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Ref: AK/DH/PG/TS

21 March 2011

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

Email: fsiattribution@treasury.gov.au

Dear Sir/Madam

**Tax Laws Amendment (Foreign Source Income Deferral) Bill 2011:
Foreign accumulation funds**

We welcome the opportunity to provide comments on the Tax Laws Amendment (Foreign Source Income Deferral) Bill 2011: Foreign accumulation funds Exposure Draft ("the FAF ED").

Pitcher Partners comprises five independent firms operating in Adelaide, Brisbane, Melbourne, Perth and Sydney. Collectively we would be regarded as one of the largest accounting associations outside the Big Four. Our specialisation is servicing and advising smaller public companies, large family businesses, small to medium enterprises and high wealth individuals (which we refer to as the "middle market"). In making this submission therefore, we have focussed on the implications of the FAF ED for the middle market.

Summary of comments

We are pleased that the FAF ED has moved away from the broad based and uncertain general integrity provision used in the previous 21 April 2010 Exposure Draft on the Anti-Roll-Up Fund Rule. We are therefore supportive of a targeted bright line approach to attribution under the FAF ED.

However, we believe that there are (still) significant areas of uncertainty in the FAF ED which will create substantial compliance issues for taxpayers in the middle market. We have outlined these concerns in the Attachment to this document.

To address the majority of these concerns, we believe it is appropriate for Treasury to consider a *de minimus* rule, so that the FAF provisions do not apply to small taxpayers.

Furthermore, where the provisions do apply, we request that Treasury consider bright line tests and exclusions to ensure that the provisions can be administered with minimal compliance costs for those in the middle market.

In short, we believe that Treasury needs to provide an appropriate balance between integrity and compliance costs - as outlined by the Board of Taxation in their review of these provisions.

Further Details

Additional information on the above (and other) points can be found in the attached Appendix.

Contacts

Should you wish to discuss any aspect of our submission in further detail, please contact one of the following people:

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Yours sincerely



THEO SAKELL
Executive Director

Attachment.

Appendix - Submission on FAF ED

De minimus exception

1. As we have noted in previous submissions, the merits of a *de minimus* exception were canvassed and accepted by the Board of Taxation in its January 2008 Position Paper. That is, the Board of Taxation (“BoT”) acknowledged in Chapter 4 of its Position Paper that a *de minimus* exception would provide an appropriate balance between the advantage to the revenue of a broadly based foreign source income (“FSI”) attribution regime and the burdens on taxpayers from such a regime. We are concerned therefore, that there is no *de minimus* exception contained in the FAF ED.
2. Given that the compliance burden of the FAF regime will fall heaviest (in relative terms) on those taxpayers who have limited resources to deal with their taxation affairs, we believe that a *de minimus* exception is required. At the very least, we suggest that the BoT’s recommendation of a *de minimus* exemption of \$200,000 be adopted.

A ‘bright line’ definition of a FAF is needed by the middle market

3. As (notwithstanding the extensive tax treaty and tax information exchange agreements that Australia now has in place) the ATO and/or Treasury do not believe that Part IVA provides an effective weapon against the type of investment targeted by the FAF ED, ‘bright line’ tests are needed by the middle market to reduce compliance costs.
4. While the FAF ED is more targeted, it is highlighted that a number of exclusions were provided in the old foreign investment fund (“FIF”) provisions that should be replicated in the FAF provisions. Many of these exclusions acknowledged the low revenue risk associated with these types of offshore investments, while also providing a reduction in compliance costs for those applying the provisions. As highlighted earlier, it is critical that appropriate bright line tests and exclusions be provided for taxpayers in the middle market.
5. It is conceivable that an investment in a financial services entity (a licensed bank, an authorised money market intermediary, an entity conducting a factoring business etc) could satisfy the debt/total assets requirement in @806-10(2). In our opinion, it would be contrary to the policy intent underlying the BoT’s original proposal that such entities be regarded as ‘roll-up’ funds. Accordingly, we believe there is a need for additional automatic ‘gateway’ exclusions.
6. Whilst the former FIF provisions do provide some precedents on the sort of exclusions that could be introduced, we would favour a single all-encompassing exclusion rather than a multiplicity of specific exclusions. A common theme running through the exclusions in the former Divisions 2 to

6 of Part XI of the 1936 Tax Act was that the entity was carrying on a business and subject to some level of prudential regulation.

