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Attribution Review Unit  
International Tax and Treaties Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Email: [fsiattribution@treasury.gov.au](mailto:fsiattribution@treasury.gov.au)

Dear sir / madam

**RE: CONSULTATION PAPER**

**REFORM OF THE CONTROLLED FOREIGN COMPANY RULES**

The Association of Superannuation Funds of Australia (ASFA) welcomes the opportunity to respond to the release of the consultation paper, and to contribute to the development of the legislation dealing with these measures.

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 include corporate, public sector, industry and retail superannuation funds plus service providers who provide professional services to SMSFs, account for more than 5.7 million member accounts and over 80% of superannuation savings.

**BACKGROUND**

The reform of the Controlled Foreign Company ("CFC") rules was announced in the 2009-10 Federal Budget as part of wider reforms to Australia's foreign source income anti-tax-deferral (attribution) rules.

The primary measure within this original announcement directly relevant to the superannuation industry was the proposal to exempt superannuation entities from the CFC rules.

In this regard, the only reference to superannuation within the consultation paper is at page 11 where it is noted (Rule 4-1: Attribution of attributable income, 4-1, 3)) that subrule (1), the attribution of CFC income for a statutory accounting period, does not apply if the Australian resident entity that is an attributable taxpayer for the CFC is a complying superannuation fund ("CSF") for the income year in which that statutory accounting period ends.

The comments in this submission focus solely on this exemption, and on issues for consideration in the development of legislation dealing with it.

All legislative references are to the Income Tax Assessment Act 1936, as amended, unless otherwise stated.

## COMMENTS

### **1. Scope of the exemption**

The reference in the consultation paper is to a “complying superannuation fund”.

The issues considered by the Board of Taxation in recommending this exemption, that is, the low risk or scale of deferral, and the administration and compliance savings that would arise from an exemption, are relevant not just to a complying superannuation fund, but also to:

- Pooled superannuation trusts (PSTs);
- Approved deposit funds (ADFs);
- Retirement savings accounts (RSAs); and
- The complying superannuation / FHSA assets and segregated exempt assets of taxpayers such as life assurance companies.

Drafting of the exemption to include all of these entities would be consistent with the present section 519B exemption, which exempts all complying superannuation entities and the complying superannuation / FHSA assets and segregated exempt assets of life assurance companies from the Foreign Investment Fund (“FIF”) rules.

ASFA submits that the exemption be drafted to include all relevant complying superannuation entities and complying superannuation-related business.

In particular, to deny PSTs an equivalent exemption from the CFC provisions to that applicable to CSFs investing directly, would result in a competitive bias in favour of the largest superannuation funds.

ASFA considers that it would be appropriate from a competitive neutrality perspective to also extend any CFC exemption to RSAs and the complying superannuation / FHSA and segregated exempt assets 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 were unable to benefit from the exemption.

#### *Recommendations*

ASFA recommends that:

- 1 The exemption be extended to all superannuation entities, that is, to all SFs, ADFs and PSTs.
- 2 The exemption be extended to RSAs, subject to any necessary integrity measures.
- 3 The exemption be extended to the “Complying superannuation/FHSA assets” and “Segregated exempt assets”, equivalently to the FIF exemption in present section 519B(1), again subject to any necessary integrity measures.

### **2. Unit trusts held wholly or predominantly by SFs or similar entities**

It is common for many CSFs and similar entities to invest in foreign entities that may give rise to CFC issues, through an Australian unit trust. 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 income 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 CSFs 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 from the CFC rules for Australian unit trusts.

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 SFs 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 CSFs 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 is 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 SF or other similar entities; or
- The other entity is committed to hold more than 5% on an ongoing basis.

Absent an appropriate de-minimis for these types of circumstances, an Australian unit trust formed primarily to cater for investments by CSFs 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 CSFs 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 CSFs in obtaining exemption from the CFC rules is a reduction in the administrative and compliance burden. In these circumstances, notwithstanding that the CSFs 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 CSFs 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**

ASFA submits that, unless the Government appropriately drafts the legislation, there is a significant risk that the benefit of the exemption to CSFs and similar entities will be of minimal or no value in many common structures.

In this regard ASFA refers you to the Australian Taxation Office position in respect of the present FIF exemption in section 519B.

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 CSF 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 that 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. CSFs or similar entities that may wish to elect that the foreign hybrid rules apply in order to obtain enhanced foreign income tax offset entitlements or capital gains tax treatment on disposal of underlying investments, 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.

Similarly, ASFA notes that CSFs or similar entities may own the interest that gives rise to potential CFC issues through a foreign hybrid entity. Accordingly, in the drafting of any relevant exemption from the CFC rules for CSFs 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.

This could be done by, for example, stating that subrule (1), that is, the attribution of CFC income for a statutory accounting period, does not apply both:

- (a) If the Australian resident entity that is an attributable taxpayer for the CFC is a CSF or similar entity; or
- (b) If the attributable income is included in the assessable income of a partnership and the partner is a CSF or similar entity.

#### *Recommendation*

ASFA recommends that the interaction between the foreign hybrid provisions and the proposed CFC exemption for CSFs 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 CSF or similar entity holds its interest through a foreign hybrid entity.

#### **4. Clarification issues**

ASFA submits that the legislation be drafted such that the exemption applies to the situation where the CSF or similar entity holds the controlling interest:

- (a) Itself; or
- (b) As one of 5 or fewer Australian entities.

ASFA submits that it is critical that the exemption extend to both of these situations, and not just to the second situation, as the value of the exemption may be of minimal or of no value otherwise.

For example, the present CFC provisions technically result in the position that any two CSFs with the same member are “associates” for the purposes of the 5 or fewer test in section 340. Given that large industry-based funds have hundreds of thousands of members (in some cases, more than one million members), it is likely that many CSFs are technically “associated”.

This could result in the technical conclusion that a group of 10 entirely independent large CSFs are a single entity for the purposes of the control test. If the exemption were restricted only to CSFs holding the controlling interest as one of 5 or fewer Australian entities, this would render the exemption of minimal or no value in many situations.

The announcement in the 2009-10 Federal Budget placed no restriction on the exemption, so as to narrow its application to the “5 or fewer” situation.

ASFA submits that, in order to ensure the efficient operation of the exemption, the legislation and the Explanatory Memorandum clarify that no such restriction applies.

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If you have any further queries, please do not hesitate to contact Robert Hodge, principal policy adviser, on 02 8079 0806 or by email: [rhodge@superannuation.asn.au](mailto:rhodge@superannuation.asn.au)

Yours sincerely



David Graus  
General Manager Policy and Industry Practice