



Investment & Financial Services Association Ltd

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9 June 2009

Mr Haydn Daw
Manager, Attribution Review Unit
International Tax and Treaties Division
Treasury
Langton Crescent
PARKES ACT 2600

By email: fsiaattribution@treasury.gov.au

Dear Mr Daw

Re: Foreign Source Income Attribution Rules

The Investment and Financial Services Association (IFSA) welcomes the opportunity to comment on the Treasury Discussion Paper 'Foreign Source Income Attribution Rules'.

IFSA is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 140 members who are responsible for investing over \$1 trillion on behalf of more than ten million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

Further to our meeting of Thursday, 21 May we attach brief responses to a number of the questions raised in the consultation paper. We look forward to discussing these issues with you and your team in more detail.

Please do not hesitate to contact Daniel Caruso on 02 9299 3022 to progress these issues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'John O'Shaughnessy', is written over a light blue horizontal line.

John O'Shaughnessy
Deputy Chief Executive Officer

Integrity Measure for Roll-up Funds

- The integrity measure for roll-up funds described in the Board of Taxation's September 2008 report would not be onerous for the industry. The type of investment described there is rarely, if ever, used and introducing a disincentive against its use will not cause any issues.
- The Government may want to consider though whether a new rule is necessary.
- IFSA notes that many taxpayers would consider Part IVA to already be an effective purpose-based deterrent to using the type of investment described in the report. IFSA notes in particular the facts in the Spotless case. While it concerned the use of an exemption rather than deferral, many would take the view that there would be a significant Part IVA risk in making an investment of the type described in the report.

Timing

- As the timetable for planned introduction of the bill into Parliament for the whole package of measures is pre-July 2010, IFSA would support the early passage of the repeal of the FIF measures ahead of the entire package of legislative changes.
- The separate passage of the repeal of the FIF measures would allow for taxpayers to better manage their compliance for the income year ending 30 June 2010 and avoid unnecessary complexity and costs with an additional income year of FIF compliance in the period from announcement of the measures to legislative change.
- IFSA would also be keen to avoid the repeal of the FIF measures being delayed due to potential interruptions in the legislative process during the year of a Federal election.

4.1 Is the operative principle an appropriate legislative expression, having regard to the policy objectives that it is intended to meet and the need to express the operative rules as principles?

- IFSA supports the operative principle in the proposed CFC provisions, which satisfies the policy objective of ensuring that Australia's tax rules should not discriminate between residents that invest in the domestic and those that invest in foreign markets. As recognised by the Board of Tax in its discussion papers and covered in the 2007 IFSA submission to the Board of Tax, offshore funds have an important position in the range of investment products available to Australian resident investors.
- The core concept in the operative principle of 'substantial ownership interest' is supported on the basis that it is unreasonable to apply anti-deferral rules to shareholders who are not able to bring about the benefit of deferral.

4.1.1 Should approved deposit funds, pooled superannuation trusts and Retirement Savings Accounts be exempt in the same way as complying superannuation funds?

- Yes. The reason that these types of structures are recognised in the tax law is to create a level playing field for all assets used to support superannuation liabilities. This policy of consistent treatment needs to be extended into the foreign source attribution rules.
- In addition to the structures listed in the question, the consistency needs to be extended to the VPST assets and segregated exempt assets of life insurance companies.

4.1.1 If the rules better target passive income... is a de-minimis exemption warranted? If so what cases should qualify for the de-minimis exemption?

- IFSA would also support a de-minimis threshold for exemption from these rules in accordance with Position 4.7 of the January 2008 Board of Tax position paper. IFSA recommends that a \$250,000 threshold to apply to the total value of interests in foreign entities (consistent with the threshold in the thin capitalisation rules).

4.1.1 The earlier Board recommendation concerning dual residents dealt with companies only. Is there a good reason not to extend that recommendation to other entities?

- IFSA supports that the recommendation being extended to other entities. IFSA believes that, to the extent possible, there should be tax neutrality in the treatment of distributions paid by different business vehicles.

