



Investment & Financial Services Association Ltd

ACN 080 744 163

16 July 2007

Mr Richard Warburton AO
Chairman
The Board of Taxation
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Mr Warburton

FOREIGN SOURCE INCOME ANTI-DEFERRAL REVIEW

Thank you for the opportunity to provide a written submission to the Board of Taxation in response to its discussion paper.

The **Investment and Financial Services Association Limited** (IFSA) is a national not-for-profit organisation which represents the retail and wholesale funds management, superannuation and life insurance industries. IFSA has over 145 members who are responsible for investing over \$1 trillion on behalf of more than nine million Australians. Members' compliance with IFSA Standards and Guidance Notes ensures the promotion of industry best practice.

IFSA believes that the Review is a key component in making Australia a global financial services centre and will assist in addressing inefficiencies in the current international tax regime. Reform of the FIF regime will enhance the competitiveness of Australia's financial services in what is a highly-contested global market.

Australia's fund managers are well positioned to meet the growing demand for products, services and expertise coming from the Asian region and beyond- representing a substantial additional export opportunity for the nation.

Australia's service industries contribute over 73% of GDP, employ 80% of the workforce and yet make up only 22% of exports.¹ As a global leader in funds management services,

¹ 'Policy options to increase Australia's export of funds management services', IFSA, (Policy Paper: July 2007): http://www.ifsa.com.au/documents/2007_0524_FINAL%20IFSA%20EFM%20Policy%20Paper.pdf

Australia's reputation and growth in this sector has largely been driven by domestic opportunities, yet real potential exists to develop a substantial export market in this area.

Financial services represents 7.2% of GDP and is the third largest sector in the Australian economy, the largest managed investment asset pool in Asia and the fourth largest managed funds market in the world.²

Given the complexity of the issues, we thank the Board and the Secretariat for their open and productive approach to reform of the regime. We hope the information contained in this submission is of assistance, and please do not hesitate to contact me if you require further information.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Richard Gilbert', is positioned to the left of a vertical red line.

Richard Gilbert
Chief Executive Officer

² Ibid.

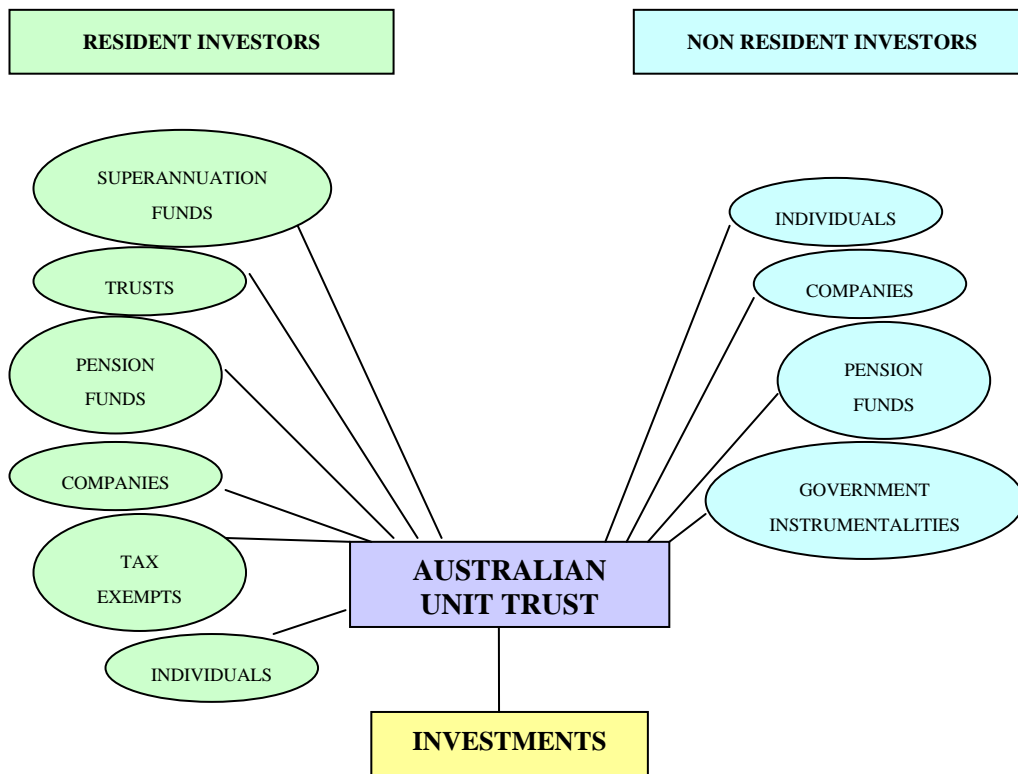
1. AUSTRALIA'S FUNDS MANAGEMENT INDUSTRY

The Australian funds management industry is one of the most efficient in the world. It is such because investments from many different sources are pooled into one investment vehicle in order to achieve economies of scale and for ease of management. In Australia the investment vehicle of choice for pooling is a unit trust.

