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

Email: fsiattribution@treasury.gov.au

Dear Sir/Madam

Exposure Draft Tax Laws Amendment (Foreign Source Income Deferral) Bill (No.1) 2010

The Taxation Institute of Australia (**Taxation Institute**) is pleased to provide comments in relation to the exposure draft of the *Tax Laws Amendment (Foreign Source Income Deferral Bill (No.1) 2010* released by the Assistant Treasurer on 18 December 2009 (**FIF Repeal ED**).

All legislative references are to the provisions of the *Income Tax Assessment Act 1936* (**ITAA 1936**) and the *Income Tax Assessment Act 1997* (**ITAA 97**) as applicable..

1. Summary of Recommendations

The Taxation Institute makes the following recommendations in respect of the FIF Repeal ED:

Recommendation 1: The repeal of the foreign investment fund (**FIF**) provisions should apply to the 2009 income year or alternatively, at the latest, should apply to the 2010 income year.

Recommendation 2: There should be no "sunset" for s.23AK or s.23B, as these provisions are designed to ensure that taxpayers are not subject to double taxation.

Recommendation 3: Taxpayers should be able, for a limited time, to revoke elections previously made under s.485AA.

Recommendation 4: The Taxation Institute reiterates its submission to Treasury on 9 June 2009 regarding the design of the proposed anti-roll-up provision.

Recommendation 5: Item 74 of the FIF Repeal ED (removal of "trustee of a foreign trust for CGT purposes" from s.855-10(1)(a)) should be removed from the ED.

Recommendation 6: Retrospective amendments should be made to the CFC provisions regarding s.401 and FIF attribution accounts for CFCs.

2. Recommendation 1: date of effect of the FIF provisions

Part 1 of Schedule 1 of the FIF Repeal ED should apply to the income year ending 30 June 2009[1] and later income years – that is, the repeal of the FIF provisions (and accompanying ancillary

[1] For ease of reference, references are to the income year ending 30 June in a particular year. For those taxpayers with a substituted accounting period, the income year will end on a different date, in accordance with the substituted accounting period.

provisions) should apply to the income year ending 30 June 2009 or alternatively, at the latest, should apply to the income year ending 30 June 2010.

The announcement to repeal the FIF rules was made during the 2009 income year, as part of the Budget announcements in May 2009. FIF is effectively an end of year matter as it is only those FIF interests held at the end of an income year that are subject to accruals under the FIF regime (refer s.485(3)(a)). Therefore, if the repeal of the FIF rules were to take effect for (say) the income year commencing 1 July 2010, this would mean that there would effectively be a 26 month delay between the announcement (May 2009) and the *actual* effective time (30 June 2011). Repeal of the FIF rules with effect from 1 July 2008 would be consistent with the view of the Federal Government that there is no policy reason for the FIF provisions to be retained.

Moreover, the Federal Government has publicly acknowledged that the repeal of the FIF rules as quickly as possible is important, particularly to the financial sector, to provide greater certainty[2]. Repeal of the FIF rules for income years ending 30 June 2009 would be consistent with this objective.

Further, the Taxation Institute does not consider that the timing of the repeal of FIF provisions should be determined by reference to when either (i) the reform of the CFC provisions is enacted; or (ii) the anti-roll-up provision is enacted.

In relation to point (ii), if the FIF rules are repealed before the anti-roll-up measure takes effect[3], then there would be a period during which there would be no accrual rules for non-controlling interests in foreign companies. However, given that the Federal Government has not given any prior indication that the FIF provisions would be repealed from 1 July 2009, the risk of taxpayers entering into arrangements to achieve inappropriate deferral in non-control cases is low. Therefore, it would not be inappropriate for the FIF provisions to be repealed with effect from a date prior to the new anti-roll-up provision taking effect.

3. Recommendation 2: sunsetting of s.23AK and s.23B

Part 2 of Schedule 1 of the FIF Repeal ED contains sunsetting provisions for the repeal of the following provisions:

- Various definitions in s.6(1) of the Act.
- Section 23AK of the Act (amounts paid out of previously attributed FIF income not assessable income).
- Section 23B of the Act (disposal consideration reduced if attributed FIF attributed income not distributed)[4].
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The FIF Repeal ED does not indicate when these provisions would be repealed. It seems that the effect of the repeal of s.23AK and s.23B is that relief from double taxation would no longer be available for taxpayers in respect of previously attributed FIF income. This is because the FIF ED does not provide for any other form of compensating adjustment or compensating measure (eg. cost base adjustment or deduction – refer below) to prevent double taxation arising.