4.2 Is it appropriate in the definition of an attributable taxpayer to count direct and indirect ownership interests as well as those of associates? What changes to the definition of associate are required in order to encompass those who share common interests in relation to the foreign entity, having regard to the various uses for which this definition is used in the law?

- Based on the intentions in the Discussion Paper of minimising compliance and administrative costs, when the core concept of substantial ownership interest is applied it should result in significantly less complexities and compliance costs than the various 'control tests' in the existing highly complex CFC rules.
- The inclusion of direct and indirect ownership interests as well as associates in determining the concept of substantial ownership interest is supported from a policy perspective.

4.2 Would the proposed notion of a non-portfolio ownership interest contained in this definition work in other areas of the law where the same or similar ideas are used?

- IFSA believes that the substantial ownership interest test outlined section 4.2 should be used to determine a 'non portfolio interest' for the purposes of the Act.

4.2.1 Does the existing concept of an 'equity interest' represent an appropriate balance for the various provisions in which it is proposed to be used, in terms of achieving their policy objectives? On what basis would an alternative definition be preferred and what would that alternative be? Would it apply in the other areas mentioned? How should the total of all direct ownership interests be measured?

Should there be any change to the use of membership interest and non-portfolio interest in Division 855 in defining an indirect Australian real property interest held by a foreign resident?

- Conceptually only membership interests that are 'equity' interests as opposed to 'debt' interests should be taken into account.
- The Government will need to tidy up the rules for what is an 'equity' interest in a partnership and a trust. Currently s.820-930 only applies for thin capitalisation purposes.
- Rules need to be able to cater for different classes of ownership interests.
- This suggests a need to focus on a range of criteria – rights to capital, rights to dividends – as per existing tests rather than focusing on a single aspect such as voting interests. At the same time Australian taxpayers who have no right to ever participate in either the capital, income or profits of the foreign entity should not be subject to attribution as they have no rights to participate in the capital, income or profits. This is important because some structures require the manager to retain voting rights even though they do not have participation rights.
- There would need to be scale back provisions where the sum of interests exceeds 100 per cent.
- Currently thin capitalisation rules (Div 820), and non-resident CGT exemption rules (Div 855), use CFC control interest provisions. Section 23AJ and participation exemption (Div 768-G) use voting interests.

4.2.1 What is required to give the flexibility to deal with the variety of ownership interests encountered throughout the world?

- Under the laws of certain countries, such as the UK and Luxembourg, the law permits the segregation of assets and liabilities of a company amongst various "portfolios" in a way which binds third parties. Such entities are known as Open-Ended Investment Companies (OEICs) or Société d'investissement à capital variable (SICAVs). Note, income from UK OEICs is currently attributable under the existing CFC rules on the basis that it is EDCI.

- Each class of shares in an SICAV or OEIC represents a different portfolio of investments and each investor's return on their respective class of shares will track the return on the portfolio allocated to their share class. A SICAV or OEIC may pay a dividend in respect of the segregated portfolio shares of any class whether or not a dividend is declared on any other class of segregated portfolio shares.

CFC rules

- The CFC rules do not deal very well with SICAVs or OEICs. Currently, the rules assume a common class of shares in determining the "interests" of shareholders. They do not contemplate entities with notionally segregated portfolio holdings.
- Section 362 of the Act provides that the attribution percentage of an attributable taxpayer at a particular time is the sum of the direct and indirect attribution interests in the CFC held by the taxpayer. In determining "direct attribution interest" in a CFC, section 356 looks at the rights of the shareholders to the capital or profits of the company. Therefore, the test cannot be done on a share class by share class basis, but rather needs to be done on the whole of the profits of the SICAV or OEIC.
- On this basis, assuming that 100% of the entity's profits will be attributable income, a taxpayer may be attributable on the total profits of the entity even where the taxpayer did not invest in the portfolio's that contributed to the profit. The taxpayer's attributable income may bear little relation to its economic entitlement to distributions from the entity. Indeed, a taxpayer may be attributable on the overall profits of the entity, even where the taxpayer's portfolios have only generated losses.