A unit trust is the preferred pooling vehicle for two reasons. Firstly it is unitised and therefore every investor's interest can be precisely quantified. Secondly, it is a "look through" vehicle for tax purposes; hence the essential tax characteristics of the investor, such as CGT discounting, can be maintained in respect of the investment notwithstanding the pooling of monies with other investors.

The various types of investors are shown below:

Diagram 1.1

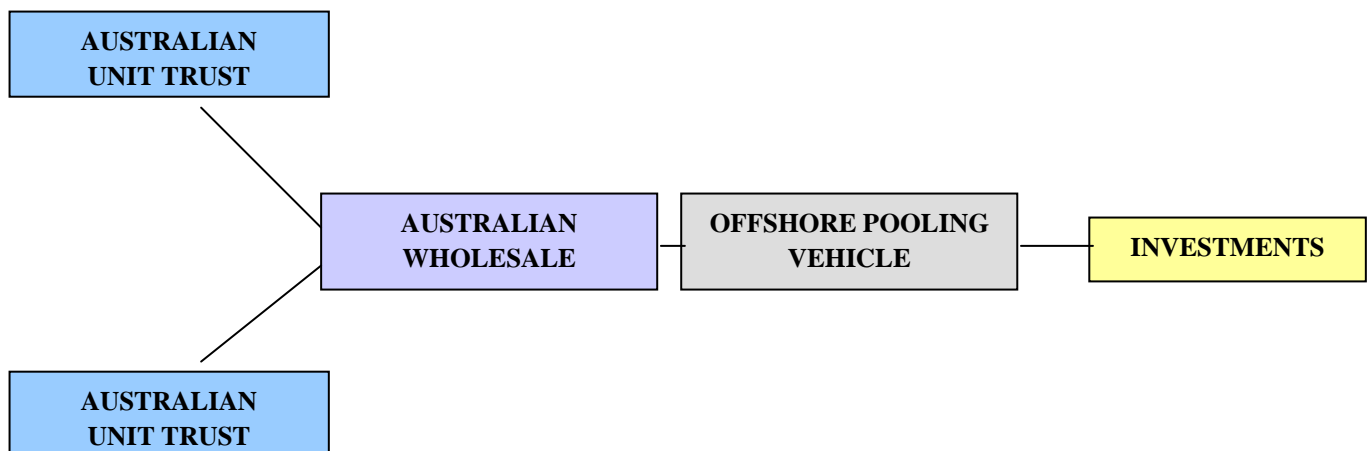


Examples of typical investment structures are shown below:

Diagram 1.2



Diagram 1.3



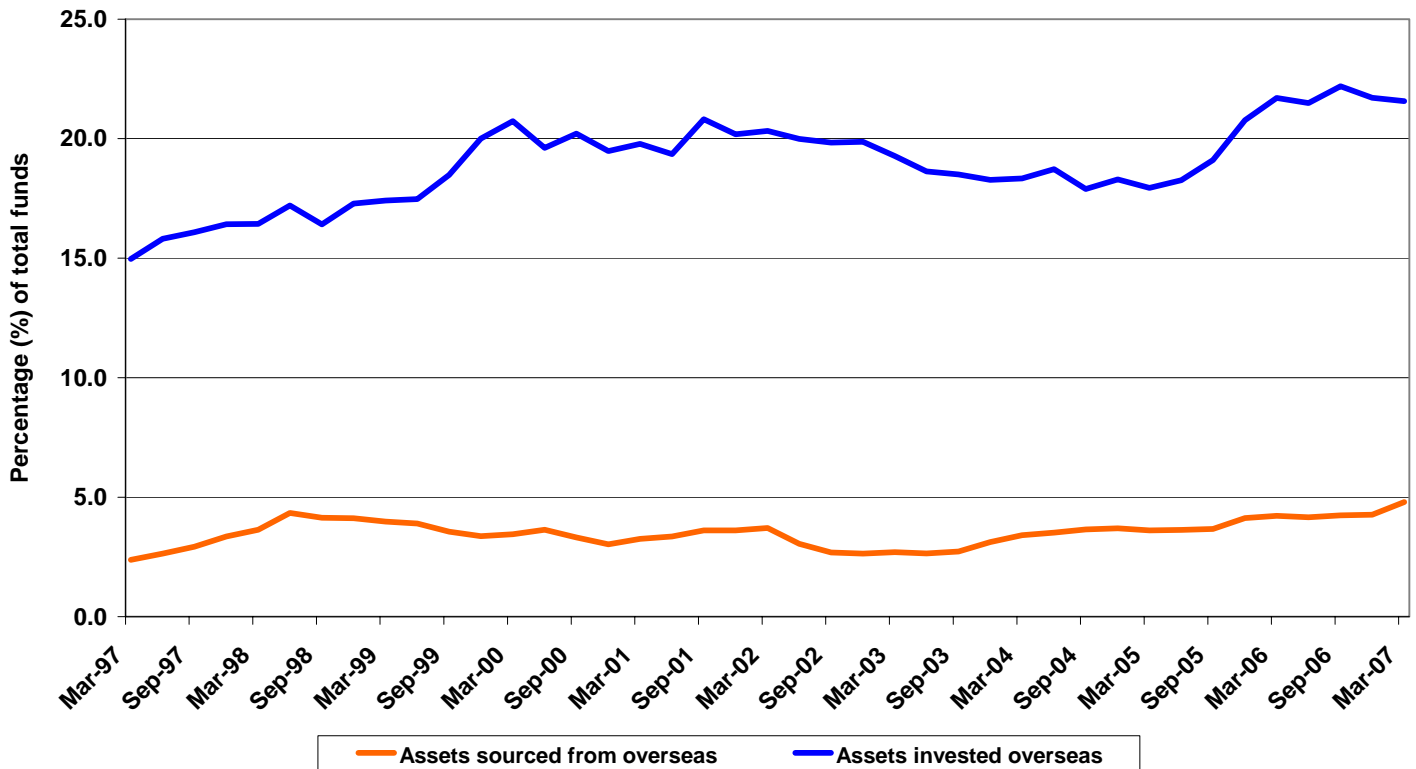
As a result of recent reform to the superannuation regime in Australia, the amount of money under management represented by retirement savings (either in the accumulation stage or pension stage) is rapidly increasing. Current superannuation assets under management are estimated to have reached \$1.1 trillion.³ One consequence of this is that Australia's capacity to provide good value investment assets is stretched, and greater amounts of money are being

³ "APRA figures show superannuation assets reach \$1.1 trillion", Australian Prudential Regulation Authority (Media Release: 28 June 2007): http://www.apra.gov.au/media-releases/07_22.cfm

invested offshore both in traditional asset classes, stocks and bonds, and in alternative asset classes such as infrastructure assets, real property and private equity. As highlighted in the graph below, we believe that approximately 22% of total funds in the industry are invested overseas.

Funds invested in and from overseas sources, 1997 to 2007

source: ABS Catalogue 5655.0 Managed Funds, Australia, March Quarter 2007



As a principle, IFSA believes that the anti-deferral regime needs to be flexible enough to accommodate the increasing quantity of offshore investment, as well as the future development of new types of investment assets in the global market.

2. CURRENT APPLICATION OF THE FIF REGIME

Under the Foreign Investment Fund (“FIF”) regime contained in Part XI of the *Income Tax Assessment Act 1936* all overseas investments by all Australian taxpayers are treated as potentially subject to attribution. Attribution requires taxable income to be recognised regardless of whether income or gains have been derived or realised. The division then contains a number of exemptions. Should the relevant investments fall within the exemptions attribution is not required.

When the FIF rules were originally developed, it was recognised that investors holding a

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022

Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

portfolio of overseas investments needed some concessions in order that they not be required to attribute income on small parts of their portfolios. To this end a balanced portfolio exemption was created, and subsequently increased. Under this exemption attribution is not required where investments that are not otherwise exempt constitute less than 10% of a taxpayer's total overseas investment. Therefore if an investment trust held 20 to 30 stocks listed on European exchanges and, say, 8% were in non exempt Finance companies then attribution would not be required in respect of those Finance company investments.