The Taxation Institute submits that there should be *no* sunsetting provisions on either s.23AK or s.23B of the Act. The key objective of both these provisions is to prevent a taxpayer being subject to double taxation by virtue of the operation of the FIF provisions. For example, the explanatory memorandum to the *Income Tax Assessment Amendment (Foreign Investment) Act 1992* which introduced s.23AK and s.613 stated:

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[2] Refer to the speech by the Assistant Treasurer (the Hon Nick Sherry) on 29 September to open the Bank of New York Mellon's First Australia Bank Branch (Speech 2009 No. 11): http://www.treasurer.gov.au/DisplayDocs.aspx?doc=speeches/2009/011.htm&pageID=005&min=njsa&Year=2009&DocType=1

[3] As more fully outlined in section 6 below, the Taxation Institute submits that the anti-roll-up provision should not take effect until after the legislation introducing that measure has been enacted (or at the very least, introduced into Parliament).

[4] Section 23B will be inserted into the Act by the FIF Repeal ED (refer 7 of Part 1 of Schedule 1), and is essentially replicating s.613 of the Act, although it clarifies that the provision can apply to FIF interests held on both revenue and capital account. This clarification is welcomed by the Taxation Institute.

Relief from double taxation

Reduction of disposal consideration if FIF attributed income not distributed

> *The disposal of an interest in a FIF attribution account entity will normally be taken into account in the calculation of a taxpayer's assessable income under the existing provisions of the Principal Act either as income under subsection 25(1) or under the capital gains tax provisions in Part IIIA. Further, the disposal consideration of a FLP is used to determine the amount to be included in a taxpayer's assessable income under the FIF measures in the year of disposal of the FLP. To avoid double taxation, the consideration received on the disposal of an interest in a FIF attribution account entity which is to be taken into account for the purposes of the relevant assessment provision will be deemed to be reduced by any amount previously attributed to a taxpayer that has not been distributed to the taxpayer.*
>
> (our emphasis)

Further, the explanatory memorandum to the *New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* (in the context of foreign tax credit amendments) stated:

> *2.84 Double Australian taxation could arise when previously attributed foreign income is repatriated. However, this is avoided by providing an exemption under section 23AI for dividends paid from a controlled foreign company out of previously attributed income. A similar exclusion is provided for dividends paid from a foreign investment fund under section 23AK. Nevertheless, an entity may have paid foreign tax on the distributed income after attribution as well as Australian tax when the income was attributed. This means, to some extent, there could continue to be double taxation on the distributed amounts. However, sections 160AFCD and 160AFCJ ensure an entity is entitled to foreign tax credits for foreign tax paid on amounts that are not included in assessable income because of sections 23AI and 23AK, respectively.*
>
> (our emphasis)

Finally, in Taxation Determination TD 2006/52, the ATO stated in respect of s.23AK:

> *13. The purpose of section 23AK applying to a dividend is to prevent double taxation. This is in recognition of the fact that, in effect, the dividend has been paid out of profits that have previously been taxed in Australia under Part XI. In further recognition of this fact, the treatment of the dividend as non-assessable non-exempt income is disregarded to preserve entitlements to deductions and foreign tax credits.*
>
> (our emphasis)

If there is a sunset date on the retention of s.23AK/s.23B, then this could lead to double taxation for those taxpayers who have previously been subject to FIF attribution and who still hold their FIF interests at the date such provisions cease to apply. This is of particular relevance in relation to FIF interests, where the taxpayer will not have a controlling interest in the FIF (as otherwise, it would be an interest in a CFC) so therefore, has no ability to determine that the FIF make distributions out of prior attributed FIF income. Taxpayers should not be forced to make investment decisions, such as selling FIF interests, due to adverse taxation considerations that may otherwise arise i.e. double taxation on disposal or on receipt of future distributions[5] if FIF interest retained after the sunset date.