Examples

OEIC with 3 classes of shares carrying the same rights:

- Taxpayer 1 owns 100% of the 100 class A shares.
- Taxpayer 1 owns 100% of the 50 class B shares.
- Taxpayer 2 owns 100% of the 50 class C shares.

Attributable percentage of Taxpayer 1 = $(100+50) / (100+50+50) = 75\%$

Example 1:

- Class A profits = \$10
- Class B profits = \$5
- Class C profits = \$5

Distribution that can be made to Taxpayer 1 = $\$10 + \$5 = \$15$

Attributable income of taxpayer 1 = $75\% \times \$20 = \15

Example 2:

- Class A profits = \$5
- Class B profits = \$5
- Class C profits = \$10

Distribution that can be made to Taxpayer 1 = $\$5 + \$5 = \$10$

Attributable income of taxpayer 1 = $75\% \times \$20 = \15

Example 3:

- Class A profits/loss = \$nil
- Class B loss = (\$10)
- Class C profits = \$10

Distribution that can be made to Taxpayer 1 = \$nil

Attributable income of taxpayer 1 = 75% x \$10 = \$7.50

4.3 Should the controlling group have to consist of Australian resident entities only or should a foreign entity be a CFE if it is controlled by a group of five or fewer entities one or more which is an Australia resident?

- The control requirements need to remove the anomalies that exist in the tests in the current CFC rules. In particular, the interaction of the associate definition and the control tests can produce an anomalous outcome for foreign organisations with domestic operations in Australia. IFSA would be pleased to expand on these issues in direct consultations.

4.4 What would be a suitable balance of equity, efficiency and compliance costs in determining when all these requirements (control, residence, attributable taxpayer, attribution percentage) have to be met?

Timing - Part-year attribution

- The CFC rules contain a peculiar rule in Section 319 which has the potential, absent making relevant elections, to attribute income of a CFC back to an Australian taxpayer for a period which the taxpayer had no economic interest. For example, if the taxpayer purchased the interests in the CFC on 29 June and did not make any elections in changing the statutory accounting period of the CFC, then the taxpayer will be attributed on the CFC's income for the whole income year, even though it had held this interest for 1 day during that period.
- This is in contrast to the FIF rules which contain part year attribution provisions to ensure that income is accrued only to the extent that the entity had an economic interest.
- IFSA recommends a rule which effectively ensures that attribution can only arise for the period of ownership.

4.5.2 Should there be any restrictions on the amounts of trust or partnership net income that are included in attributable income?

- Currently different tests apply to income from interests in partnerships and trusts held by listed and unlisted CFCs.
- The Discussion Paper suggests that the benchmark should be Australian resident holding direct investment in foreign partnership or foreign trust. Thus full net income of partnership or trust would be included in attributable income of the CFC.

- IFSA recommends that benchmark should be the CFC's direct investment in underlying assets. Thus if the CFC derived income directly and such income was not attributable, the same income derived indirectly via a partnership of trust would also not be attributable.
- This largely picks up current rules re interests in partnerships held by listed CFC in s.385(2)(d).
- These provisions should be extended to interests in trusts held by CFCs. Thus only the EDCI / tainted income of a trust would be included in attributable income of a CFC.

4.5.3 Which other provisions, if any, should be disregarded and if so why? Should any of the provisions listed above not be disregarded? What modifications are required when applying other parts of the law? What is the simplest and fairest way to overcome the potential double taxation of the passive income of a CFT, under these attribution rules and under Division 6, without reducing what is included in the assessable income of Australian resident beneficiaries under Division 6?

