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31 August 2010

Manager  
International Tax Projects Unit  
International Tax and Treaties Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Sir/madam

**Consultation Paper  
Reform of the controlled foreign company rules  
July 2010**

Attached please find a response from the Association of Superannuation Funds of Australia (ASFA) to the above consultation paper.

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 membership includes corporate, public sector, industry and retail superannuation funds, and accounts 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.

David Graus

General Manager Policy and Industry Practice

## CONSULTATION PAPER

### REFORM OF THE CONTROLLED FOREIGN COMPANY RULES – JULY 2010

The Association of Superannuation Funds of Australia (ASFA) considers that the proposed rules in Subpart 1-C and the commentary on page 18 of the Consultation Paper address most of the issues affecting its members.

ASFA strongly endorses the measures in respect of ‘lightly taxed entities’, and would welcome an opportunity to review any Draft Legislation to consider any unintended consequences from the manner in which the Government implements this measure.

We note that for the purposes of this submission we refer to ‘lightly tax entities’ for ease of reference. Based on the consultation paper, these entities are:

- (a) A complying superannuation entity (including superannuation funds, approved deposit funds and pooled superannuation trusts); and
- (b) A life assurance company, to the extent that the interest in the CFC is wholly held within complying superannuation /FHSA assets or segregated exempt assets of the company.

However, we note that this introduces a new concept into the income tax legislation. While this would simplify the CFC rules, this could cause confusion in the future if this terminology is not adopted throughout the income tax legislation (eg. in the current public trading rules). We recommend that common terminology be used throughout the income tax legislation in relation to ‘lightly taxed entities’.

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 that the lightly taxed entity exemption is presently intended to apply to:

- (a) A complying superannuation entity (including superannuation funds, approved deposit funds and pooled superannuation trusts);
- (b) A life assurance company, to the extent that the interest in the CFC is wholly held within complying superannuation /FHSA assets or segregated exempt assets of the company; or
- (c) A trust or partnership interposed [directly] between the CFC and another entity, where that other entity is either a complying superannuation entity (as per item (a)) or a life assurance company in respect of its complying superannuation/FHSA or segregated exempt assets (as per item (b)).

Based on the words on page 18 of the consultation paper, it is proposed the lightly taxed entity exemption will apply to the extent that a lightly taxed entity holds an interest in an interposed partnership/trust that is required to include attributable CFC income in its net income. That is, to the extent that an interposed partnership/trust is held by a lightly taxed entity, attributable

CFC income included in the interposed entity's net income should be excluded from the assessable income of the lightly taxed entity.

ASFA agrees that lightly taxed entities should not be required to include in their assessable income attributable CFC income included in the net income of the interposed partnerships/trusts.

Based on the words in proposed Subpart 1-C, it appears that the net income of the interposed entity is excluded from the assessable income of a lightly taxed entity to the extent that the interposed entity's net income includes attributable CFC income. However, it would appear that it is the net income of the trust which excludes the attributable CFC income rather than the lightly taxed entity excluding the attributable CFC income included in its share of the net income of the interposed partnership/trust. Consequently, the attributable CFC income is excluded from the interposed partnership/trust's net income calculations to the extent that it relates to a distribution to a lightly taxed entity.

Under this proposed mechanism, issues will potentially arise for investors in terms of correctly identifying their share of the net income of the interposed partnership/trust. In most instances, investors are entitled to a percentage of the net income of the interposed partnership/trust rather than a percentage of the different types of income included in the net income calculations.

For this exemption to work effectively, it would be more appropriate for the exemption to apply at the lightly taxed entity level whereby the lightly taxed entity would exclude from its assessable income that portion of its share of the interposed entity's net income that relates to attributable CFC income. It will be necessary for the interposed partnership/trust to provide the lightly taxed entity with adequate information regarding the attributable CFC income included in the interposed entity's net income. However, this is no different to the current reporting requirements regarding capital gains tax (CGT) amounts and other taxable amounts in the interposed entity's distribution statements.

It should be noted that there are many instances where a lightly taxed entity owns 100% of an interposed partnership/trust or a group of lightly taxed entities own 100% of an interposed partnership/trust. Rather than requiring an interposed partnership/trust that is 100% held by lightly taxed entities (either by a single entity or a group of such entities) to calculate its attributable CFC income and report it to its investors, such interposed entities should not be required to include attributable CFC income in their net income calculations on the basis that 100% of that income will be excluded by the investors under the lightly taxed entity rules.

In addition, we suggest that the Explanatory Memorandum to the Bill introducing the above amendments make it clear that lightly taxed entities do not need to own all of the "interposed" entity, or that the exemption does not require a group of lightly taxed entities to own 100% of the interests in a particular trust or partnership.

### ***Recommendations***

ASFA recommends that:

- 1 Lightly taxed entities be defined as those entities currently listed in subpart 1-C (a) and (b) subject to our comments above regarding common terminology throughout the income tax legislation;

- 2 Lightly taxed entities be able to exclude from their assessable income that portion of the net income received from interposed partnerships/trusts which relate to attributable CFC income;
- 3 Interposed partnerships/trusts which are 100% held by a lightly taxed entity or group of lightly taxed entities be able to exclude attributable CFC income from their net income calculations; and
- 4 The words in any legislation and the Explanatory Memorandum based on the rules in Subpart 1-C make clear that the exemption does not require that the interposed entity be wholly owned by the lightly taxed entities or group of such entities.

## **2. 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 former foreign investment fund (FIF) exemption for complying superannuation funds and similar entities in former section 519B of the Income Tax Assessment Act 1936, where the superannuation fund did 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 regarded the partnership as the holder of the interest in the FIF, and thus the ATO concludes that the exemption from the FIF rules did not apply to an interest in a FIF held through a foreign hybrid. ASFA understands that the reason for this is that limited partnerships are treated as companies for Australian tax purposes and that limited partnerships formed in Cayman Islands, etc cannot be foreign hybrids because they are not subject to tax.

This rendered the value of the former exemption from the FIF rules of minimal or no value in these circumstances. Complying superannuation funds or similar entities may have wished to elect that the foreign hybrid rules applied, in order to obtain foreign tax offset entitlements or capital gains tax treatment on disposal of underlying investments, but were 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.

The Consultation paper would appear to have addressed this issue by the flow through of the exemption through a partnership, as per Subpart 1-C paragraph (c).

However, there is some uncertainty in relation to this.

### ***Recommendations***

ASFA recommends that any Explanatory Memorandum or other material released with Draft Legislation or with the eventual Bill include examples that clearly illustrate the scope of Subpart 1-C, and illustrate that the exemption will apply to:

- CFC income otherwise attributable to a partnership, to the extent that the partner is a lightly taxed entity; and
- CFC income otherwise attributable to a trust, to the extent that the unit holder in the trust that is presently entitled to the assessable income of the trust is a lightly taxed entity.

ASFA submits that the examples in the EM or similar documentation should ensure that it is clear that this flow through of the exemption applies notwithstanding that the relevant CFC income may flow through several tiers of partnerships or trusts.

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.

Finally, ASFA requests that the legislation recognises circumstances where an investment in a CFC has previously resulted in attribution of income and makes provisions such that, should the CFC provisions now no longer apply, any overall gains are not double taxed through the CGT provisions on disposal