Further, the repeal of the FIF provisions does not make redundant or change the policy rationale behind s.23AK or s.613/s.23B of avoiding double taxation – just because taxpayers will no longer be subject to FIF attribution going forward does not mean that taxpayers should potentially be subject to double taxation in respect of previously attributed FIF income.

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[5] It should be noted that it cannot be assumed that s.23AJ will apply to prevent double taxation in relation to any distributions by the foreign company that was previously a FIF (either under current law or under the proposed changes to s.23AJ as per Treasury's Consultation Paper *Reform of controlled foreign company rules* released on 5 January 2010 – referred to as the **Treasury January 2010 Consultation Paper**). For example, the relevant taxpayer may not be a company or, if it is a company, may hold less than 10% in the foreign company.

Moreover, there are numerous examples in the ITAA 97 where “old rules” continue to apply notwithstanding the introduction of new rules or the repeal of other measures. One current example is the TOFA rules whereby, for those taxpayers who are subject to the TOFA rules, pre-existing financial arrangements will continue to be subject to the “old” (pre-TOFA) rules unless the taxpayer makes an “ungrandfathering” election (under Item 104(2) of Part 3 of Schedule 1 to the *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*) to bring pre-existing arrangements within TOFA. If a taxpayer does not make an “ungrandfathering” election, the old rules will continue to apply without any sunset date.

For these reasons, the sunsetting provisions in Part 2 of Schedule 1 should be removed. Alternatively, a deduction or an adjustment to the cost base of the relevant interest should be available for any FIF attribution surplus existing at the time s.23AK/s.23B are repealed.

4. Recommendation 3: revoking s.485AA elections

The FIF Repeal ED currently contains no mechanism for taxpayers who have previously made an election under s.485AA for an interest to be subject to the foreign hybrid provisions in Division 830 to revoke this election in light of the repeal of the FIF provisions.

The foreign hybrid provisions were originally introduced to overcome issues arising in respect of foreign entities that were treated for foreign tax purposes as a flow-through entity (e.g. a partnership) but treated for Australian tax purposes as companies[6].

One issue which led to the introduction of the foreign hybrid rules included taxpayers being inappropriately taxed under the FIF rules, for example, because the taxpayer was not able to access exemptions under the FIF rules for its relevant FIF interest, although the underlying assets would qualify for exemption from the FIF rules. This situation could arise where the taxpayer held an interest in a flow-through collective investment vehicle (e.g. a limited partnership) which was not listed, but the underlying assets were shares in listed companies that would qualify for exemption under s.495 using the stock exchange listing method. The effect of making a s.485AA election would be that the interest in the foreign collective investment vehicle would be treated as a partnership (and hence outside the FIF rules), with the relevant taxpayer being the deemed partnership (the collective investment vehicle) and the FIF rules applying to the underlying assets (which would qualify for FIF exemption).

A further issue behind the introduction of the foreign hybrid rules was that double taxation could arise due to the inability to access foreign tax credits. This situation arose because the foreign entity was treated as a flow-through entity in the foreign jurisdiction, but as a company for Australian tax purposes and hence there was a mismatch in the type of income in respect of which foreign tax had been paid for Australian FTC purposes[7].

With the repeal of the FIF provisions, one of the primary reasons for a taxpayer to have made a s.485AA election will no longer apply. Therefore, taxpayers who have previously made a s.485AA election (to have a FIF interest treated as a partnership) should not be disadvantaged and should be given the opportunity, for a limited period, to revoke a s.485AA election such that the relevant entity would cease to either be a “foreign hybrid limited partnership” (s.830-10(2)) or a “foreign hybrid company” (s.830-15(5)).

Moreover, since the introduction of the foreign hybrid rules, the former FTC rules (in Division 18 of Part III) have been rewritten in such a manner that the issue of potential double taxation due to the difference in characterisation of a foreign entity under foreign and Australian tax laws, has been resolved. In particular, as part of the rewrite of the former FTC rules into Division 770 (foreign income tax offsets (**FITO)**), it was clarified that taxpayers could still obtain a FITO even though there

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6 See http://assistant.treasurer.gov.au/DisplayDocs.aspx?pageID=&doc=pressreleases/2003/026.htm&min=hlc **(Pres Release**) and http://www.treasury.gov.au/documents/588/PDF/hybrid.pdf (**Treasury Paper**).