- IFSA recommends that Division 6 be the principal taxing provision in respect of an Australian residents direct interest in a CFT.
- IFSA notes that any changes to Division 6 recommended by the Board of Tax as part of its review into a Managed Investment Tax Regime will need to be considered.
- IFSA supports the anti-overlap rules giving exclusive application to Division 6 where beneficiaries of trust are entitled to all the income and capital of a CFT – including where some beneficiaries are non residents.
- The rules could be along the lines of current deemed present entitlement rules in ss. 96B and 96C re measurement of beneficiaries' interest in CFT net income.

4.5.4 In practice, how much impact on compliance costs is the availability of this choice likely to have?

- Individual taxpayers should have the flexibility to determine which calculation method to use and take into account compliance costs in making that decision.
- An attributable taxpayer should be afforded the following flexibility in calculating attributable income:
 - to choose any of the following methods¹ to calculate their attributable income;
 - the method of calculation should be able to be changed where a taxpayers holding of the investment changes (eg goes from being a 100% interest to a 10% interest in which case branch equivalent calculations may no longer be practical); and

¹ Deemed rate of return method, market value method, branch equivalent method.

- to choose different calculation methods for each separate CFC interest
- Allowing choice of these alternate methods allows taxpayers to balance cost of compliance with obtaining more accurate measures of attributable income should they so desire to incur additional compliance costs.

4.5.5 Would a deduction for foreign accruals tax levied by any foreign country be a simpler but still fair way of relieving this double taxation?

- No. In situations where the top CFCs home country also has a CFC regime, there is a duplication of anti-tax deferral tax regimes to the underlying subsidiaries.
- Although each CFC regime will have its own particular rules and concessions, the principles in eliminating the deferral of tax should be consistent.
- Hence it should be possible to rely on the CFC regimes of other jurisdictions and therefore eliminate the need to duplicate the process across 2 countries in analysing the underlying entities for tax deferral. Therefore an exemption should be allowed from the Australian CFC rules in respect of the underlying CFC's income.
- Furthermore, Australia has a foreign income tax offset system to relieve double taxation and in accordance with policy objective of not distorting passive investment decisions a full foreign tax offset should be allowed for foreign tax paid by foreign CFCs.

4.7 Should the exemption for non – portfolio dividends extend to returns on equity interests held indirectly by resident companies through resident trusts or partnerships?

- The exemption for non-portfolio dividends should be extended to returns on equity interests held indirectly by resident companies through foreign trusts and partnerships and domestic trusts and partnerships. This could operate in a similar way to the existing provisions in s.23AH.
- It should also be clarified that that exemption applies for such equity interests held through bare trusts or nominee arrangements.
- With the very significant narrowing of the FIF rules, it will be very unusual for an Australian managed investment trust to ever have to do any attribution. In the odd circumstances where an Australian managed investment trust does hold an attributable interest in a CFE, IFSA continues to be strongly of the view that the attribution accounting needs to be done at the level of the managed investment trust, not at the level of the investors in the managed investment trust.
- This was set out in submissions earlier in the consultation. With a significant reduction in the circumstances in which attribution will be required, it is even more onerous to expect managed investment trusts to undertake the complex systems development and education that would be required get investors to do attribution accounting. Any equity considerations regarding the changing of unitholders are now even more outweighed by the compliance costs.

- Attributable income calculated under the market value method and the deemed rate of return method has traditionally been treated as ordinary income of a taxpayer, despite the fact that such an attributed amount may represent both retained profits of the CFC and increments in the unrealised market value of the CFC. To the extent that the disposal of the CFC would be treated on capital account, an anomaly is created by treating the attribution as ordinary income. IFSA recommends that to the extent that any profit on disposal of the CFC would be treated as being on capital account, any amount attributed in respect of that CFC should also be treated as a capital gain with appropriate discounting being available if the CFC has been held for more than 12 months.

4.7 Should the exemption also apply to corporate unit or public trading trusts?

- This exemption should also apply to such equity interests held by corporate unit trusts and public trading trusts as these entities are effectively taxed as if they were companies.