However, the practical implication of the balanced portfolio exemption is that while most parties making an investment offshore only have to consider the transaction once at the time of initiation: FIF issues can be ruled out once and for all, at that time. In contrast, a fund manager needs to consider the FIF position at least annually, because of the need to consider a total portfolio. Consequently this industry probably has the most practical experience of any in actually managing and assessing FIF exposures. The current task of determining whether particular investments fall within one of the exemptions can be quite time consuming because the information needed to make a decision is not readily available. For example, many Russian companies do not provide accounts and the accounts of entities in other jurisdictions will often be written in a foreign language. This difficulty has meant that in some instances it takes up to four hours to determine whether exemption is available for each individual FIF security held. Funds investing in global assets can have hundreds if not thousands of investments in separate FIF securities. Further specific examples about the current compliance difficulties, and anomalous results, are provided below.

3. EXEMPTIONS FROM THE FIF REGIME

Paragraphs 4.75 - 4.84 of the discussion paper, consider the case for providing an exemption from the foreign source income anti-deferral rules for Australian managed funds. IFSA supports the 'multi-filter' approach to the foreign source income anti-deferral rules, which will exclude taxpayers from the FIF regime as appropriate. Broadly, IFSA would support filters based on:

1. An exemption for the type of Australian investor (eg managed fund or superannuation fund);
Where the investment is made in:
2. An comparable tax jurisdiction; or
3. An offshore vehicle which distributes a large proportion of its income.

IFSA believes that the exemptions should apply to both the FIF and the CFC regime. For example, superannuation funds owning greater than 40% of a foreign company or holding a non-portfolio interest (where 5 or fewer Australian 1% entities have greater than 50% interest) will be subject to the CFC rules, even though there is an exemption from the FIF rules for superannuation funds.

3.1 Exemption for the type of Australian investor

Managed Funds Exemption

IFSA believes that there should be a targeted exemption for the managed funds industry, as it has been most affected by the compliance costs and disruption to business because of the practical necessity of ‘bed and breakfasting’ thousands of investments annually. This ‘bed and breakfast’ practice has arisen not to avoid tax but simply because of the inability of managed funds to keep FIF attribution accounts for thousands of retail clients. In fact, ‘bed and breakfasting’ generally results in the payment of tax equal to that payable under the FIF provisions.

IFSA agrees with the Board's view that the challenge in designing a FIF regime for managed funds is to balance the need to prevent investments giving rise to significant tax deferral against not unduly restricting foreign investment or creating significant tax compliance costs.

IFSA believes that most investments in tax haven resident entities should be subject to the anti-deferral rules, *where the income is not returned to Australia or there is significant deferral*. However, we note that given the growing sophistication of the Australian market, and the success of Australian fund managers, it is possible that, for example, an Australian fund manager which is part of a global group may use an offshore global pooling vehicle in a tax haven. More often than not, underlying investments of the global pooling vehicle would be FIF exempt or not subject to FIF (eg fixed income securities).

However, IFSA does not accept that these rules should apply to investments made by Australian managed funds in entities which are not resident in tax haven countries, or where the investment vehicle distributes a large proportion of its income.

As such, IFSA’s key recommendation is that managed funds be exempt from the application of the FIF rules.

The Managed Fund Exemption would be available to:

- (i) Registered Managed Investment Schemes or a unit trust, all of the units of which are held by Managed Investment Schemes and/or complying superannuation funds;
- (ii) Such funds would be required to satisfy a widely held test (as per s 12-395 of the *Taxation Administration Act 1953*);
- (iii) For investments in entities resident in jurisdictions with which Australia has entered into a Double Tax Agreement; or
- (iv) The offshore vehicle distributes a large proportion of its income.

In other words, investments made in certain entities and jurisdictions should not fall foul of the anti-deferral rules for the following reasons:

- The offshore entities are subject to tax on worldwide income and gains in the

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022

Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

broadly comparable tax jurisdiction and distributions from such entities are generally subject to withholding tax imposed by the comparable tax jurisdiction on distribution to Australian residents.

- Some offshore entities are collective investment vehicles (such as US mutual funds or REITs resident in dozens of countries) which are required to distribute taxable income (or at least 90% of taxable income) annually in order to maintain their flow through tax status.