7 See for example, the following excerpt from the Press Release:

However, the current treatment of foreign hybrids under the CFC regime (and to a lesser extent the FIF regime) has lead to inappropriate and unintended consequences for taxpayers, including the double taxation risk and significant compliance costs.

is a different characterisation of the foreign entity under the tax laws of the foreign jurisdiction and Australian tax laws[8].

Therefore, with the repeal of the FIF rules and clarification of the ability to obtain a credit for foreign taxes paid (under the FITO rules), taxpayers have significantly less reason to make a s.485AA (or equivalent) election. Those taxpayers who previously made an election under s.485AA, *based on the tax laws as they were at that time*, should not be disadvantaged and unable to benefit from the repeal of the FIF rules. Accordingly, the Taxation Institute submits that taxpayers should be given the opportunity, for a limited time (say one income year), to revoke a s.485AA election previously made.

The Taxation Institute also recommends that, if it is the case that a s.485AA election can be revoked (for a limited time), appropriate rules should be included to determine the cost base in the interests in the foreign entity after such election is revoked. Division 830 contains some rules that apply when an entity ceases to be a foreign hybrid[9]. However, these rules do not contain any provision for determining the cost base of a taxpayer's interest *in the foreign entity* when it ceases to be a foreign hybrid. The opportunity should be taken rectify this omission.

5. Recommendation 4: design of the anti-roll-up fund provision

The Taxation Institute reiterates its previous submission to Treasury on 9 June 2009 regarding the anti-roll-up fund provision:

As a starting point, the Taxation Institute notes that Federal Government announced in the 2009-10 Federal Budget that a review will be undertaken to "*consolidate, streamline and improve the operation of provisions designed to counter tax avoidance*". In the Taxation Institute's view, rather than enacting a specific anti-roll-up rule, the general anti-avoidance rules (however modified) should be used to counter any "abuse" arising from tax payers achieving tax-deferral in non-control situations. Therefore, at the very least, consideration of whether a specific anti-roll-up measure is required should be delayed until (and undertaken as part of) this review.

If an anti-roll-up rule is enacted, then at a minimum, the following exemptions should be incorporated:

- A de minimis exemption should apply.
- The exemption for superannuation funds should equally apply to the anti-roll-up measure.
- An equivalent exemption as in s.519 (for interest in employer-sponsored superannuation fund) should be adopted.
- Exclude all interests in entities resident in "listed countries".

Further, the Commissioner should be precluded from being able to apply Part IVA where the anti-roll-up rule does *not* apply.

Further, the Taxation Institute submits that any new anti-roll-up measure should only be introduced after appropriate consultation[10]. Moreover, any such measure should only have effect *after* legislation (to give effect to such measure) has been enacted, or at the very least, the relevant Bill

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[8] Refer paragraphs 1.102 and 1.103 (including Example 1.10), in particular (at para 1.103) of the explanatory memorandum that accompanied the *Tax Laws Amendment (2007 Measures No4) Act 2007*:

Even where the Australian resident has not elected for the US limited liability company to be a foreign hybrid, the Australian resident will be entitled to a tax offset for the US withholding tax imposed on the distribution of profits of the limited liability company.

[9] Section 830-110 provides that no CGT event or disposal for tax purposes occurs by virtue of an entity ceasing to be a foreign hybrid. Further, Subdivision 830-D currently contains tax cost setting rules where an entity ceases to be a foreign hybrid in respect of the *assets* of the entity.

[10] It is noted that Treasury has indicated that there will be consultation in relation to any proposed anti-roll-up rules: refer Treasury announcement accompanying the release of the Treasury January 2010 Consultation Paper. This opportunity to comment on such draft measures is to be welcomed.

has been introduced into Parliament. This is appropriate considering that the anti-roll-up provision is intended to be a specific *anti-avoidance* measure.

6. Recommendation 5: item 74 of the FIF Repeal ED

6.1 Overview

Item 74 of the FIF Repeal ED will make the following amendment to s.855-10(1)(a)[11]:

> (1) Disregard a *capital gain or *capital loss from a *CGT event if:
>
> (a) you are a foreign resident, or the trustee of a *foreign trust for CGT purposes, just before the CGT event happens; and
>
> (b) the CGT event happens in relation to a *CGT asset that is not *taxable Australian property.

