

# Treasury Discussion Paper: Foreign source income attribution rules

ASFA Submission

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Association of Superannuation Funds of Australia

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Manager  
Attribution Review Unit  
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The Treasury  
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Dear Sir/madam

## **Treasury Discussion Paper: Foreign source income attribution rules**

Attached please find a response from the Association of Superannuation Funds of Australia (ASFA) to *Treasury Discussion Paper: Foreign source income attribution rules*.

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. Our members, which include corporate, public sector, industry and retail superannuation funds, account for more than 5.7 million member accounts and over 80% of superannuation savings.

ASFA welcomes this initiative by the Government, which seeks to address an issue of growing importance with respect to investments made by superannuation funds, and commends the Government on its timely response to this issue.

On the following pages we have addressed the specific issues that arise from the paper

Should you require further information please contact Robert Hodge, Principal Policy Adviser, on (02) 8079 0806.

**Melinda Howes**  
Director Policy and Industry Practice

## TREASURY DISCUSSION PAPER: FOREIGN SOURCE INCOME ATTRIBUTION RULES

ASFA considers that Recommendation 5 addresses most of the issues affecting its members, that is, that the Government amend the legislation to exempt complying superannuation funds from the Controlled Foreign Corporation (“CFC”) rules.

ASFA strongly endorses this recommendation, and welcomes the opportunity to review any Draft Legislation to consider any unintended consequences from the manner in which the Government implements this recommendation.

The comments below address specific technical issues and issues for clarification associated with the proposals.

Legislative references are to the *Income Tax Assessment Act 1936*, as amended, unless otherwise noted.

### 1. Extension of the exemption to certain other entities

ASFA notes the consultation questions in section 4.1.1 seek comment on whether approved deposit funds (ADFs), pooled superannuation trusts (PSTs) and retirement savings accounts (“RSAs”) be exempt in the same way as complying superannuation funds.

In ASFA’s view, ADFs and PSTs are in all relevant respects equivalent to complying superannuation funds from an investment perspective. The factors considered by the Board of Taxation in recommending an exemption for complying superannuation funds, that is, the low risk or scale of deferral, and the administration and compliance savings that would arise from an exemption, are equally relevant. This treatment would be consistent with that in present section 519B, which exempts all complying superannuation entities (that is, complying superannuation funds, ADFs and PSTs) from the Foreign Investment Fund (“FIF”) rules.

In addition, many superannuation funds have insufficient scale to invest in foreign entities that may give rise to CFC issues directly. To date those funds have typically done so instead via:

- PSTs; or
- Australian unit trusts.

To deny PSTs an exemption from the CFC provisions that is equivalent to that applicable to directly-investing complying superannuation funds would result in a competitive bias in favour of the largest superannuation funds.

The position of RSAs is somewhat different to that for ADFs and PSTs, in so far as an RSA is not a taxpayer in its own right, but rather is a section of a larger taxpayer subject to the lower tax regime applicable to complying superannuation funds, ADFs and PSTs. This larger taxpayer may be a bank, credit union, life assurance company or similar financial entity. This treatment is not dissimilar to the position of the “virtual PST” business of life assurance companies.

In ASFA’s view, it would be appropriate from a competitive neutrality perspective to extend any CFC exemption to RSAs and the virtual PST business of life assurance companies. However, integrity measures may be needed in conjunction with any such exemption to ensure that the rest of the relevant taxpayer was unable to benefit from the exemption.

## **Recommendations**

ASFA recommends as follows in respect of exemption from the CFC rules:

1. That the exemption be extended to all superannuation entities. That is, to all complying superannuation funds, ADFs and PSTs.
2. That the exemption be extended to RSAs, subject to any necessary integrity measures.
3. That, subject to any necessary integrity measures, the exemption be extended to “complying superannuation/FHSA assets” and “segregated exempt assets”, in a manner equivalent to the present FIF exemption in section 519B(1).

## **2. Unit trusts held wholly or predominantly by complying superannuation funds or similar entities**

As noted above, it is common for many complying superannuation funds and similar entities to invest through an Australian unit trust in foreign entities that may give rise to CFC issues. Whilst pooling can be achieved through a PST, this structure is not always suitable for investments in some foreign jurisdictions, and does not allow the flow-through of foreign tax offsets in the same way that may be achievable through an Australian unit trust.

Present section 519B, which deals with the exemption presently available for complying superannuation funds and similar entities (or the equivalent lower-taxed sections of life assurance companies), allows an equivalent exemption to Australian unit trusts wholly owned by such entities.