Little or no tax deferral opportunity arises from such investments as the entities themselves are taxed annually in the broadly comparable jurisdictions or are forced to distribute income and gains annually which will be taxable to Australian investors without deferral.

Definition of a managed fund

IFSA believes that the managed fund exemption should extend to:

- Registered Managed Investment Schemes (as defined by Section 9 of the Corporations Act 2001) which are operated by a financial services licensee (as defined by section 761A of that Act) whose licence covers operating such managed investment scheme; or
- A unit trust, all of the units of which are held by Managed Investment Schemes (as defined above), a life insurance company, and/or complying superannuation funds.

The first limb of this exemption is unexceptional and is taken from s12-395 of the *Tax Administration Act 1953*.

The second limb takes into account the fact that not all unit trusts managed by Australian fund managers, which invest in foreign assets are registered managed investment funds. As a matter of practice some fund managers only obtain MIS registration for those unit trusts which are offered to external investors. This excludes the very funds which often hold direct foreign investments which are used solely to make such investments. These unit trusts are then wholly owned by other MIS registered unit trusts and complying superannuation funds managed by the same fund manager. Failure to extend the exemption to such unit trusts would result in an exemption only being available to part of the managed fund industry and would therefore have a serious impact on the competitive neutrality of tax treatment of funds managed by different Australian fund managers.

Consideration could be given to extending the exemption to listed investment companies, where they hold interests in foreign entities.

Widely held test

IFSA accepts that the government may wish to limit any managed fund exemption to widely held unit trusts. Therefore we propose that exemption be limited to those unit trusts which satisfy the widely held test in s 12-395 of the *Taxation Administration Act 1953*. This test was

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022

Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

introduced in 2007 to define the managed funds who would qualify for inclusion in the concessional withholding tax regime introduced in Sub Division 12H of the *Taxation Administration Act 1953*.

3.2 Investment in a comparable tax jurisdiction

The current list of seven closely comparable tax jurisdictions is too narrow a basis on which to base a funds management exemption. For example, a typical global property fund (see example below) would invest in REITs resident in many countries other than the seven closely comparable jurisdictions. Many of these investments would remain subject to attribution if a seven country based exemption was enacted. Given that REITs are required to distribute income annually in order to maintain tax flow through status, no deferral opportunities arise and REIT investments should not be subject to anti deferral rules.

Actual Example

An IFSA member's global property sector unit trust invests in the following publicly listed REITs:

82% US resident listed REITs
8% Asian listed REITs
10% European listed REITs

The US REITs qualify for FIF exemption under s519A of the ITAA 1936 and the Asian and European REITs do not qualify for any FIF exemption.

As the trust has an 18% holdings of non exempt REITs it fails to qualify for the s511, 10% balanced portfolio exemption. The IFSA member also has thousands of beneficiaries who hold interests unit trusts, where the unit trust is then invest in the Global property fund and it is literally impossible to do attribution account keeping for the end investors. The fund 'bed and breakfasts' all holdings in Asian and European REITs each 30 June and gives rise to a tax liability identical to that which would have arisen if it had held the non exempt FIFs at year end. Of interest is the loss of CGT discount that would otherwise be available to the fund on holdings of the Asian and European REITs, as the fund would otherwise hold most investments for greater than 1 year.

Australia's current Double Tax Agreement (DTA) partners provide a sound basis to:

- (i) Identify countries which are broadly comparable tax jurisdictions to Australia;
- (ii) Identify likely destinations for investment by the Australian managed funds industry; and
- (iii) Monitor the list of countries, which may change over time based on Australia's trade and investment trends.

Therefore IFSA believes that a managed fund exemption should be allowed for investments in entities resident in any country with which Australia has concluded a DTA. This may be seen as a starting point and it may be appropriate to exclude some countries on the DTA list if the

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Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

tax system of the treaty partner is not broadly comparable to Australia.

It has been suggested that certain treaty partners' tax systems give rise to deferral opportunities as follows:

- New Zealand does not tax capital gains held by passive investors
- Canada does not have a robust FIF regime

These are in fact minor tax benefits as far as Australian investors are concerned. NZ and Canadian entities remain subject to tax on worldwide income, pay withholding tax on distributions, and such distributions are subject to Australian tax. Surely the anti deferral regime should be targeted at investments in tax haven entities with real scope for tax deferral rather than entities resident in NZ or Canada.