6.2 Background

The Taxation Institute assumes that this deletion, although entirely unrelated to the repeal of the FIF provisions and deemed present entitlement provisions (and not previously announced by the Federal Government) is designed to overcome the impact of ATO ID 2003/231.

In ATO ID 2003/231, the ATO ruled in the context of former s.136-10:

> *Issue*
>
> Is the trustee of a trust that is not a resident trust for CGT purposes required to include a capital gain, in relation to the sale of an asset that does not have the necessary connection with Australia, in the net income of the trust calculated under section 95 of the ITAA 1936?
>
> *Decision*
>
> No. The trustee of a trust that is not a resident trust for CGT purposes will not be required to include in the net income of the trust a capital gain from an asset that does not have the necessary connection with Australia. It is considered that section 136-10 of the ITAA 1997 overrides the requirement in section 95 of the ITAA 1936 that the net income of a trust be calculated as though the trustee were a resident of Australia (which would require the inclusion of capital gains from assets that do not have the necessary connection with Australia).
>
> *Facts*
>
> The taxpayer is the trustee of a trust that is not a unit trust. The taxpayer is not a resident of Australia and the central management and control of the trust is not in Australia.
>
> The trust owns shares in a company listed on the Australian stock exchange. During the income year the trustee disposed of some of these shares.
>
> The trust owns less than 10% of the total value of the shares in the company and has not owned more than 10% by value of the shares in the company at any time during the five years before the shares were sold.
>
> **Reasons for Decision**
>
> An issue arises as to how section 136-10 of the ITAA 1997 interacts with section 95 of the ITAA 1936.
>
> Section 95 requires the trustee of a trust estate to calculate the net income of the trust as if the trustee were a taxpayer in respect of that income and a resident. Residents are required

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[11] Section 855-10(1)(a) is a rewrite of former s.136-5(b) which also provided an exclusion for a trustee of a trust that is not a resident trust for CGT purposes, which in turn is a rewrite of former s.160L(2)(a)(ii).

to include capital gains or capital losses from all sources in the calculation of their net capital gain for a year of income.

Sections 136-5 and 136-10 of the ITAA 1997 however, provide that the trustee of a trust that is not a resident trust for CGT purposes will only make a capital gain or capital loss from CGT event A1 happening to a share if it has the necessary connection with Australia. A share in a public company will only have the necessary connection with Australia if the trustees owns at least 10% by value of the shares at any time during the 5 years before they were sold (see item 5 in the table in section 136-25 of the ITAA 1997).

In this situation, the trust is not a unit trust. The trustee is not a resident of Australia and the central management and control of the trust is not in Australia. Therefore, the trust is not a resident trust for CGT purposes for the purposes of the definition in subsection 995-1(1) of the ITAA 1997.

The shares sold by the trustee do not have the necessary connection with Australia because the trustee has never owned 10% by value of the shares in that company. Therefore, under section 136-10 of the ITAA 1997 the trustee will not make a capital gain on the disposal of the shares.

It is a general rule of statutory interpretation that where there is a conflict between general and specific provisions, the specific provision prevails, see for example, *Perpetual Executors and Trustees Association of Australia Ltd v. Federal Commissioner of Taxation* (1948) 77 CLR 1.

Section 95 of the ITAA 1936 contains general provisions dealing with the calculation of the net income of a trust estate. Sections 136-5 and 136-10 of the ITAA 1997 contain more specific rules in relation to capital gains made by a trustee of a trust that is not a resident trust for CGT purposes. It is considered that these provisions override section 95 of the ITAA 1936.

Therefore it is considered that the trustee of a trust that is not a resident trust for CGT purposes will not be required to include a capital gain from an asset that does not have the necessary connection with Australia in the net income of the trust calculated under section 95 of the ITAA 1936 (our emphasis)

At the Trust Consultation Sub-group meeting of 18 February 2008[12], the ATO stated in respect of ATO ID 2003/231 and Division 855:

(1) Could the ATO confirm that the analysis in ATO ID 2003/231 in relation to 'assets without the necessary connection with Australia' will also apply to assets that are not 'taxable Australian property' in Division 855?