ASFA supports a similar exemption for Australian unit trusts from the CFC rules.

In addition, ASFA notes some limitations in the present operation of the section 519B exemption for unit trusts, which it considers should be taken into account in the design of any equivalent exemption from the CFC rules.

In particular, the fund manager associated with the relevant foreign investment entity may form an Australian unit trust so as to pool the resources of a small number of Complying superannuation funds or similar entities. As a sign of good faith, or as a demonstration of its commitment or belief in the investment, the fund manager may commit to holding a small unit holding in the Australian unit trust itself.

For such structures, the exemption from the FIF rules for Australian unit trusts, and any equivalently drafted exemption from the CFC rules, is ineffective if it requires that the Australian unit trust be wholly owned by complying superannuation funds or similar entities.

Sub-section 519B(4) addresses this issue to some degree, in allowing a *de-minimis* interest of up to 5% of the units in the Australian unit trust to be owned by other entities.

However, this de-minimis approach may not work in a number of circumstances. For example:

- The other entity may be the initial investor in the foreign entity, and thus, its interest is significantly above the 5% *de-minimis* level until such time as it attracts sufficient investments from superannuation funds or other similar entities; or
- The other entity may be committed to hold more than 5% on an ongoing basis.

In the absence of an appropriate *de minimis* rule for these types of circumstances, an Australian unit trust formed primarily to cater for investments by complying superannuation funds or similar entities would be forced to adopt a “two trust” structure, with investments being made in parallel by:

- An Australian unit trust owned wholly by complying superannuation funds or similar entities, which would be exempt from the CFC provisions; and
- An Australian unit trust owned wholly by the fund manager, which would be subject to the CFC provisions.

The primary benefit sought by complying superannuation funds in obtaining exemption from the CFC rules is a reduction in the administrative and compliance burden. In these circumstances, notwithstanding that the complying superannuation funds would not be subject to the CFC rules, they may suffer indirectly from the compliance burden associated with the rules, as the fund manager would need to factor these issues into its overall cost structure.

### **Recommendation**

ASFA recommends that:

1. An exemption from the CFC provisions be enacted for Australian unit trusts equivalent to that in present sub-section 519B(3).
2. A *de minimis* provision equivalent to that in present sub-section 519B(4) be enacted in respect to the application of the CFC provisions to Australian unit trusts, but that the quantum of the de-minimis holding by entities other than complying superannuation funds or similar entities be:
  - (a) Set at a long-term level of less than 10%; and
  - (b) Allow for an initial level of greater than 10%, provided that this level reduces to below 10% within 2 years of the establishment of the Australian unit trust.

### **3. Interaction with foreign hybrid provisions**

The Australian Taxation Office issued Interpretative Decision ATO ID 2008/99 on 4 July 2008. This ATO ID considers the interaction of the present FIF exemption for Complying superannuation funds and similar entities in section 519B, where the superannuation fund does not hold the FIF directly, but through a foreign hybrid such as a Limited Partnership or Limited Liability Company.

The long-standing position in respect to capital gains tax, as stated in section 106-5 of the Income Tax Assessment Act 1997, as amended (and as accepted according to basic principles in the former capital gains tax provisions in the 1936 Act), is that a partnership does not own an asset, but rather the partners are the owners of fractional interests in each of the assets held within a partnership.

Notwithstanding this position in respect to capital gains tax, the ATO ID states that the ATO regards the partnership as the holder of the interest in the FIF, and thus the ATO concludes that the exemption from the FIF rules does not apply to an interest in a FIF held through a foreign hybrid.

This renders the value of the present exemption from the FIF rules of minimal or no value in these circumstances. Complying superannuation funds or similar entities may wish to elect that the foreign hybrid rules apply, in order to obtain enhanced foreign tax offset entitlements or capital gains tax treatment on disposal of underlying investments, but are required to weigh these advantages against the significant administrative and compliance costs involved in applying the FIF rules to the underlying investments held within the foreign hybrid.

ASFA notes that Complying superannuation funds or similar entities may own the interest that gives rise to potential CFC issues through a foreign hybrid entity. Accordingly, upon the introduction of any relevant exemption from the CFC rules for complying superannuation funds and similar entities, it will be important to ensure that holding the CFC through a foreign hybrid does not remove entitlement to the CFC exemption.

***Recommendation***

ASFA recommends that the interaction between the foreign hybrid provisions and the proposed CFC exemption for complying superannuation funds and similar entities be considered in the development of relevant legislation, to ensure that any exemption is not rendered of minimal or no value where the superannuation fund or similar entity holds its interest through a foreign hybrid entity.