The staff who make investment management decisions are unlikely to be aware of subtleties of overseas tax regimes and their investment decisions are not motivated by tax considerations other than:

- (i) Ensuring the benefit of CGT discount is available on investment holdings and compliance with the 45 day rule in relation to Australian investments which produce franking credits; and
- (ii) Being aware of significant tax inefficiencies related to making certain investments - eg prior to the introduction of the foreign hybrid provisions, the inability of Australian investors in US limited liability partnerships to claim foreign tax credit relief in respect of tax paid by the US limited liability partnership on the Australian investor's behalf. This led to double taxation of the Australian investor.

3.3 Investment in an offshore vehicle which distributes a large proportion of its income

Outlined below is a sample of investment vehicles currently caught by the FIF rules. IFSA believes that an exemption based on the distribution characteristic of the offshore vehicle, would greatly reduce the compliance cost for fund managers. In addition, by framing an exemption around the characteristics of the investment vehicle, it will allow the FIF provisions to accommodate emerging global investment trends.

Real Estate Investment Trusts (REITs)

As highlighted above, REITs are trust vehicles which are required to distribute income annually in order to maintain tax flow through status.

They are highly attractive investments for Australian trusts offering investments in global property securities, and are available not only in Europe but in other parts of the world, such as Asia. However, Australian fund managers have been hampered in their ability to take advantage of this growing trend by the FIF rules, and have to engage in year end sales and repurchases or navigate the attribution provisions.

Private Equity Funds

The private equity industry has gained prominence and attention in the media over the last few years. Investors generally take a passive investment approach and invest in private equity investment funds ("funds"). The funds are typically limited partnerships (ie limited liability partnerships or limited liability companies), with the fund managers as general partners and investors as limited partners.

The funds are close-ended and have a term of approximately 12 years. The funds have three stages being fund raising, investment and exit. In the current market the funds will generally acquire investments and dispose of their investments within 2 -3 years. This period may extend to 5 years in a different economic environment. Upon disposal of the investment, the General Partner distributes to the limited partners their share of income and capital of the fund, withholding an amount of tax to remit to the relevant tax authorities on behalf of the limited partner. In addition, the limited partner is also taxed in their home jurisdiction on the distributed income.

IFSA believes that although the private equity funds may appear as patient capital investors, the funds distribute all their income and capital to the limited partners in a timely and efficient manner, thereby eliminating the need to attribute income on this investment class. Further, IFSA believes that the compliance and administrative burden associated with attributing income as opposed to the actual attribution is very minimal.

Undertakings for Collective Investments in Transferable Securities (UCITS)

UCITS are collective investment vehicles which are managed across all European Union member states and distribute all profit to investors on a regular basis. UCITS are a set of European Union directives that aim to allow collective investment schemes to operate freely throughout the European Union on the basis of a single authorisation from one member state. It is the main form of collective investment vehicle used in Europe.

4. COMMENTS ON OTHER EXEMPTIONS

Current exemption for super funds

Super funds are currently exempt from the FIF regime, where they invest through an Australian unit trust that is wholly invested in by super funds. However, if they invest into an Australian managed fund that has other investors, the exemption is nullified. IFSA recommends that the current exemption for super funds should be modified to ensure that they retain their exempt status, regardless of whether the fund they are investing is: a) exempt itself or; b) has other investors that are not super funds.

Life insurance company exemption

Individuals may also hold ordinary investment policies via a life company. The life company

Level 24, 44 Market Street, Sydney NSW 2000 | Ph: 61 2 9299 3022

Email: ifsa@ifsa.com.au | Fax: 61 2 9299 3198

may hold a non-exempt FIF investment as part of the overall investment portfolio (over which the individual would have no choice), and as such, would get indirectly caught by the FIF regime. If individuals held the investment directly, that investment would most likely be below the current **de minimus exemption**.

We therefore propose that the current FIF exemptions be extended to include life insurance companies, to ensure superannuation funds or individuals are not disadvantaged by having such investments via a life insurance company versus holding them directly.

De minimus exemption

IFSA supports the retention of the de minimus exemption for individuals. We note, however, that given the complexity of the FIF rules, it is unlikely that the majority of individuals know whether or not they have breached the threshold.

The industry is unable to utilise this exemption, as the individual threshold amount cannot be aggregated across a fund. For example, where the Australian pooling vehicle has identifiable ‘Mum and Dad’ unit holders, the fund should be able to aggregate the individual threshold amounts, and use the de minimus exemption where the aggregated threshold amount exceeds the balanced portfolio exemption.