4.7 Since controlled foreign trusts are to be subject to the attribution regime, should there be a similar exemption for distributions paid directly by them on non-portfolio equity interests so that there is neutrality in the tax treatment of different business vehicles? How would such an exemption fit within Division 6 as it applies to these foreign trusts?

- IFSA believes that, to the extent possible, there should be tax neutrality in the treatment of distributions paid by different business vehicles on non portfolio equity interests.
- Where a controlled foreign trusts (CFT) is subject to Division 6, the exemption could be provided to corporate beneficiaries. This could be done through a distribution statement issued by the CFT which provides the components of the distribution. Such distribution statements are currently issued by managed investment trusts. Those investors eligible for the exemption would claim it. Those ineligible would simply return the amount as assessable.

5 Does the proposed interaction between Division 230 and the rewritten CFC rules explained above provide an appropriate outcome?

- The principles set out in the Treasury Discussion Paper are:
 - If a taxpayer is an attributable taxpayer in respect of a CFC then the Division 230 is totally excluded from operating. This includes situations, such as complying superannuation funds, where the CFC rules do not require attribution.
 - If a taxpayer has an interest in a foreign entity but is not an attributable taxpayer then Division 230 has its full application.
- The application of Division 230 to equity interests is that the accruals and realisation methods never apply but the taxpayer can choose to use one of

the four elective methods. Choosing to use an elective method will generally be done to save compliance costs.

- Consideration should be given to allowing an attributable taxpayer in respect of a CFC to use one of the elective Division 230 methods when doing so effectively applies a market value method to the interest in the CFC.
- For example, a managed investment trust is using the 'reliance on financial reports method' for a portfolio of hybrid securities in order to reduce compliance costs. The accounting standards require it to mark its assets to market so the use of this method includes market value movements in its assessable income each year. Some of its securities may be attributable interests in CFCs. To require the managed investment trust to identify these securities separately and consider whether the attribution rules require a slightly different amount to be included in assessable income is creating unnecessary work.
- The managed investment trust, knowing that it is using a method for the whole portfolio that is effectively a market value method, should be able to ignore the CFC attribution rules.

Additional Issues

Retention and expansion of the 'white list'

- The purpose of the white list is to provide an exemption from the CFC rules where the CFCs operate in a comparable tax jurisdiction. This jurisdictional-based approach is aimed at reducing compliance for CFCs in countries where the ability to defer tax is negligible. To the extent that there are concessions provided in those tax systems, such income that may benefit from deferral is specifically included through the operation of the Eligible Designated Concession Income rules in Schedule 9 of the Income Tax Regulations.
- We believe this approach aids in reducing the compliance with the CFC rules which would otherwise be extremely onerous.
- The present list should be expanded to include other jurisdictions which also do not pose a material risk of tax deferral. As in the present case, where that jurisdiction does present opportunities for tax deferral, the EDCI measures should capture such income.
- Based on our experience, we believe that the following jurisdictions have corporate tax rates and regimes which are comparable to Australia's or exceed Australia's in terms of rates and complexity and should not provide a significant revenue risk to Government if these countries were included on an expanded white list:
 - Brazil
 - China
 - India
 - Korea
 - Members of the EU

Foreign Hybrid Provisions - Division 830

- Division 830 currently provides that holdings of CFCs which constitute foreign hybrids must be treated as a partnership for tax purposes. By contrast holdings of FIFs which constitute foreign hybrids can only be treated as foreign hybrids ie partnerships for tax purposes where an election is made under s 485AA. We have found some anomalies and unexpected outcomes in the operation of Division 830 and in the ATO's interpretation of Division 830. It is therefore desirable that taxpayers be granted flexibility to elect into the operation of Division 830 in all cases to avoid the aforementioned anomalies.
- Also with the proposed repeal of the FIF provisions, the tax treatment of a non controlling interest in a foreign hybrid is uncertain. Therefore we request that all taxpayers be allowed to elect Division 830 foreign hybrid treatment regardless of whether they holds those interests as CFC interests or as non controlling interests.