Glenn Davies (ATO) explained that ATO ID 2003/231 considers the interaction between the requirement in section 95 of the ITAA 1936 that the net income of a trust be calculated as if the trustee were a resident and the operation of the former Subdivision 136-A of the ITAA 1997 which allowed the trustee of a non-resident trust estate to disregard a capital gain or loss from an asset without the necessary connection with Australia.

Section 136-10 was replaced by section 855-10 of the ITAA 1997 for CGT events that happen on or after 12 December 2006. Section 855-10 provides that the trustee of a foreign trust for CGT purposes can disregard a capital gain or loss from an asset that is not taxable Australian property (**TAP**). Mr Davies indicated that if the approach in the ATO ID is correct, then it would apply equally in respect of Division 855.

There was a discussion about the issue. Mr Davies noted that the ATO ID dealt only with the position of a non-resident beneficiary. The position of a resident beneficiary raised additional questions which may warrant further consideration by the Office. It was suggested by one member that the taxable Australian property rules in Division 855 might be viewed as replacing the source rules in Division 6. Mr Davies advised that Treasury has informally

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[12] See http://www.ato.gov.au/print.asp?doc=/content/00137672.htm

indicated to him that the rules in Division 855 had not been intended to displace source rules in other provisions, but operated subject to them. There was some discussion about general law source rules in the context of section 98 and the disposal of indirect interests in taxable Australian property. The ATO advised it would consider this issue further.

Finally, the Taxation Institute notes that this issue has been raised by the ATO with Treasury[13].

6.3 Observations

The Taxation Institute submits that Item 74 should be deleted from the FIF Repeal ED:

- This amendment is completely unrelated to the repeal of the FIF provisions and deemed present entitlement provisions. Further, this change has not previously been announced by the Federal Government. Accordingly, it is not appropriate for it to be included in the FIF Repeal ED.
- To the extent that the amendment is designed to overcome ATO concerns that resident beneficiaries of a non-resident trust are able to benefit from the CGT exemptions in Division 855, the Taxation Institute notes that resident beneficiaries will generally be subject to tax under s.99B on any subsequent distribution of untaxed gains by the trust and may be subject to additional tax under s.102AAM. In addition, the transferor trust provisions are designed to prevent resident beneficiaries deferring income in non-resident trusts.
- The amendment will increase uncertainty for *non-resident beneficiaries* of non-resident trusts, which is clearly contrary to statements in the recent report by the Australian Financial Centre Forum on *Australia as a Financial Centre*[14] on the importance of providing certainty on Australian tax implications for foreign residents. For example:
  - Under s.98(2A), the trustee may be subject to tax where non-resident beneficiaries are presently entitled to the income of the trust to the extent the net income is attributable to *sources* in Australia. Further, under s.99 and s.99A, a trustee of a *non-resident trust estate* may be subject to tax to the extent that no beneficiaries are presently entitled to the income of the trust *and* the net income of the trust is attributable to sources in Australia.
  - Further, under s.98A, a non-resident beneficiary is subject to Australian tax to the extent that the net income is attributable to *sources* in Australia[15].
  - In both of the above cases, the current exclusion in s.855-40 will not necessarily apply to prevent inappropriate taxation in respect of CGT events occurring to assets that are *not* taxable Australian property, but have a source in Australia, as the exclusion requires that the trust be a "fixed trust".
  - One example where this situation could arise is in relation to ASX listed shares. The ATO's current view is that gains from the disposal of ASX listed shares will generally have an Australian source[16]. Under the proposed amendment, this would mean that regardless of whether such shares are "taxable Australian property", the non-resident beneficiary may be subject to Australian tax when a trust disposes of ASX listed shares – this is clearly an inappropriate outcome.

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[13] Refer Issue 12.1 of the Trust Consultation Sub-group issues register - http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00104507.htm&page=12&H12

[14] See http://www.treasury.gov.au/afcf/content/final_report.asp.

[15] This is subject to the "MIT withholding" regime in Subdivision 12-H of the *Taxation Administration Act 1953*.