In addition, the de minimis threshold is still at its original level of \$50,000. In 1993 when the FIF rules began this was the threshold at which the top marginal tax rate first applied. It may be appropriate to tie the exemption to the tax rate thresholds, as a low-maintenance way of keeping the threshold up-to-date.

Balanced portfolio exemption

IFSA supports the increase in the balanced portfolio exemption to 25% of the net asset value of the fund, as we believe that an increase in both the threshold and scope of the exemption will greatly reduce the need for funds to ‘bed and breakfast’. Whilst, the existing concession does make it possible to offer the individual investors products that are based upon global portfolios, the concession has a number of failings.

Firstly, it is still necessary to examine the portfolio at year-end and ascertain what proportion does not qualify for exemption. In practice this means paying a custodian or accounting firm a fee to review the investments held and advise which are, or are not, exempt.

Secondly, the 10% test is calculated using total foreign investments as the denominator. Consequently if foreign stocks are an incidental part of a much larger portfolio the percentage is not based upon the total portfolio but rather the smaller foreign component. This can produce some bizarre results. For example attribution can be required where a fund holds a portfolio of Australian stocks which happens to contain a 1% investment in a New Zealand entity with listing in both New Zealand and Australia. No such failure would occur if the balanced portfolio exemption be calculated based on the net asset value of the fund.

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As mentioned previously, if it is found that non-exempt investments represent in excess of 10% of the portfolio it is necessary to sell the entire holding of non-exempt FIFs prior to year-end. The non-exempt investments are in the portfolio for sound economic reasons and hence are bought back immediately after year end. The ‘bed and breakfasting’ arrangement also results in a loss of the CGT discount and transaction costs. In particular, the transaction costs are borne across the fund by all investors, regardless of whether they are non-resident, Australian, taxable or FIF-exempt. Ultimately, this makes the pooled fund structure less competitive.

Actual Example

An IFSA member is Responsible Entity of a unit trust (a global property securities unit trust) which at 30 June 2006 invests 98% of assets in Australian LPTs and 2% in Asian REITs.

The 2% investment is in Maple Tree Logistics Trust a Singaporean REIT which does not qualify for any FIF exemption and is therefore prima facie subject to FIF attribution unless the balanced portfolio exemption applies. The 10% balanced portfolio exemption will not apply to the unit trust as it only holds the one FIF which is non-exempt, therefore 100% of its FIF holdings are non exempt breaching the 10% limit. This is despite holding only 2% of the net asset value of the fund in non-exempt FIFs.

The Fund has thousands of indirect beneficiaries for which it is unable to keep FIF attribution accounts, therefore it realises the investment before 30 June each year end and pays tax on non-discounted capital gain and repurchases the REIT on 1 July each year. The unit trust loses the benefit of CGT discount on holding the investment which would have otherwise applied because without the annual realisation it would have held the investment for greater than 12 months.

5. ATTRIBUTION

Methods for attributing income

Under the market value method option, the FIF rules seek to tax the increment in market value without there being an actual disposal. However the amount so taxed comes within statutory income and is not treated as a capital gain. However, if the investor is an Australian super fund, all FIF investments receive capital account treatment.

Moving to a mark to market regime, on capital account, will remove any distortion between the types of Australian investors about the treatment of FIF income, and ensure parity between the position of Australian investors if they invest directly, or through an Australian managed fund.

Attribution accounting

As mentioned previously, one of the reasons for the ‘bed and breakfast’ practice is the

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difficulty of maintaining separate attribution accounts on behalf of each investor. It is suggested that attribution accounts be maintained at the fund level rather than the investor level.

The fund can then distribute any attributable income to investors and when the non-exempt FIFs are sold, the fund can offset the tax paid against the capital gain and make a tax deferred payment.

Conduit treatment for non-residents

Non-resident beneficiaries are not subject to tax on the trust income that is foreign sourced income. However, if the trust income is FIF attribution income, it is included in the 'net income' of the trust estate (section 485A and section 95). The trustee is subject to tax under section 99A(4A) on the part of the net income of the trust is attributable to a period when the beneficiary was not a resident and is also attributable to sources outside Australia. This includes FIF income.

Section 485A should be amended to specifically exclude FIF income from section 99A(4A) (ie. FIF income should be included as part of the net income to which a beneficiary is presently entitled).