7. In addition, for a foreign entity that holds a portfolio of debt interests, there is a need to distinguish between investment and non-investment grade debt. Again, in our opinion, it would be contrary to the policy intent underlying the BoT's original proposal that entities holding riskier non-investment grade debt be regarded as 'roll-up' funds.
8. We also believe there should be an 'automatic' exclusion for any interest(s) in an entity that is an employment related superannuation fund. That is, a modified form of the old section 519 of the 1936 Tax Act should be in the new regime. We are unsure why this exclusion has not been replicated and why Treasury has only provided an exemption (ie. @804-205) for entities covered by the old section 519B of the 1936 Tax Act.
9. We also note that the proposed measure will have application to individuals who may not always have been tax resident in Australia. We believe further consideration is required on whether/how the proposed measure should apply to the legitimate retirement investments such individuals hold at the time they become tax resident.

Greater clarity is required on the meaning of a number of terms

10. As outlined in previous submissions, the complexity of the FIF rules presented a compliance burden for taxpayers in the middle market. In that context, it is important that taxpayers (who typically act on independent advice in implementing a bona fide investment strategy) can easily identify whether or not the proposed rules apply to their own circumstances without imposing unnecessary compliance burdens.
11. Under the approach that has been adopted in the FAF ED however, a taxpayer in the middle market would be required to make numerous determinations where information would not be available. In many cases, investments held by the taxpayers may amount to no more than 1% of the issued capital of the relevant foreign entity.
12. As outlined in the following paragraphs, the FAF ED can require a taxpayer to determine: (i) whether a trust is a fixed trust; (ii) the net income of an underlying trust; (iii) whether a foreign entity holds debt or equity interests under Division 974 of the 1997 Tax Act; (iv) the market value of underlying investments; and (v) whether gains have been realised.
13. Treasury must acknowledge that it would be onerous, if not virtually impossible, to require a taxpayer to ascertain the above in circumstances where the investment amounts to a nominal interest (say less than 1%) in a foreign entity or where the investment amount is below a de minimus threshold. As outlined earlier, we believe there is a clear case for providing a de minimus threshold.

14. However, where taxpayers are subject to the provisions, and thus required to test the application of these provisions, we highlight our concerns with the proposed tests below.

Fixed Trusts

15. The definition of a “fixed trust” that is used in @806-10(1)(a) of the FAF ED is notoriously difficult to interpret and apply, as evidenced by the recent decision of the Federal Court in Colonial First State Investments Ltd v FCT [2011] FCA 16). These interpretational difficulties are exacerbated by the fact that the ATO has a discretion to treat a trust as a “fixed trust”. Accordingly, an investment in a foreign trust may (or may not) be subject to attribution under the FAF ED, depending on whether the Commissioner exercises his discretion. This would provide little certainty to taxpayers unless they were to apply for a private ruling on their minority interest in the FAF.
16. In any case, we question whether fixed trusts should be subject to the FAF rules - i.e. Division 6 of Part III of the 1936 Tax Act would already seem to apply to tax the Australian resident beneficiaries of a fixed trust on their share of the worldwide net income of that fixed trust. That is, as the beneficiary of the fixed trust would have a fixed and indefeasible interest in the income of that trust, subsection 95A(2) of the 1936 Tax Act deems that beneficiary to be presently entitled to that income. Therefore, there would seem to be no need for FAF attribution to arise as the net income of the FAF is taxed to the beneficiary regardless of whether or not such income was accumulated.
17. We question therefore, whether fixed trusts need to be included in the definition of a FAF in @806-10..
18. If it was still deemed necessary to include fixed trusts as a FAF, we believe that in the context of the objectives of the FAF provisions, the type of fixed trust subject to the provisions should be limited to a public unit trust as defined in section 102AAF of the 1936 Tax Act. In any event, the following additional uncertainties arise for any kind of trust that would need to be addressed:
 - 18.1 Without a definition being provided of the term “distributed” in @806-10(3)(b)(i) it is not possible to ascertain whether the accumulation requirement will be met for a trust. For example, we are not sure whether an amount will be taken to be “distributed” if a beneficiary has a right to call for it to be paid to them (i.e. there is a present entitlement);
 - 18.2 We believe that Treasury needs to consider alternative bright line tests that can be practically administered by taxpayers. For

example, the test in @806-10(3)(b) could simply be whether an amount “constitutes income of the trust allocated to one or more beneficiaries of the trust”; and

