (1936) 55 CLR 725, 731; *British Franco Electric Pty Ltd v Dowling Plastics Pty Ltd* (1981) 1 NSWLR 448, 461; *Dart Industries Inc v Décor Corp Pty Ltd* (1989) 15 IPR 403; *Rapee J & Co Pty Ltd v Kas Cushions Pty Ltd* (1989) 90 ALR 288.

[68] See *Dalgety Australia Operations Ltd v FF Seeley Nominees Pty Ltd* (1986) 10 FCR 403.

[69] See *R v Resource Planning & Development Commission; Ex parte Aquatas Pty Ltd* (1998) 100 LGERA 1; *Addicoat v Fox (No 2)* [1979] VR 347; *R v Land Use Planning Review Panel* (1998) 103 LGERA 38.

[70] *R v Resource Planning & Development Commission* (1999) 103 LGERA 181; [1999] TASSC 60.

[71] *Hatfield v Health Insurance Commission* (1987) 15 FCR 487.

[72] *Hatfield v Health Insurance Commission* (1987) 15 FCR 487, 491.

[73] *Burswood Management Ltd v Attorney-General* (1990) 23 FCR 144.

[74] *Burswood Management Ltd v Attorney-General* (1990) 23 FCR 144, 146.

[75] See *R v Land Use Planning Review Panel* (1998) 103 LGERA 38; *R v Resource Planning & Development Commission* (1999) 103 LGERA 181; [1999] TASSC 60.

[76] Explanatory Memorandum, *Taxation Laws Amendment Act (No 2) 1992* (Cth) Ch 5, quoting *Palser v Grinling* [1948] AC 291, 317.

Office uses a benchmark of 10% of the value, or less depending on circumstances, for the purposes of GST.[77] It is known that such a benchmark is susceptible to abuse.

Instead, focus may be given to whether substantial alteration is carried out by directors or employees, which is currently required for sales income only. However, it is also not a sound basis, as digitalisation has significantly reduced human involvements, hence not reaching the legislative objective to overcome tax avoidance. Within the scope of a digital business, *minimal* activities may be enough to argue for an exclusion of tainted income. How much is too little in the digital context? The answer is not modest. If one compares digital expressions to putting a front page of this article or changing fonts of the entire article from Arial to Times New Roman, this comparison is not truly apples-to-apples, while visual effects are undoubtedly important. A bunch of codes in a programming language do not make sense to a vast majority of end users.

An obstacle also arises in relation to services income. Instead of directors or employees' exertion, it requires enhancing the market value of goods unless goods are internally produced. The precise theory for placing the importance on goods instead of the substance of services is uncertain, but it is consistent with the observations that Winsor et al made in respect of what is a "logical, functional and strategically sound schema" for characterising transactional activities.[78] It was suggested that the "degree of the change in the condition of an object" (or service value added) must be considered with the "degree to which possession or ownership of [underlying] goods transferred to the customer".[79]

Enhancement of the market value is easily achievable by way of adding, modifying or even bundling of goods. Besides, it is also difficult to judge whether goods are not acquired from another entity for the same reason, which is an alternative criteria to satisfy exempted services income, as well as the reason that abundant information and technology are free-ridden these days. Drawing a line at which a service product is considered to be internally produced is difficult.

This highlights an important aspect, intangibles. Intangibles are mobile, hence easily relocatable. The value enhanced by the use of intangibles is difficult to measure where the value of intangibles themselves is hard to measure. The OECD suggests that CFC rules embed *excess profit analysis*, independent of the substance approach discussed above, as an added rule to catch profits that are above a normal return on investment when intellectual property is used.[80] It considers that CFC rules do not apply when a parent in Australia sells manufacturing-related intellectual property to a subsidiary in a low or no taxing jurisdiction whereby the subsidiary derives excess profits from the use of intellectual property. The subsidiary's profits are exempt from tax by reason of carrying on manufacturing activities.

It is directly relevant facing the digital economy as it involves high utilisation of intangibles. The digital economy may increase the scope of services where tainted services income can escape the CFC rules by reason of value enhancement of underlying goods. While the substantial alteration test remains subjective, intangibles facilitate the exemption conditions to be satisfied. The issue is real, as some countries like Singapore attract businesses that own and manage intangibles.[81] There are incentives for taxpayers to relocate intangibles, which subsequently increases the risk of a potential revenue loss in Australia. Despite this, whether Australia considers excess profits analysis is not known to date.

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[77] Goods and Services Tax Ruling, GSTR 2001/7, [43]. See also *A New Tax System (Goods and Services Tax) Act 1999* (Cth) s 188-25.

[78] Winsor, Sheth and Manolis, n 43, 249.

[79] Winsor, Sheth and Manolis, n 43, 253.

[80] OECD, n 12, 49-50. It provides an exemplary formula where the excess return is calculated as the total return subtracted by a normal return. A normal return is a risk-bearing return that a normal investor would expect to make, which is calculated as a rate of return multiplied by eligible equity.

[81] Alan Ross and Sui Fun Chai, 'Bracing for New Global Tax Rules: A Look at what OECD's Action Plan Means for S'pore Policymakers and Businesses and What they Need to Do', *The Business Times* (Singapore), 24 July 2013.

VII. Conclusion

This article highlights that the existing CFC rules do not adequately address various revenue models in the digital economy. They use the traditional concepts of the tangible world to categorise income. While any categorisation in taxation raises concern for the abuse of tax concession, the CFC rules are of particular concern as it generously provides tax exemption. Information and communication technology is rapidly developing, and the internet enables any person to reach the global market with reasonable operating costs. Digitalisation has become a feature of the modern economy affecting multinationals and small taxpayers alike. In this climate, taxpayers are presented with more opportunities, and little restriction, to divert profits circumventing the CFC rules.

Under the CFC rules, certain income is exempt from tax provided that it is taken to be earned from active business. The conditions on which this exemption is given differ upon whether sales income is derived from goods or manufactured goods or whether income is derived from goods or services. Subsequently, the key terms making these distinctions such as “manufacturing”, “goods” and “substantial alteration” were examined.

It was found that the principles governing the interpretation of these terms were ambiguous in the digital context. It was subsequently suggested that the reference to manufactured goods be removed and consolidated it to the treatment of goods, as the existing distinction may lead to arbitrary exclusion of non-active businesses from the scope of the CFC rules. In addition, the following suggestions may be drawn with respect to the redesign of attributable income:

(1) the wider definition of attributable income as a starting base;
(2) the consolidation of tainted sales income and tainted services income;
(3) the application of consistent criteria for exempting tainted income irrespective of how income is categorised;
(4) the use of alternative substance analysis to identify active business (eg functions, assets, risks or other like substance); and/or
(5) the inclusion of excess profits analysis, independent of the substance analysis, when intellectual property is exploited.

There are limitations to these suggestions, which is that the scope of this article is narrowly focused on income categorisation under the existing CFC rules. Broader analysis may be necessary, including further study of different industries and emerging business models. Also, the most appropriate mechanism to deal with intangibles must be considered with other tax provisions such as transfer pricing and royalty taxation to ensure coherence of the tax system.

Above all, clear policy objectives need to be established for reform, as mere promotion of CEN and CIN itself is insufficient to justify the underlying framework of the CFC rules. Reform must be imminent, as the longer the CFC rules remain untouched, the more potential revenue may be foregone. Once the sound design of the CFC rules is set, strategic and effective compliance must follow to overcome limited accessibility of foreign information.