[16] For example, see ATO ID 2004/904. This is also implicit in ATO ID 2003/231 which involved the trust disposing of shares listed on the ASX as the ATO stated:

> "It is considered that section 136-10 of the ITAA 1997 overrides the requirement in section 95 of the ITAA 1936 that the net income of a trust be calculated as though the trustee were a resident of Australia **(which would require the inclusion of capital gains from assets that do not have the necessary connection with Australia)."** (our emphasis)

    - Accordingly, if Item 74 is enacted, non-residents who were previously not subject to tax in respect of capital gains arising in respect of non-taxable Australian property may now be subject to tax – there is no policy justification for such an outcome, and clearly no justification for such a result arising from the repeal of the FIF provisions and the deemed present entitlement provisions.
- There are a number of other provisions in the Act which utilise the concept of "trustee of a trust that is a foreign trust for CGT purposes" – see s.124-70(3) and s.124-140(1A), yet the FIF Repeal ED makes no amendment to these provisions. This clearly demonstrates that further consideration is required prior to this amendment being enacted (if at all).
- Finally, given that the Federal Government is currently considering the Board of Taxation's report into the taxation of "Managed Investment Trusts", any amendments covered by item 74 should be delayed until that review is finalised and accordingly removed from this ED

7. Recommendation 6: retrospective amendments regarding s.401 and FIF attribution accounts for CFCs

7.1 Section 401

Similar amendments that are being made to s.461 regarding *consideration received from the disposal of an asset* (see Item 92 of the FIF Repeal ED) should also be made to s.401, as a similar amendment was made to s.401 by the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006* as was made to s.461.
There is no reason why only s.461 should be amended.

7.2 FIF attribution accounts for CFCs

Under current law, the recognition of FIF income by a CFC is inadequately taken into account for CGT purposes when the FIF interest is disposed. This is because the CGT relief provided by s.401 is limited to the attributable income actually assessed to an attributable taxpayer. Accordingly, to the extent that FIF income has been recognised by the CFC but has been offset by allowable deductions, it will not be deducted from the capital proceeds upon the disposal of the FIF interest.

For example:

Assume two taxpayers each invest $20 million in a FIF on 1 July 2005 (one directly and one indirectly via a CFC) and that they each dispose of their interest for $30 million on 31 December 2007. Assume the FIF income is $2 million for the year ended 30 June 2006, and $2.5 million for the year ended 30 June 2007. Further, assume that both taxpayers have allowable deductions (for the CFC, *notional* allowable deductions) of $1 million per annum. Assume that the CGT participation exemption does not apply, and that the FIF makes no distribution. The *only* difference between the two taxpayers is that one is an Australian resident company and that the other is a CFC (wholly-owned by an Australian resident).

		Holder of FIF Interest	
		Australian resident	**CFC**
Year One	FIF Income	2,000,000	2,000,000
	Allowable Deduction	(1,000,000)	(1,000,000)
	Taxable/attributable	1,000,000	1,000,000
	FIF/CFC attribution credits	2,000,000[17]	1,000,000[18]
Year Two	FIF Income	2,500,000	2,500,000
	Allowable Deduction	(1,000,000)	(1,000,000)
	Taxable/attributable	1,500,000	1,500,000
	FIF/CFC attribution credits	2,500,000[19]	1,500,000[20]
Year Three	FIF proceeds	30,000,000	30,000,000
	Less: attribution surplus	(4,500,000)[21]	(2,500,000)[22]
	cost	(20,000,000)	(20,000,000)
	Capital gain	**$5,500,000**	**$7,500,000**

The Taxation Institute submits that this issue should be fixed retrospectively to ensue adequate CGT relief arises for CFC with interests in FIFs.

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If you require any further information or assistance in respect of our submission, please contact David Williams on 02 9958 3 or the Taxation Institute's Tax Counsel, Angie Ananda, on 02 8223 0011.

Yours sincerely

David Williams
President

17 Paragraph 605(1)(a) of the Act.

18 Paragraph 371(1)(aa) of the Act (The CFC is the "other entity"; and the FIF is the "eligible entity").

19 See note 17.

20 See note 18.

21 Paragraph 613(1)(c) of the Act.

22 Paragraph 401(1)(c) of the Act.