- 18.3 Section @806-10(3)(b)(ii) requires the investor to determine the “net income” of a foreign trust. This will, quite simply, be impossible for a minority investor to determine. That is, we are unsure how a small Australian investor in a foreign trust could obtain the information necessary to perform a notional Australian tax calculation under section 95 of the 1936 Tax Act.

Debt Interests and market values

19. The test in @806-10(2) currently requires access to information and resources that a middle market taxpayer may not possess. That is, the test not only requires the taxpayer to ascertain whether the investment is a debt interest or equity interest but also requires the taxpayer to determine the market value of the arrangement.
20. As evidenced by the large number of ATO private rulings that have been issued on Division 974, the determination as to whether a security is a debt or equity interest can be a matter of some conjecture, even for those with full access to information.
21. Furthermore, taxpayers in the middle market rarely have to consider the application of Division 974 due to the “automatic debt test” contained in subsection 974-75(6) of the 1997 Tax Act - i.e. the ‘carve out’ for at call loans to a company that has a GST turnover of less than \$20 million.
22. Even if taxpayers were able to determine (or guess) whether the underlying investments were debt or equity for the purpose of Division 974, it would be near impossible to ascertain the market value of the relevant instruments held by the foreign entity in the absence of access to such information.
23. We believe that these concerns can be best addressed, without significantly re-designing @806-10(2), by enabling the attributable taxpayer to be able to rely upon the financial statements of the FAF that could be used as a proxy for determining whether an instrument is a debt instrument and the market value of that instrument.

Determining unrealised and realised profits

24. A key element in determining whether or not an investment in a foreign company or trust is regarded as a “foreign accumulation fund”, is knowing the extent of the unrealised profits and gains of the company/trust. It is unclear what Treasury mean by the term “unrealised profits or gains”.

Furthermore, it is not entirely clear how a taxpayer will be able to obtain information as to whether underlying gains or losses have been (in fact) realised by the relevant entity.

25. The test also requires one to consider the realised profits and gains of one or more lower tier entities. This is likely to be practically very difficult, if not impossible, to calculate except in circumstances of “substantial control” of the lower tier entities.
26. We are concerned that the tests proposed will be practically very difficult for a taxpayer in the middle market to comply with.

Other comments and queries

27. Subdivision 806-B is supposed to include FAF attributable income as assessable income (being equal to the movement in market value plus distributions). The proposed double tax relief will provide non-assessable non exempt (“NANE”) treatment for distributions received. Generally distributions will be received prior to attribution. Whilst we would expect this will be catered for by a credit being created at the start of the year, confirmation of this point would be appreciated.
28. Proposed @805-15 does not seem to have an equivalent to the old subsection 23AK(10) of the 1936 Tax Act. This provision is required to ensure the deductibility of expenses (other than debt deductions) on such amounts where they are not covered by section 25-90 of the 1997 Tax Act or subsection 230-15(3) of the 1997 Tax Act.
29. We suggest that paragraph (e) in @806-5 should read “you are not an attributable taxpayer in relation to the entity under section 102AAT or @801-20 at the end of the FAF statutory accounting period.”
30. In the context of @806-10(4)(b)(i), where the two entity’s have the same accounting period, can it be said that the accounting period of the second entity ‘ends in’ the accounting period of the first entity?
31. In the context of the comments in the box titled “Double Tax Relief” after @806-55, we note that amendments were made to s.613 et al to clarify that the consideration in respect of the disposal of a revenue asset was reduced in like manner to a CGT asset. Such amendments should also be adopted in the FAF regime.